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Leased Line Charge Control – Starting Charge Adjustments - a report for BT

Analysis of Ofcom's proposed approach to starting charge adjustments in the 2015 Leased Line Charge Control consultation

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Glossary

Term	Definition
BCMR	Business connectivity market review
CI	Contemporary interface markets, including CLA, LP and RoUK
CLA	Central London Area
DLRIC	Distributed Long Run Incremental Cost
DSAC	Distributed Stand Alone Cost
EUR	European euro.
FAC	Fully Allocated Cost
FTI Consulting	FTI Consulting LLP
GBP	British pounds
LLCC	Leased line charge control
LP	London Periphery
RFS	BT's Regulatory Financial Statements
RoUK	Rest of UK
SMP	Significant Market Power
TI	Traditional interface market
USD	United States dollars

1. Introduction

Introduction

1.1 This report has been prepared by FTI Consulting LLP ("FTI Consulting") for BT in connection with Ofcom's business connectivity market review ("BCMR") and associated leased lines charge control ("LLCC"). We have been asked to advise on the appropriateness of Ofcom's approach of adjusting starting charges in the 2015 LLCC Consultation.

Background

1.2 On 12 June 2015 Ofcom published its consultation on the LLCC and dark fibre pricing. This set out Ofcom's proposals for the regulated provision of dark fibre, including the approach to setting the regulated price.[1]

1.3 The LLCC is part of the BCMR. In May 2015, Ofcom launched the main BCMR consultation setting out its initial proposals on market definition, SMP findings, and remedies (including high level proposals for the application of charge controls and dark fibre pricing).[2]

1.4 In the 2015 BCMR Consultation, Ofcom defined the following markets outside of Hull:

- Traditional Interface ("TI") services below 8Mb/s = National market.
- Contemporary Interface ("CI") services at all bandwidths = Three markets of Central London Area ("CLA"), London Periphery ("LP"), and Rest of UK ("RoUK").

1.5 BT was found to have SMP in the TI market, and in the CI markets of LP and RoUK.[3]

1.6 Ofcom has proposed a charge control on CI services up to and including 1Gb/s. Ofcom has also proposed that BT reduces its charges for CI services up to and including 1Gb/s by 9%, and reduces its charges for regulated TI services by 7.75% on 1st April 2016 - these are referred to as the starting charge adjustments. This reduction is in addition to a proposed reduction in prices of CPI-13.75% over the next three years.

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1 2015 LLCC Consultation.

2 2015 BCMR Consultation.

3 2015 BCMR Consultation, table 1.2.

Our instructions

1.7 FTI Consulting has been asked to consider the appropriateness of Ofcom's approach to making starting charge adjustments to CI services below 1Gb/s.

Sources of information

1.8 Our primary sources of information are reports from Ofcom. Unless otherwise indicated we only have access to non-confidential versions of these reports.

Restrictions

1.9 This report has been prepared solely for the benefit of BT for use for the purpose described in this introduction. In all other respects, this report is confidential. It should not be used by any other party for any purpose or reproduced or circulated, in whole or in part, by any party without the prior written consent of FTI Consulting. We have agreed that BT may provide this report to Ofcom and that a non-confidential version of this report may be published by Ofcom in the context of the BCMR.

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1.12 No representation or warranty of any kind (whether express or implied) is given by FTI Consulting to any person (except to BT under the relevant terms of our engagement) as to the accuracy or completeness of this report.

1.13 This report is based on information available to FTI Consulting at the time of writing of the report and does not take into account any new information which becomes known to us after the date of the report. We accept no responsibility for updating the report or informing any recipient of the report of any such new information.

2. Summary

2.1 In its proposals for the leased line charge control, Ofcom is proposing significant adjustments to BT's prices for leased line products to be implemented as adjustments to starting charges (as opposed to adjustments over the period of the charge control through a glide path).

2.2 For the CI (Ethernet) basket of services, Ofcom is proposing a starting charge adjustment of -9%, and for Traditional Interface ('TI') services, a reduction of -7.75%.[4,5]

2.3 We consider that Ofcom's analysis is flawed for a number of reasons:

- Ofcom's rationale for including changes to cost attribution methodologies on allocative efficiency grounds is incorrect. (Section 4)
- Ofcom's calculation of a starting charge adjustment to reflect changes in cost attribution methodologies is incorrect. (Section 5)
- Ofcom's approach unfairly takes away BT's delivered efficiencies. (Section 6)
- Ofcom's justification for applying a starting charge adjustment in relation to Access Cards does not meet its stated criteria and is inconsistent with precedent. (Section 7)
- Ofcom's calculation of adjustments for changes in cost attribution methodologies in the 2013/14 Regulatory Financial Statements ('RFS') is based on incorrect assumptions. (Section 8)
- Ofcom's proposed approach to applying starting charge adjustments does not follow a key regulatory principle of consistency. (Section 9)
- Ofcom's approach risks undermining investment incentives in potentially competitive areas. (Section 10)
- Ofcom has failed to assess the impact of its proposals on other closely related markets with the risk that competition is distorted. (Section 11)

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4 2015 LLCC Consultation, paragraph 6.139.

5 2015 LLCC Consultation, paragraph 7.99.

3. Background

Introduction

3.1 In its proposals for the leased line charge control, Ofcom is proposing significant adjustments to BT's prices for leased line products to be implemented as adjustments to starting charges (as opposed to adjustments over the period of the charge control through a glide path).

3.2 For the CI (Ethernet) basket of services, Ofcom is proposing a starting charge adjustment of -9%, and for Traditional Interface ('TI') services, a reduction of -7.75%.[6,7]

3.3 In discussing its approach to implementing starting charge adjustments, Ofcom states that *'Our general preference is for glide paths'*[8] because it promotes productive and dynamic efficiency.[9]

3.4 Ofcom then sets out that there are only two circumstances in which starting charge adjustments may be appropriate:

> *"• where the risks to economic efficiency or competition from distorted pricing signals are particularly significant, and therefore outweigh the benefits of a glide path approach; and*
>
> *• where prices are significantly above or below cost for reasons other than efficiency or volume growth."*[10]
>
> and
>
> *"However, even in those circumstances, if we considered that a starting charge adjustment would undermine the stability and predictability of the regulatory regime, including implications for future investment, we may still not consider it appropriate to make one."*

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6 2015 LLCC Consultation, paragraph 6.139.

7 2015 LLCC Consultation, paragraph 7.99.

8 2015 LLCC Consultation, Sub heading paragraph 4.73.

9 2015 LLCC Consultation, paragraph 4.75.

10 2015 LLCC Consultation, paragraph 4.79.

3.5 In this report we consider whether Ofcom's approach to applying starting charge adjustments is reasonable in general and in particular whether or not it meets Ofcom's stated criteria of circumstances in which a starting charge adjustment may be appropriate.

Ofcom's approach to setting charge controls in the 2015 LLCC

3.6 In the following subsections we set out:

- How Ofcom set prices in the 2013 LLCC. This is relevant in understanding the basis on which the current prices were set; the starting charge adjustments are applied to these current prices;
- How Ofcom has forecast costs and final year revenues in the 2015 LLCC Consultation; and
- How Ofcom has calculated starting charge adjustments.

The 2013 LLCC

3.7 The 2013 LLCC set prices for the period from 1st April 2013 to 30th March 2016. Prices were set based on forecasting total costs and volumes for 2015/16. In particular:

- Costs were derived from the 2011/12 RFS. Ofcom applied some adjustments to the 2011/12 RFS to obtain base year costs for 2011/12. Ofcom then forecast these costs forward until 2015/16 (the final year of the charge control).
- Ofcom forecast revenues were calculated firstly by forecasting revenues in the absence of the charge control by taking BT's 2012/13 prices from the Openreach Price List and then projecting volumes forward to forecast revenues in 2015/16 in the absence of a charge control.
- The value of X in the RPI –X charge control formula was then determined such that expected revenues after the charge control formula equalled expected costs by the end of the charge control.

Costs and final year revenues in the 2015 LLCC Consultation

3.8 The 2015 LLCC Consultation will set prices for the period 1 April 2016 to 31 March 2019.

3.9 In the 2015 LLCC Consultation, Ofcom states that in its final determination it will use actual costs from the 2014/15 RFS data as the basis for its cost calculations, but costs and prices in its analysis are currently based on costs derived from the 2013/14 RFS data.[11]

Starting charge adjustment

3.10 Ofcom explains that it calculated the starting charge adjustment as follows:

- First it forecasts costs in 2016/17 (the first year of the charge control) under two scenarios: (a) including and (b) excluding those costs it considers should be reflected in the starting charge adjustment.
- Secondly, the percentage difference between these two costs is calculated (for the Ethernet basket this is 9%).
- Thirdly, this percentage difference is applied to current (i.e. 2014/15) prices effective from 1 April 2016.[12]

Report structure

3.11 The rest of this report is structured as follows:

- In Section 4 we explain why Ofcom's rationale for including changes to cost attribution methodologies on allocative efficiency grounds is flawed.
- In Section 5 we explain why Ofcom's calculation of a starting charge adjustment to reflect changes in cost attribution methodologies is incorrect.
- In Section 6 we discuss why Ofcom's approach unfairly takes away volume driven efficiencies.
- In Section 7 we explain why Ofcom's justification for applying a starting charge adjustment in relation to Access Cards does not meet its stated criteria and is inconsistent with precedent.
- In Section 8 we explain why Ofcom's calculation of adjustments for changes in cost attribution methodologies in the 2013/14 RFS is based on incorrect assumptions.
- In Section 9 we explain why Ofcom's proposed approach to applying starting charge adjustments does not follow a key regulatory principle of consistency.
- In Section 10 we explain why Ofcom's approach risks undermining investment

11 2015 LLCC Consultation, paragraph 5.3.

12 2015 LLCC Consultation paragraphs 6.137-6.138.

incentives in potentially competitive areas.

- In Section 11 we explain why Ofcom has failed to assess the impact of its proposals on other closely related markets, with the risk that competition is distorted.

4. Ofcom's rationale for starting charge adjustments

Summary

4.1 In this section we consider Ofcom's rationale for making starting charge adjustments due to changes in BT's cost attribution methodologies and accounting errors.

4.2 We first set out Ofcom's approach to making starting charge adjustments as a result of changes to cost allocations/accounting errors on the basis that they will improve allocative efficiency.

4.3 We then set out why we consider Ofcom's analysis to be flawed, for the following reasons:

- Ofcom's justification to implement methodology changes on the grounds of allocative efficiency is incorrect;
- Any adjustments required to achieve efficiency should be limited to incremental costs;
- Ofcom's rationale for imposing starting charges mistakenly applies long run considerations to a short run situation;
- Regulated markets may not respond instantly to changes in costs; and
- Ofcom's distinction between moving costs between regulated markets and from regulated markets to unregulated markets is flawed.

Ofcom's rationale for including changes in cost allocations in starting charge adjustments

4.4 In an accompanying consultation to the 2015 LLCC Consultation, Ofcom has published a consultation proposing a number of changes to the cost attribution methodologies BT uses to prepare its RFS, and also to correct calculation and accounting errors in BT's RFS.[13] Changes in cost attribution methodologies and errors change the amount of costs in the BCMR markets. Ofcom has considered whether to reflect these changes in costs via a starting charge adjustment or a glide path. To do so Ofcom applies the following analysis.

13 Ofcom, *Review of BT's cost attribution methodologies*, Consultation, 12 June 2015.

4.5 Firstly, it considers whether the change in methodology is from one ‘reasonable approach’ to another ‘reasonable approach’:

> *“we do not believe it is appropriate to make starting charge adjustments if costs are reattributed from one service to another over time on the basis of changing from one reasonable approach to another”*[14]

4.6 Secondly, Ofcom considers whether the change replaces an approach that is ‘not appropriate on the basis that:

> *“In such circumstances, the new approach may better reflect cost causality and represent a more objective attribution”* [15]

4.7 Thirdly, Ofcom considers whether or not the change in methodology relates to incremental costs:

> *“It is possible that costs which are incremental to a specific service were previously included in another service FAC, which may have resulted in higher charges for the latter than if a more objective cost base had been used”*[16]

4.8 This is important because:

> *“In this case, a starting charge adjustment, which brings charges closer to the appropriate cost for the service, will result in improved allocative efficiency”*[17]

4.9 Fourthly, Ofcom considers whether or not the change in methodology moves costs from regulated to unregulated markets:

> *“Where costs are reattributed between regulated markets, we believe that there can be risks to BT’s opportunity to recover its efficiently incurred costs of provision from making a starting charge adjustment.”*[18]

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14 2015 LLCC Consultation, paragraph 4.105.

15 2015 LLCC Consultation, paragraph 4.105.

16 2015 LLCC Consultation, paragraph 4.105.

17 2015 LLCC Consultation, paragraph 4.106.

18 2015 LLCC Consultation, paragraph 4.106.

4.10 This is because any changes in methodology affecting costs of products in other charge controls would not be able to flow through to price increases without an adjustment to that existing charge control. Ofcom therefore concludes:

> *"we believe that it is appropriate to ensure that such cost reattributions, i.e. between regulated markets, are recovered via a glide path"*[19]

4.11 However Ofcom does not believe that this is the case for costs which are reallocated between regulated and unregulated markets where it argues that:

> *"there is a significant risk of competition being distorted if prices do not respond quickly to improved cost allocations"*[20]

4.12 Ofcom then finds that a reallocation of incremental costs between regulated and unregulated markets is a cause for concern because:

> *"If BT allocates costs that are incremental to an unregulated service to a regulated service, charges for the latter will be set at too high a level relative to cost, which will distort competition and investment and give rise to an economically inefficient outcome."*[21]

4.13 Ofcom therefore finds:

> *"In this scenario, where the costs involved are significant, we believe it is appropriate to impose a starting charge adjustment because a glide path would result in the competitive distortion persisting for a longer period"*[22]

4.14 Ofcom also argues that:

> *"We consider that the use of a glide path to take such changes into account would also give BT incentives to continue making inappropriate cost attributions going forward. Furthermore, in cases where costs that are incremental to a downstream unregulated service are allocated to a regulated upstream input, it would be difficult to detect certain anti-competitive behaviour, such as margin squeeze"*[23]

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19 2015 LLCC Consultation, paragraph 4.106.

20 2015 LLCC Consultation, paragraph 4.111.

21 2015 LLCC Consultation, paragraph 4.111.

22 2015 LLCC Consultation, paragraph 4.111.

23 2015 LLCC Consultation, paragraph 4.111.

4.15 In our view there are a number of flaws in Ofcom's rationale.

Ofcom's justification to implement attribution methodology changes on the grounds of allocative efficiency is flawed

4.16 Ofcom argues that applying a change in methodology to starting charges is necessary because it:

> *"brings charges closer to the appropriate cost for the service, [which] will result in improved allocative efficiency"*[24]

And

> *"we believe it is appropriate to impose a starting charge adjustment because a glide path would result in the competitive distortion persisting for a longer period."*[25]

4.17 However, as Ofcom notes elsewhere, allocative efficiency and competitive distortion are not present where individual prices lie between the Distributed Long Run Incremental Cost ('DLRIC') floor and Distributed Stand Alone Cost ('DSAC') ceiling:

> *"We would normally expect the charges observed in a competitive market to be consistent with maximising economic efficiency. Therefore, if a charge could be considered to be consistent with that which would be levied in a competitive market, we would not expect it to give rise to distorted economic signals. In determining whether a charge appears to give rise to particular risks of economic distortion, we have historically considered whether it appears to be consistent with that which we would expect in a competitive market. To do so we have compared BT's charges against DLRIC and DSAC"*[26]

4.18 Ofcom notes that providing BT with flexibility in how it recovers its common costs should improve allocative efficiency.

24 2015 LLCC Consultation, paragraph 4.106.

25 2015 LLCC Consultation, paragraph 4.111.

26 2015 LLCC Consultation, paragraph 4.84.

> *"A regulated firm is typically much better placed to understand the nature of demand for its products than the regulator, so that there may be a high risk of regulatory failure if the regulator seeks to set allocatively efficient prices itself. As a result, it can be more efficient to allow the firm to decide how it should recover its common costs, at least where incentives to set prices to disadvantage rivals are absent or can be controlled, for example through the use of appropriate sub-caps. By allowing it to reflect the underlying market demand elasticities in this process, the regulator can allow the firm to act in a way that minimises the impact on demand from the mark-up over LRIC. "*[27]

4.19 Ofcom is therefore incorrect to say that any particular price between DLRIC and DSAC is '*closer to the appropriate cost for the service'* in terms of allocative efficiency or represents a 'competitive distortion'– all prices between the floor and ceiling can be considered equally 'efficient' in an allocative efficiency sense and consistent with a competitive market.

4.20 Ofcom has checked current prices against costs and found that no services would be priced above DSAC absent the starting charge adjustment– and so current prices cannot be regarded as allocatively inefficient.[28]

4.21 Ofcom's argument therefore that starting charges need to be adjusted immediately because they '*will brings charges closer to the appropriate cost for the service, [which] will result in improved allocative efficiency'* or to correct *'competitive distortions'* is flawed.

4.22 Of course, in the long run, if all prices were close to DSAC, BT would over-recover common costs, and this would lead to poor allocative efficiency. To prevent this occurring, Ofcom sets glide path charge controls to the level of expected FAC at a basket level so that general path of prices should reflect the general path of costs **in the long run**. The key issue here is that allocative efficiency is achieved in the long run. Ofcom itself notes that the purpose of charge controls is not to "*achieve allocative efficiency at every point in time*".[29]

Any adjustments required to achieve efficiency should be limited to incremental costs

4.23 Ofcom recognises that:

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[27] Cost Orientation Review, July 2013.

[28] 2015 LLCC Consultation, paragraph 4.122.

[29] 2015 LLCC Consultation, paragraph 4.76.

> *"In the case of common costs, there are a number of ways in which these can be reasonably apportioned and economic analysis would typically suggest that there is no singularly 'correct' way of apportioning them. Given this, we do not believe it is appropriate to make starting charge adjustments if costs are reattributed from one service to another over time on the basis of changing from one reasonable approach to another."*[30]

4.24 Ofcom therefore restricts the need for a starting charge adjustment to reflect improved attribution methodology to 'incremental costs' only. Ofcom identifies incremental costs by reference to whether or not it has identified a cost driver based on cost causality:

> *"Given that our economic test applies to incremental cost, we consider that where a cost category has been given a single driver, it is likely that BT's current attribution methodology allocates costs that are incremental to unregulated services to regulated Ethernet services."* [31]

4.25 However, given the nature of BT's network and the cost categories for which Ofcom has made starting charge adjustments, we do not consider that any of them are wholly incremental.

4.26 Rather, all of the cost categories being adjusted for will have at least some element of common costs. In some cases this will be significant. For example Access Cards have a Fully Allocated Cost ('FAC') of around £[10-50]m, but a LRIC of only £[10-50]m.

4.27 Any adjustment needed in order to address allocative efficiency concerns should therefore be restricted to a LRIC adjustment, rather than the FAC adjustment that Ofcom has applied.

Ofcom's rationale for imposing starting charges mistakenly applies long run considerations to a short run situation

4.28 Ofcom argues that the need to make starting charge adjustments for changes in incremental cost allocations is because:

> *"we believe that there is a significant risk of competition being distorted if prices do not respond quickly to improved cost allocations"*[32]

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30 2015 LLCC Consultation, paragraph 4.105.

31 2015 LLCC Consultation, paragraph 6.135.

32 2015 LLCC Consultation, paragraph 4.111.

4.29 However, Ofcom's approach fails to recognise that:

- The charge control framework relies on achieving efficiency over the long run
- Pricing signals take time to become effective

4.30 In telecommunications, the long-run (defined as the period over which all costs are considered variable) can be up to 40 years. Given this extended timeframe for the long-run, it is highly unlikely that prices and costs would align even over a three year charge control. Allocative efficiency at any point in time is therefore very challenging to achieve. This suggests that even more weight should be given to productive and dynamic rather than allocative efficiency, which clearly favours a glide path.

4.31 Even in competitive markets, prices will not respond immediately to changes in costs. It will take time to renegotiate contracts, and BT's ability to increase prices will be limited, given the competitive nature of the market.

Regulated markets may not instantly respond to changes in cost allocation

4.32 The aim of charge controls is to mimic competitive markets. In competitive markets, any 'excess' profits are reduced over time as competition erodes profits. Charge controls mimic this effect by bringing prices in line with costs over a number of years, rather than immediately.

4.33 Economic theory suggests that in a competitive market prices are between LRIC and Stand Alone Cost ('SAC'). If prices were below LRIC, firms would exit the market and prices would rise whereas if prices were above SAC firms would enter the market and prices would fall.

4.34 Multi-product firms in a competitive market would also need to recover their fixed and common costs across all services. However the pattern of common cost recovery will depend on a wide range of demand-side factors relating to market conditions.

4.35 As a result, the pattern of fixed and common cost recovery would therefore vary between markets. Ofcom's charge control effectively ensures that in the SMP markets BT recovers no more than expected FAC. However, this is a tighter restriction than would apply in competitive markets - the mark-up over LRIC could result in prices that are above or below FAC. In competitive markets, when a firm faces an increase in incremental costs, the market would respond and in the long run these cost increases would be passed onto consumers. In addition to changes in incremental costs, there may also be a change to common cost allocation. Where there are both increases and decreases to incremental costs, the entire pattern of common cost recovery may change. As the whole pattern of prices is affected by relative marginal costs and patterns of common cost recovery, it cannot be determined whether an increase in incremental cost would necessarily lead to an increase in price in a given set of markets.

4.36 Any adjustment of prices could take some time as prices cannot be instantly increased as many customers are on existing contracts where the price cannot rise.

4.37 Furthermore, the ability of one firm to pass on any increases in costs in competitive markets will vary, and in some cases may not be possible, at least in the short term.

4.38 Where there are markets downstream of wholesale markets, existing customers may be locked into contracts and this acts as a further reason why there may be some delay in markets responding to changes in costs.

4.39 If the level of costs allocated to the unregulated markets were to change (because of a change in methodology), it would take some time for these changes to be passed onto consumers via changes in prices. The shock to prices as a result of starting charge adjustments could therefore lead to these costs not being fully recovered as unregulated markets cannot respond sufficiently quickly.

4.40 In summary, Ofcom is wrong to assume that an increase in incremental costs in one market would necessarily lead to an increase in prices in that market. Therefore the assumption that starting charge adjustments are required on the grounds of allocative efficiency is incorrect.

Distinction between moving costs within regulated markets and from regulated to unregulated markets is unclear

4.41 Ofcom has proposed only making starting charge adjustments when costs move from regulated to unregulated markets, not where costs move between regulated markets.[33]

[33] 2015 LLCC Consultation, paragraph 4.107.

4.42 The distinction between costs that move from regulated to unregulated markets and from regulated to regulated markets is not as distinct as Ofcom has set out.

4.43 Consider an example with three cost categories – Item 1 and Item 2 and three markets – Regulated Market A, Regulated Market B and Unregulated Market U. The effect on costs is set out in Table 4-1.

Table 4-1: Illustrative effect of costs moving between markets

	Regulated Market A	Regulated Market B	Unregulated Market U
Item 1	£5m	(£5m)	
Item 2		(£5m)	£5m
Aggregate	£5m	(£10m)	£5m

Source: FTI

4.44 In aggregate, £10m moves out of Regulated Market B. By Ofcom's analysis this £10m would be removed via a starting charge adjustment. However, on a disaggregated basis only Item 2 would be relevant – and therefore only £5m moves out of Regulated Market B. It is therefore clear that the level of aggregation of costs will affect the amount of costs that move between regulated and unregulated markets.

4.45 Ofcom acknowledged the difficulty in determining whether costs have moves between regulated markets or from regulated to unregulated markets:

> *"In some cases, distinguishing between the two types of cost allocation and account error[s], i.e. between regulated and unregulated services and regulated and regulated services, may be relatively straightforward but in other cases it is not clear-cut. Where the latter applies, out approach is to consider the evidence and apply a regulatory judgment based on the information that is available."*[34]

4.46 In applying its "regulatory judgment", Ofcom appears to have included any methodological change where BT previously allocated costs without a specific cost driver, but now Ofcom has found a relevant cost driver. Ofcom has assumed in this case that this leads to a movement of costs between the regulated and unregulated markets. It would appear that Ofcom has not applied any particular "regulatory judgment" in this regard.

4.47 The effect of a starting charge adjustment is to reduce costs immediately, and for this effect to be carried through for all years of the charge control. Given the materiality of this effect, Ofcom should take a cautious approach when applying starting charge adjustments. It has not done so.

34 LLCC Consultation, paragraph 4.113.

5. Ofcom's approach unfairly takes away BT's efficiencies

5.1 Ofcom has proposed a 9% adjustment to starting prices. As explained earlier this was calculated by comparing Ofcom's FAC cost estimate in 2016/17 both with and without the starting charge cost adjustments. The difference in percentage terms is then applied to expected revenues in 2015/16.

5.2 However, if, as is the case, BT's revenues in 2015-16 exceeded those assumed in the charge control, then that must be attributable to BT outperforming the charge control by exceeding volume forecasts or by delivering more efficiencies than expected.

5.3 Ofcom states that:

> *"We therefore do not believe that excess returns that are driven by efficiency and volume improvements should result in a starting charge adjustment"*[35]

5.4 The starting charge adjustment is calculated by reference to BT's costs. Ofcom then applies the starting charge adjustments to BT's revenues. To the extent that BT has outperformed the charge control (i.e. its prices are higher than forecast costs), some of this benefit is taken away by Ofcom's adjustments as the adjustment is to BT's revenues, rather than its forecast FAC.

5.5 If any reduction is to be made to reflect changes in cost attribution methodologies, it should be based on a reduction in prices that would have been made had the cost allocation changes been applied in the 2013 LLCC modelling. It is clear that given higher than forecast volumes achieved in 2015/16, this would have led to a smaller starting charge adjustment than that proposed by Ofcom.

5.6 If Ofcom does intend to apply a starting charge adjustment, it should not do so in a way that reduces prices because of better performance achieved through higher than forecast volumes.

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35 2015 LLCC Consultation paragraph 4.96.

6. Ofcom's calculation of a starting charge adjustment to reflect changes in cost attribution methodologies

Introduction

6.1 Ofcom explains that it calculated the starting charge adjustment as follows:

- First it forecasts costs in 2016/17 (the first year of the charge control) under two scenarios: (a) including and (b) excluding those costs it considers should be reflected in the starting charge adjustment.
- The percentage difference between these two costs is calculated (for the Ethernet basket this is 9%).
- This percentage difference is then applied to current (i.e. 2014/15) prices effective from 1 April 2016.[36]

6.2 In our view, Ofcom's approach of applying the percentage reduction in forecast costs in 2016/17 as a starting charge adjustment to prices in 2015/16 is methodologically unsound for a number of reasons:

- Firstly, Ofcom's approach incorrectly assumes that the proportionate breakdown of total costs by cost categories in the 2013/14 RFS and on which it has based its starting charge adjustments is the same as in the 2011/2012 cost stacks it used to calculate revenue caps for 2013/14 in the 2013 LLCC. This results in too high a starting charge adjustment.
- Secondly, the amount of costs included in the Corporate Overheads cost category has increased between 2012 and 2014 and so the absolute impact of Ofcom's adjustment on forecast costs is overstated.

6.3 We explain these two issues below.

Adjustment for changes in cost allocation methodologies

6.4 Ofcom's implicit approach to applying the starting charge adjustment appears to be:

- Current prices were based on the application of cost attribution methodologies that Ofcom now considers inappropriate.

36 2015 LLCC Consultation paragraphs 6.137-6.138.

- It is necessary to adjust current prices immediately (rather than through a glide path) to correct allocative efficiency issues.
- The starting charge adjustment aims to bring prices down to the overall level that would have been charged had the proposed changes to cost allocation methodologies been applied in the 2012 LLCC.

6.5 The simplest way to estimate the impact of what the 2012 LLCC prices would have been is to rerun the 2012 LLCC model applying the new methodologies. It is not clear why Ofcom has not done this.

6.6 Instead, Ofcom has made the adjustment set out in paragraph 6.1.

6.7 However, Ofcom's approach will only provide the right adjustment if the proportionate breakdown of costs forecasts for 2014/15 assumed in the 2012 LLCC (derived from the 2011/12 RFS) was the same as the 2013/14 RFS.

6.8 This was not the case. Table 6-1 below illustrates why Ofcom's approach overstates the starting charge adjustment in relation to its change in attribution methodologies for corporate overheads because of a change in the cost structure of BCMR products:

Table 6-1: Basis of forecast revenues and costs

		2011/12	2013/14
Corporate Overhead costs in BCMR markets	£m	[50-100]	[50-100]
Total Operating Costs in BCMR markets	£m	[500-1,000]	[500-1,000]
Corp Overheads as % of Operating costs		[5-10]%	[5-10]%
Impact in 13/14 of Ofcom's adjustments to Corp Overheads attribution methodology	%		[-25 to -35] %
	£m		[-10 to -50]
	%		[0 to -5]%
Estimated impact of change in in attribution methodologies to 2011/12 costs based on adjusting total costs	£m	[-10 to -50]	
Estimated impact of change in in attribution methodologies to 2011/12 costs based on adjusting overheads	£m	[-10 to -50]	
Implied Ofcom overstatement of adjustment	£m	[-10 to -50]	

Source: FTI analysis

6.9 Table 6-1 shows that where the cost structure of products changes (in terms of the proportion of overheads included in operating costs), Ofcom's approach is likely to understate or overstate the adjustment needed to apply the changes so as to reflect the situation had the changes been applied in the 2012 LLCC.

6.10 In the case of BCMR, because the proportion of overhead costs in the total cost stack has increased between 2011/12 and 2013/14, Ofcom's starting charge adjustment, based on 2013/14 costs will be overstated.

7. Access Cards starting charge adjustment

7.1 In its 2013 Leased Line Charge Control Ofcom excluded only the direct costs of 21CN access cards from its calculation of relevant costs for the purpose of setting prices for leased line products. Ofcom explained that:

> *TI basket services include an element of the cost BT is investing in its 21CN network. In line with our proposal on the anchor pricing approach, we consider that the costs to be recovered from customers should not increase as a result of the 21CN investment, particularly as the decision to migrate customers to 21CN is BT's and not the customers'. As such, these costs should be excluded from our cost base. We propose to eliminate an estimate of 21CN costs reflected in TI services.* [37]

7.2 In the statement it confirmed that only the 'avoidable elements' would be excluded:

> *"**Avoidable versus unavoidable elements** We asked BT to provide us with an analysis for 2011/12 of the 21CN costs identifying which costs were truly specific to 21CN (e.g. equipment and software) including overheads that would not have been included in the service costs had the MCE of 21CN components been excluded from the services. Based on this analysis, we have removed the costs associated with two components that are allocated on a future benefit basis – namely high bandwidth data cards and Ethernet switches"38*

7.3 The adjustment made to costs of BT's 21CN in BT's RFS for the purpose of calculating costs of BT's leased line products has been subject to consideration in a number of regulatory disputes and charge control appeals.

7.4 For example, in December 2012 in a dispute relating to historical ethernet pricing, Ofcom stated that:

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37 Ofcom, Leased Line Charge Control Consultation, 5 July 2012, Paragraph 5.125.

38 Ofcom, Business Connectivity Market Review, 28 March 2013, Page 288, Table A12.5.

"we do not consider that it was obviously inappropriate to allocate these [overhead] costs to Ethernet services during the Relevant Period".[39]

7.5 Thus the allocation of overhead costs associated with 21CN components (and access cards in particular) to BCMR services, had been expressly considered and agreed to by Ofcom. There was no indication in the 2012 LLCC that Ofcom intended that its approach would be changed in future periods.

7.6 In the current consultation, Ofcom states that:

BT has allocated costs of its 'Access cards' component to regulated Ethernet services. As discussed in Annex 7, this component includes the cost of Ethernet Switches and other equipment which are not currently used to provide CISBO services, but are instead used in the provision of services that are downstream of wholesale leased lines, specifically Harmonised Ethernet and Mobile Ethernet Access Service (or MEAS). They are therefore not incremental to any services in the Ethernet basket. Including an attribution of these costs to Ethernet service, results in charges that are too high and which, therefore, distort competition and investment. Moreover, if such costs have been included in the current charge control it would result in charges that are above cost for reasons unrelated to efficiency.

"We have removed all Access card costs from our base data, and therefore our cost forecasts. In the March 2013 BCMR Statement, we made a partial adjustment to remove some Access card costs but not all of them; in particular we did not remove the 'unavoidable' costs associated with the component. For our current base year data, the total impact of removing all Access card costs from the base year is around £35 million; the 'unavoidable' costs account for about £19 million of these. We propose to include only the latter in our starting charge adjustment. We do not believe it would be appropriate to make a starting charge adjustment for the Access card costs removed from our cost estimates in the 2013 LLCC. That is, we do not take into account £16 million when calculating the starting charge adjustment, as those costs are not reflected in current charges for Ethernet services."[40]

7.7 Ofcom has previously indicated that changes in regulatory approach would not result in starting charge adjustments:

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39 Paragraph 13.169.

40 Paragraphs 6.126, 6.127.

"In each charge control, we re-evaluate our approach on a number of areas. In some cases, we have adopted a different approach to that taken in the LLCC 2009. It is possible that, if we had made the same policy decisions in the LLCC 2009 as in the present charge control, different overall reductions in charges may have resulted. Such changes in regulatory approach between charge controls are not likely to be biased in favour of one direction or another. We do not consider it proportionate to make a starting charge in this charge control to correct for a different regulatory approach in the previous charge control."[41]

7.8 Ofcom's stated criteria for making changes to starting charge adjustments, is that the current approach is 'clearly inappropriate' and relates to incremental costs.[42] Given that the decision to remove the overheads of 21CN components from BCMR products represents a change in policy decision, it is not clear its decision to remove common costs associated with Access Cards meets its criteria.

7.9 Firstly, the overhead costs being removed are clearly common costs and not incremental costs.

7.10 Secondly given Ofcom's previous policy decision that common costs relating to 21CN components can be included in BCMR products, the general regulatory of consistency would seem relevant.

7.11 If Ofcom is to depart from its regulatory principle of consistency, it should, as an evidence-based regulator, explain why it has done so and why the change is necessary, appropriate and proportionate, providing supporting evidence. In our view, Ofcom has not done so and, in particular, has not properly assessed the potential adverse effects on investment incentives discussed in Section 10.

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41 2013 BCMR Statement, paragraph 18.117.

42 Paragraph 6.124.

8. Inclusion of 2013/14 changes in cost attribution

8.1 Ofcom's starting charge adjustments include changes it considers BT made to its attribution methodologies in the 2013/14 RFS:

> *"The changes that were implemented in 2013/14 resulted in the transfer of over £25 million of costs from CISBO markets to unregulated wholesale markets. Given that BT has identified more appropriate cost drivers in this case, i.e. they are more consistent with the principles of objectivity and causality, we believe that these costs are incremental to unregulated services and so should not previously have been attributed to Ethernet services. We therefore propose to include these in our starting charge adjustment. If we did not do this, it could result in a continuing distortion in the regulated market unregulated as BT would continue to recover costs that are incremental to the unregulated service from regulated charges."*[43]

8.2 Ofcom's proposed adjustment of -£25m to reflect changes in attribution methodologies in the 2013/14 RFS are based on BT's report to Ofcom setting out changes in allocation methodologies in the RFS.[44]

8.3 Ofcom's adjustment to starting charges in 2016/17 based on the amount of the adjustments in 2013/14 appears to be based on the assumption that this is the amount by which estimated costs in the final year of the previous charge control (2015/16) would have been reduced by had Ofcom made the adjustments in the 2013 LLCC based on 2011/12 RFS.

8.4 If Ofcom is to make any adjustment to starting charges to reflect the 2013/14 changes in allocation methodologies, it would be reasonable that it should be on the basis of what the expected impact would have been in 2011/12, forecast forward to 2015/16. We understand from BT that it has made a start on this analysis which it will provide to Ofcom once it has been completed.

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43 Paragraph 6.129.

44 BT, Report requested by Ofcom describing certain changes to the Accounting Documents for the year ended 31 March 2014 and illustrating the resulting differences to the Current Cost Financial Statements had those changes not applied, 2 October 2014, Section 4.1, page 20.

9. Regulatory Consistency

Summary

9.1 In determining whether to make starting charge adjustments or glide paths, Ofcom has previously stated a preference for glide paths. This places greater weight on productive and dynamic efficiency considerations than attempting to achieve allocative efficiency at all points in time. Ofcom's charge controls work over a number of years and their aim is to drive down costs over the longer term, rather than for costs and prices to always be in equilibrium.

9.2 We have analysed previous decisions by Ofcom which suggest that Ofcom's proposed approach to applying starting charge adjustments in the 2015 LLCC is inconsistent with previous practice. In particular:

- In the 2009 LLCC, Ofcom applied a RAV adjustment to TI costs, but did not apply a starting charge adjustment. Ofcom also did not make a starting charge adjustment for the removal of 21CN costs.
- In the 2013 LLCC, Ofcom removed ECC and 21CN costs from the basket, but did not apply a starting charge adjustment. Both these adjustments were based on changes to BT's allocation methodologies that Ofcom did not agree with.
- In the 2014 WBA charge control, Ofcom adjusted for an error in BT's costs, but did not make a corresponding starting charge adjustment. In the 2011 and 2014 WBA charge controls, Ofcom added costs to BT's cost stack to take account of the fact that the networks were heavily depreciated. Ofcom did not make a starting charge adjustment despite adding costs to BT's cost stack.

Starting charge adjustments in the LLCC were because prices were above DSAC

9.3 Ofcom has repeatedly expressed a preference for glide paths over starting charge adjustments. Ofcom has noted that it may consider starting charge adjustments where charges are significantly out of line with costs. It has typically assessed this by comparing current prices with DSAC/DLRIC benchmarks. Most notably, Ofcom adjusted the charges for BES 1000 rental by 17% in the 2009 LLCC as a result of charges exceeding DSAC by some margin.[45] Ofcom also considers that starting charge adjustments may be appropriate when services have not previously been subject to a charge controlled and so high prices may be a reflection of market power.

9.4 When considering starting charge adjustments, Ofcom acknowledges that it is necessary to balance allocative efficiency with productive and dynamic efficiency. Where there is a case for starting charge adjustments, Ofcom should consider carefully whether price reductions will harm productive and dynamic efficiency.

9.5 Ofcom contends that where an error/inappropriate methodology has been found and that this leads to a reallocation of costs between regulated and unregulated markets, that this should be taken into account via a starting charge adjustment.

9.6 We have reviewed Ofcom's previous charge controls and have found some analogous situations where Ofcom has not applied starting charge adjustments, even where errors/inappropriate methodologies have been identified.

Ofcom has a general preference for glide paths

9.7 Ofcom has previously indicated that it has a general preference for glide paths over one-off adjustments.

> *"The benefit of the glide path approach is that it approximates more closely to the workings of a competitive market than one-off reductions, where excess profits are gradually eroded as rivals improve their own efficiency. It also avoids discontinuities in prices over time and leads to a more stable and predictable background against which investment and other decisions may be taken, by both suppliers and customers."*[46]

> *"This approach also has greater incentives for efficiency as it allows the firm to retain the benefits of cost reductions made under a previous charge control for longer. This means that cost reductions feed into price reductions*

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45 2009 LLCC, paragraph 5.90.

46 2013 Business Connectivity Market Review Statement (2013 BCMR Statement), paragraph 18.101.

with an intentional regulatory lag. One-off adjustments to prices would reduce the effective regulatory lag, and hence the incentives to reduce costs."[47]

"This suggests that it is often not appropriate, for example, to apply one-off reductions simply because prices at the start of the control are out of line with costs. One-off reductions may also reduce incentives to invest and make efficiency improvements; they impact on regulatory certainty and stability; and they would not necessarily best reflect the outcomes in competitive markets (whereby surplus profits are gradually eroded). Therefore, if returns at the start of a control are initially high, cutting the difference between prices and costs via a glide path is generally preferable."[48]

9.8 Ofcom has considered the case for making one-off adjustments before:

"Whilst the above suggests a general preference for glide paths in the context of RPI-X controls, we still considered making one-off adjustments where we considered there to be good reasons for doing so. The circumstances under which they could be appropriate include

- *when there are strong allocative efficiency arguments for bringing charges into line with cost sooner (such as where BT's charges for particular services are out of line with cost-orientation requirements); and/or*
- *where the previous charges were unregulated or were not subject to a charge control and where BT's charges are high relative to costs.*

Therefore, if prices of individual services are out of line with costs to an extent which could distort competition, we may need to address this through one-off reductions. However, in assessing possible starting charge reductions (and increases), we needed to balance this against alternative (and potentially more proportionate) regulatory approaches. It may be possible, for instance, for BT to make acceptable voluntary adjustments in prices without us having to mandate this through detailed one-off reductions (increases). We also needed to consider the materiality of the issue (particularly given the risk of damage to incentives associated with one-off adjustments)."[49]

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47 2013 BCMR Statement, paragraph 18.102.

48 2013 BCMR Statement, paragraph 18.104.

49 2013 BCMR Statement, paragraphs 18.105-18.106.

9.9 Ofcom preferred glide paths to starting charge adjustments in the 2009 LLCC.[50] It considered that starting charge adjustments may be necessary in a limited number of cases.

> *"We explained, however, that some starting charge adjustments can be justified where there are strong efficiency arguments for bringing prices in line with costs sooner. We highlighted that if prices are markedly out of line with cost, we may want to mandate one-off reductions. In particular, if prices are very high relative to costs, and especially if this could distort entry decisions or downstream competition, this may justify price reductions sooner. We thought however that there could be a stronger case where services had not previously been charge controlled and the high profitability was reflective of market power, rather than past efficiency gains made under a price cap. "*[51]

9.10 Ofcom itself acknowledges that a change in regulatory approach may occur between charge controls and that it is not appropriate to making a starting charge adjustment where there is a difference in regulatory approaches between charge controls.

> *"In each charge control, we re-evaluate our approach on a number of areas. In some cases, we have adopted a different approach to that taken in the LLCC 2009. It is possible that, if we had made the same policy decisions in the LLCC 2009 as in the present charge control, different overall reductions in charges may have resulted. Such changes in regulatory approach between charge controls are not likely to be biased in favour of one direction or another. We do not consider it proportionate to make a starting charge in this charge control to correct for a different regulatory approach in the previous charge control. "*[52]

Inconsistent approaches in the 2013 LLCC

9.11 In the 2013 LLCC, Ofcom made a number of adjustments to BT's costs in the base year.

- **ECCs:** In the TI charge control, Ofcom removed the MCE associated with ECCs. This was because the MCE associated with ECCs was not part of the ongoing cost of the service, as it had already been recovered from customers through upfront charges. These costs were removed from the base year costs. However,

50 2009 LLCC Statement, paragraph 3.218.

51 2009 LLCC Statement, paragraph 3.219.

52 2013 BCMR Statement, paragraph 18.117.

a starting charge adjustment was not made.[53] The costs were removed from the 2013 control, but had not been removed in the 2009 control. There is therefore clear regulatory precedent that Ofcom has removed costs from a basket, but not passed this on via a starting charge adjustment. These costs were also removed from the AI basket.[54]

- **21CN (AI basket)**: In the 2013 charge control in the AI basket, BT was allowed to recover its 21CN costs.[55] This was a different approach to the 2009 charge control were 21CN costs were excluded. Ofcom took this approach because the 2013 charge control was based on a modern equivalent asset (MEA) approach which assumed that legacy products (WES/WEES/BES) were delivered using the MEA (i.e. EAD). Ofcom considered it appropriate to include the 21CN costs associated with EAD. Ofcom removed the 21CN costs that were allocated on a "future benefits" basis.[56] In the AI basket, some of the 21CN costs were therefore being added to the cost stack (as they had been disallowed in the 2009 LLCC). By Ofcom's logic this addition of costs that was not reflected in prior charge controls should have flown through as a starting charge increase.

Inconsistent approaches in the 2009 LLCC

9.12 In the 2009 LLCC there are some changes to costs that Ofcom imposed and where it did not impose a starting charge adjustment.

- **RAV adjustment:** In the TI basket, Ofcom made an adjustment to costs based on the RAV methodology.[57] This RAV adjustment had not been made in the 2004 PPC charge control. This was therefore a reduction in costs that had not been reflected in the prior control, and by Ofcom's logic should have resulted in a starting charge adjustment, but it did not.
- **21CN costs (AI basket):** In the AI basket, direct 21CN costs were removed from the basket.[58] In 2009 AI services had not been previously charge controlled. There was no starting charge adjustment applied, even though direct costs were being excluded from the base year.

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53 2013 BCMR Statement, paragraphs 19.130-19.132.

54 2013 BCMR Statement, paragraphs 20.232-20.233.

55 2013 BCMR Statement, paragraph 20.131.

56 2013 BCMR Statement, paragraph 20.250.

57 2009 LLCC Statement, paragraph 4.121.

58 2009 LLCC Statement, paragraph 5.68.

WBA Charge Controls

9.13 Ofcom's stated preference for glide paths over starting charge adjustments is maintained in other charge controls. For example in the 2014 WBA Charge Control[59] Ofcom stated:

> *"In some cases one-off adjustments could be justified at the start of the control. We have decided in this case however to adopt a "glide-path" approach, whereby the charge control will bring about a gradual convergence of prices and unit costs over the period of the control.*
>
> - *This charge control is replacing a similar expiring control on the same set of services. In such circumstances, we have a strong preference for glide-paths rather than one-off adjustments as it allows the firm to retain the benefits of cost reductions made under a previous charge control for longer and thus retains strong incentive properties.*
> - *It approximates more closely the workings of a competitive market in which excess profits are gradually eroded as rivals improve their own efficiency.*
> - *It avoids discontinuities in prices over time and leads to a more stable and predictable background against which investment and other decisions may be taken, by both suppliers and customers in the telecoms market."*[60]

9.14 In the 2014 WBA charge control, Ofcom adjusted BT's costs for SG&A Broadband and ATM because BT's allocations were based on forecasts revenues rather than actual revenues.[61] This cost adjustment was not put through as a starting charge adjustment.

9.15 In both the 2014 WBA charge control and the 2011 WBA charge control,[62] Ofcom made a "hypothetical ongoing network" (HON) adjustment. This is to take account of the fact that WBA networks are heavily depreciated and that an efficient network would typically be around 50% of the way through its life. This adjustment increases BT's costs. This adjustment was not put through as a starting charge adjustment in 2014 or in 2011. Had Ofcom applied such an adjustment, BT's starting charges would have increased.

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59 2014 WBA CC, June 2014.

60 2014 WBA Market Review, paragraph 7.307.

61 2014 WBA Market Review, paragraphs 7.185-7.188.

62 2011 WBA Market Review, paragraphs 5.92-5.96.

2009 NCC

9.16 By the end of the 2005-2009 NCC, BT's actual return on NCC services was substantially below its WACC.[63] In the 2009 NCC there was a positive value of X in the charge control as BT's prices were below its efficiently incurred costs. Ofcom did not make a starting charge adjustment in this case.

2014 *FAMR*

9.17 Ofcom did make one-off starting charge adjustments to WLR and SMPF in the 2014 FAMR charge control. In particular, costs related to telephone directories,[64] evoTAMS,[65] and some DSLAM capital maintenance costs[66] were excluded from the relevant cost stack and a starting charge adjustment was made to reflect this.[67] In the same charge control Ofcom removed non-UK overheads allocations, but did not pass this through as a starting charge adjustment.[68] In this case, Ofcom appears to have drawn a distinction between costs for which there was no direct causality link between the cost activity and product being sold (where a starting charge adjustment was made), and wider cost categories which were subject to a cost allocation methodology change (where no starting charge adjustment was made).

9.18 Ofcom also made starting charge adjustments to Caller Display reducing it from the prevailing price down to LRIC (a reduction from £6 a month to £0.45 a month).[69] In this case the service had not been previously charge controlled. Ofcom also implemented a starting charge adjustment on WLR + SMPF Simultaneous migration. This was done to align the prices of WLR Conversion and WLR + SMPF Simultaneous migration which could not have been done through a glide path.[70]

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63 2009 NCC, paragraph 4.56.

64 2014 FAMR, paragraphs A13.332.

65 2014 FAMR, paragraph A13.147.

66 2014 FAMR, paragraphs A13.264-A13.265.

67 2014 FAMR, paragraphs 6.67-6.84.

68 2014 FAMR, paragraph A13.72.

69 2014 FAMR, paragraph 4.252.

70 2014 FAMR, paragraph 6.90.

Conclusion

9.19 Our review of Ofcom's approach to implementing starting charge adjustments indicates that, in general, Ofcom has adhered to its stated principle of preferring to implement price changes through a glide path rather than starting charge adjustments.

9.20 Ofcom has departed from this principle on very few occasions – where prices are above DSAC ceilings and to adjust for specific 'direct' cost items not relevant to a particular product.

9.21 Based on our review we have not identified any change in allocation methodologies for overhead costs which has been implemented through a starting charge adjustment.[71]

9.22 Ofcom's general regulatory principle of consistency would suggest that the changes in cost attribution methods for overhead costs which Ofcom is now proposing should be reflected in regulated prices through a glide path and not starting charge adjustments.[72]

9.23 If Ofcom is to depart from its regulatory principle of consistency, it should, as an evidence-based regulator, explain why it has done so and why the change is necessary, appropriate and proportionate, providing supporting evidence. In our view, Ofcom has not done so and, in particular, has not properly assessed the potential adverse effects on investment incentives discussed in Section 10.

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71 Excluding any reallocation of overhead costs resulting from a change in allocation of 'direct' costs.

72 Ofcom is mandated "in pursuit of the policy objectives", to promote "regulatory predictability by ensuring a consistent regulatory approach over appropriate review periods" (Article 8(5)(a) of the Framework Directive (2002/21/EC) as amended); and "In performing their duties…Ofcom must have regard, in all cases, to – (a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed;" (Section 3(3)(a) of the Communications Act 2003).

10. Investment incentives

Effect of Price Shocks

10.1 The degree of competition in alternative infrastructure is very material in London, with the CLA market being completely deregulated. We would consider that if the CLA and the LP markets were assessed in aggregate (i.e. the old WECLA) then BT might not have SMP (noting that BT's market share is likely to be under 40%). However, even if the LP is considered a separate geographic market, it clear that there is a significant amount of non-BT infrastructure providing services in this market such that it has the potential to be sufficiently competitive to support withdrawal of price control regulation. This would also be consistent with Ofcom's previous finding that there was no SMP in the WECLA above 1Gb/s.

10.2 The competitiveness of the London markets has occurred because of extensive investment by alternative infrastructure operators such as Virgin, Geofibre (Zayo), and Interoute.

10.3 The proposed starting charge adjustment requires BT to reduce its overall Ethernet basket revenues by 9%.[73] BT has some flexibility in how to reduce its revenues by 9%, but is subject to the additional constraint that both EAD 1Gb/s rental and main link charges are also subject to a 9% starting charge adjustment. The proposed dark fibre product's price is also linked to the EAD 1Gb/s and main link charge.

10.4 Ofcom's starting charge adjustments represent a 'price shock' to the price of 1Gb/s circuits and Ofcom has also introduced a price for dark fibre that is otherwise lower than it might have been.

10.5 This shock to prices will have a negative impact on the investment incentives of firms that have invested, or are considering investing in competing infrastructure such as Virgin and Zayo (who acquired Geo – a dark fibre supplier in London). Ofcom has previously acknowledged that unanticipated price reduction can damage future investment incentives if the regulatory regime is deemed to be unstable:

[73] 2015 LLCC Consultation, Table 1.1.

"We also recognised that whilst the charge control incentive arguments are of less relevance to the WBA charge control, the potential impacts of one-off charge changes on regulatory certainty and stability may be more so. CPs have made investment decisions regarding their presence in Market 1 areas, the location of their interconnection with BT's network and therefore the type of WBA services purchased. Unanticipated one-off changes to WBA charges could make some of these investments appear to be "the wrong choice" and would not necessarily best reflect outcomes likely in competitive markets (whereby surplus profits are gradually eroded)."[74]

"We consider that an immediate adjustment (moving to the LRIC differential at the start of the charge control period) would tend to undermine the stability and predictability of the regulatory regime, and hence could reduce dynamic efficiency. It would be out of line with our usual approach, which is to make these adjustments gradually via a glide path, which we consider has important advantages as set out earlier in this section. We have therefore decided that an immediate adjustment would not strike a good balance in terms of overall efficiency, because it would tend to undermine the perception of stability and predictability of the regulatory regime."[75]

10.6 Ofcom considered whether to apply an RPI-X regime in the 2013 LLCC for services in the WECLA. Ofcom considered that an RPI-X regime was not appropriate in London:

" if we were to apply an RPI-X% charge control, this could ultimately reduce the benefits to consumers in the long-run associated with greater competition, as further competitive entry could bring innovation and investment and so constrain BT's prices."[76]

10.7 BT faces the strongest levels of competition above 1Gb/s, where BT's market share varies between 15-30%.[77] The investments that alternative infrastructure operators made would have been relatively high risk, given the high levels of fixed costs involved in installing fibre networks. The shock to 1Gb/s prices and dark fibre prices will tend to undermine alternative infrastructure investment.

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74 2011 WBA Charge Control, paragraph 5.204.

75 2014 FAMR, paragraph 6.44.

76 2013 BCMR, paragraph 21.11.

77 2015 BCMR, Table 4.4.

10.8 Virgin itself has announced plans to invest a further £3bn in network expansion.[78] If the regulatory environment is considered unstable, Virgin may consider slowing or reducing its investment in alternative infrastructure. This could affect not only wholesale and retail leased lines markets, but also retail broadband markets.

10.9 BT also faces further investment decisions related to potential investment in fibre to the distribution point (FTTdp) to deliver G.Fast and other "hyperfast" broadband services. [Confidential]

10.10 Ofcom's intervention may therefore have the unintended consequences of reducing availability of low-cost alternatives to leased lines.

Importance of regulatory certainty

10.11 In its Ethernet dispute determination, Ofcom stressed the importance of regulatory certainty on investment incentives:

> *"Dynamic efficiency is enhanced by giving the incumbent adequate incentives to invest efficiently, as well as by encouraging investment and competition by others. One of the key factors in creating such incentives is ensuring regulatory certainty and consistency.* ***Consistent and stable decision making by the regulator allows all industry players to plan their investments and outputs with sufficient certainty about charging or regulatory decision making (i.e. it reduces risk)****"*[79] *(emphasis added)*
>
> and
>
> *"Where BT (or indeed Ofcom) suggests an adjustment which involves a change to BT's cost allocation methodology and materially affects the costs not just of the services in dispute but other services, we should carefully consider the wider implications of making such an adjustment"*[80]

78 http://about.virginmedia.com/press-release/9467/virgin-media-and-liberty-global-announce-largest-investment-in-uks-internet-infrastructure-for-more-than-a-decade

79 Ofcom Ethernet, Dispute Determination, 20 December 2012, Paragraph 9.98.

80 Ofcom Ethernet, Dispute Determination, 20 December 2012, Paragraph 11.33.

> *"In addition, where data published in the RFS have been used in other regulatory decisions (such as for the purposes of setting a charge control), by retrospectively reallocating costs between services we risk introducing inconsistency between regulatory decisions. This can impact on BT's ability to recover its costs, potentially leading to it either under- or over-recovering its costs, and will also affect other stakeholders."*[81]

10.12 Ofcom's approach in setting starting charge adjustments to reflect the impact of changes in cost attribution methodologies for common costs potentially increases the risks associated with investment in network infrastructure for both BT and other operators.

10.13 As discussed above, the BCMR is one which in many areas is subject to increasing levels of competition. The impact of Ofcom's proposed starting charge adjustments will be to reduce the profitability of any new investment in infrastructure and also increase the risk of that investment by raising doubt around future regulated prices.

10.14 Ofcom does not appear to have included a full and proper assessment of the effect on investment incentives in its assessment of whether or not to apply a starting charge adjustment to reflect changes in cost attribution methodologies.

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81 Ofcom Ethernet, Dispute Determination, 20 December 2012, Paragraph 11.36.

11. Starting charge adjustments will affect other markets

11.1 Ofcom has not placed any restrictions on the use of dark fibre. Purchasers of dark fibre can use it for leased lines services, but in theory could also use it for consumer FTTH services or other markets. The use of dark fibre therefore has the potential to affect other markets downstream to those in leased lines, and also in the wholesale local access markets. Ofcom has not taken into account the effect of these interactions between markets.

11.2 The starting price adjustments will impact on dark fibre prices, which will have a consequence on other markets. Ofcom has not considered the effect on other markets.

11.3 In our view, Ofcom's proposed regulation of dark fibre prices in the BCMR is ill-timed, given the clear connection between physical access, access to WBA services, and access to leased lines.

- Ofcom has not fully acknowledged the relationship between low bandwidth leased lines and VULA services. Low bandwidth GEA services may act as a competitive constraint on low bandwidth leased lines.[82] The relationship between these two products should be acknowledged.
- The dark fibre remedy clearly impacts on other markets. The dark fibre remedy has no restrictions on use and could be used as an input into retail broadband markets and wholesale broadband access markets.
- In the next fixed access market review, Ofcom is likely to consider the possibility of unbundled access to FTTH lines. It is not clear how the current dark fibre remedy would interact with FTTH access.

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82 This competitive constraint arises because for some customers of low bandwidth leased lines services (eg 10Mb/s), fibre services can be used to provide effective uncontended symmetric services. For example, Openreach's 80/20 VULA service can be used to provide symmetric services up to 20MB/s, albeit there are some technical characteristics that are difficult to replicate with VULA services.

11.4 Ofcom needs to consider the impact of dark fibre on all the markets downstream of dark fibre. These include not just the leased lines markets, but also the physical access and WBA markets. It would be more appropriate, for Ofcom to consider passive access remedies as part of that market review, rather than to impose a remedy that could have unintended consequences in other markets.

11.5 BEREC's guidance is that physical access and WBA markets should be considered together. We would argue that the EC's set of revised markets means that wholesale broadband markets could include a component of leased lines services. The introduction of a dark fibre remedy is high-risk and Ofcom should consider its potential effect on all regulated markets. As such, Ofcom should delay its analysis of the dark fibre remedy and consider it alongside the 2016 FAMR.