Ofcom BCMR and LLCC consultations

August 2012

UKCTA Response to Ofcom Consultation

Submitted to Ofcom: 30 August 2012

UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at www.ukcta.com.

This response is focused upon Ofcom's proposals for the Business Connectivity Market Review and associated Leased Lines Charge Control. KCOM is a member of UKCTA and therefore UKCTA will not be commenting on any of the changes proposed for the Hull area. Reflecting its particular interests, KCOM's view on some aspects of the BCMR will differ from the views expressed in this response. Virgin Media's views on certain aspects of the BCMR will also differ from the views expressed in this response.

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Introduction

BCMR markets are critical to UKCTA members. UKCTA members operate across the BCMR markets to varying degrees, often with differing business interests. Despite these differences there is much common ground regarding views on what regulatory approach should apply to business connectivity. Looking back to our response to Ofcom's Call for Inputs at the outset of the BCMR project we are pleased to note that many of the issues that we consider important have resonated with Ofcom. However there are a number of areas of detail which we believe still need to be addressed. The issue of Cost Orientation is of particular concern to UKCTA members and this response should be read in conjunction with the report prepared by Alix Partners for UKCTA.

Our response focusses upon the following areas:

(i) The BCMR consultation brings forward a new and unexpected proposal to remove cost orientation obligations for those services covered by the BCMR. Due to the gravity of this proposal, UKCTA has commissioned an expert report on the economic effects that may be expected should the cost orientation remedy be removed, and whether the proposed structure of the charge controls are able to act as a sufficient restraint on BT pricing behaviour in its absence. We are left in no doubt that cost orientation remains a relevant and critical remedy that Ofcom must impose when concluding the BCMR.

(ii) Availability of very high bandwidth services on a clear and regulated basis was highlighted in our Call for Inputs response as an issue of great concern. We are united in our welcome of Ofcom's findings of the new MISBO market and designation of BT with SMP therein but consider that a few key questions remain unanswered. In particular the lack of cost orientation or charge control for MISBO services beyond "traditional single interface". This leaves UKCTA members in a situation where they are unable to predict pricing for these critical services, in particular backhaul services. We consider this is a situation which merits a rethink. We have responded under separate cover to the related exemption request for MISBO services within the WECLA area.

(iii) PPC/TI circuits continue to have a significant installed base, serving an important customer base. We consider that it is important that Ofcom retains its regulatory focus on this area of the market. We are pleased to see on-going regulation and proposals for charge controls.

(iv) UKCTA has serious reservations concerning the proposals to find separate trunk markets. We are less than convinced that the evidence supports a finding of no SMP for national trunk. We consider that a single market for trunk exists with BT holding SMP across all of this single market.

(v) Our concerns from the last market review with respect to Ofcom's methodology to determine geographic markets are on-going. Fundamentally Ofcom has pursued its geographic market policy despite clear evidence from CPs that digs involving distances of more than 200 metres rarely occur. Where the BCMR 2008 only saw legacy high bandwidth TI services subject to geographic market deregulation Ofcom now extends this proposal to critical AI services. Fortunately Ofcom proposes to retain EoI obligations (which we fully support) – including on price- leaving a safety net against which we are able to assess reliance on BT's supply of AI services in the WECLA market for the next review.

(vi) Service migration is an issue of escalating importance for this review. We are facing the need to migrate from legacy TI and AI services, as far as this is possible and cost-effective. A focus on the availability of non- discriminatory, relevant migration products is essential when concluding this review.

(vii) We have learned many lessons since the last review regarding the importance of the SMP obligations clearly specifying BT's obligations. In honouring its regulatory obligations we know that BT relies solely upon the legal text of the relevant SMP condition and will not entertain any considerations as to the intention or spirit in which the SMP condition was drafted in the first place Ofcom's drafting of these conditions is therefore paramount.

(viii) Where Ofcom requires BT to engage in additional activity we consider that Ofcom must accompany these requirements with formal directions to that effect. With market review cycles becoming shorter (following a three year cycle) we observe a knock on difficulty in Ofcom's ability to conduct and conclude accompanying charge controls so that new controls commence when old controls expire. We observe that it is only the charge control that has time limited effect. Where Ofcom is delayed with the general BCMR it is not the case that other SMP obligations cease to have effect. We consider that Ofcom needs to modify its approach to charge controls, whilst aiming to replace these after the three year period they must be retained until such time as Ofcom introduces a replacement. This is particularly relevant should Ofcom proceed with its proposal to remove cost orientation which would leave services with absolutely no ex ante regulatory protection during interim periods between charge controls. During these interim periods we are subject to BT's voluntary "commitments", which foster uncertainty and an undue reliance on the Dominant Provider behaving reasonably.

(ix) We note that the commitments that BT has proposed after 30 September 2012 are highly selective in terms of which services it chooses to reflect Ofcom's provisional thinking. We would urge Ofcom to move as swiftly as possible to issue its final Statement.

(x) We are concerned that the proposed Migration credit is overly generous to BT and doesn't perform the function it was designed to achieve. There remains a great deal of confusion around the operation of the credit and we consider that Ofcom needs to rethink these proposals to ensure that any migration assistance credit is targeted at CPs wishing to move services and not just provided to BT to act as a cushion in meeting their charge control obligations.

(xi) Ofcom should reconsider whether the full extent of existing geographic discounts should be included within the starting base year costs for the upcoming charge control. Its current approach risks creating excessive incentives for BT to target competitive areas with discounts whether this is cost-justified or not and to game the charge control framework in future.

We discuss below our views in detail.

Cost Orientation

UKCTA considers that Ofcom has entirely failed to properly consider the impact of removing cost orientation within its proposals. Given the gravity of what it is proposing, Ofcom should set out a comprehensive analysis of how the removal of this remedy aligns with its core statutory duties and how the structure of the new charge controls will serve to meet the desired objective, namely preventing the risk of excessive prices. Yet this is absent from the analysis. Indeed the rationale for Ofcom's view presented in the consultation document is extremely limited and effectively limited to a single paragraph.[1] Given the disputes that have arisen concerning the Basis of Charging Condition, and the scrutiny applied to BT's

[1] Paragraph 5.72 of the LLCC

behaviour by the regulator and the courts, we struggle to comprehend how Ofcom can possibly consider it appropriate to remove constraints from BT – and how it can consider that the arguments it sets out in support of such a proposal are sufficient. This is an issue of vital importance to UKCTA members and we would ask Ofcom to consider in full, the contents of the expert report on the subject commissioned by UKCTA and prepared by Alix Partners which accompanies this response.

It is clear from that report that the BCMR proposals require the imposition of remedies for both TI and AI services. Further there is a need to impose cost orientation for the generality of MISBO services (beyond the minor number of single interface charge controlled MISBO services).

UKCTA would highlight the following points in relation to Ofcom's proposed removal of the Cost Orientation remedy:

I. The purpose of the cost orientation obligation in previous charge controls was to place a reasonable constraint on the degree of pricing flexibility afforded to BT so as to ensure that charges were neither excessively high nor unreasonably low. In the absence of the condition, the concern was that BT would be able to take advantage of its status as the SMP operator of the network to the disadvantage of customers and competition.

II. Ofcom's proposed charge control structure will allow BT to raise prices for services which it does not consume, thus enabling it to load price increases onto services for which competition is least likely to develop, or which are used by downstream rivals in greater proportions than BT. Sub-baskets and sub-caps only provide a limit to the extent of rebalancing and do not ensure that charges are related to actual costs. Therefore, even if a charge control were to protect against an overall pattern of excessive pricing, it would not ensure that the interests of end users were protected for all services, and especially not for services where there is less competition. This should be of significant concern to Ofcom when considering the necessary remedies.

III. For these reasons a cost orientation obligation is essential to prevent excessive pricing at the individual service level. A charge control alone, based on Ofcom's proposals, will not achieve this. Indeed if Ofcom no longer considers that it is necessary to constrain prices at an individual level, then no arguments have been advanced to support this view. The cost orientation obligation has proven to be an essential tool in helping to rectify occurrences of where prices for wholesale services have not been set in compliance with SMP obligations in the past. For example, Ofcom has successfully carried out a number of investigations following disputes in relation to BT's compliance with its cost orientation obligations, with the PPC overcharging determination having been upheld by the Competition Appeal Tribunal and the Court of Appeal.

IV. Ofcom has identified that risks of margin squeeze, predatory pricing and/or anticompetitive cross-subsidisation are of concern in both the TISBO and AISBO markets but does not impose any remedies which explicitly address these risks. A cost orientation obligation complements the charge control remedy in preventing BT from pricing below cost. Whereas the charge control remedy serves only to prevent BT's ability to price excessively at the aggregate level, it does not address BT's financial incentives or ability to set unfairly low prices for more competitive services or those which its own retail business uses disproportionately. Broad tariff baskets exacerbate this financial incentive by allowing BT to fully offset the lost margin suffered as a result of below-cost pricing by raising prices to a greater extent on other services in the basket. Another important consideration is that charge controls deal with excessive charging on an aggregate basis, but when it comes to build or buy investment decisions undertaken by individual CPs, cost orientation at each and every charge level is important in determining what services are economically sustainable to self-provide.

V. A further distinction between the charge control remedy and the cost orientation condition is that the former is an *ex ante* remedy which takes account of forecast costs over the charge control period whereas the cost orientation condition applies to the relationship between actual prices and actual costs. This means that the test can enhance allocative efficiency by ensuring that BT takes account of any changes in actual costs which may arise over the course of the price control period. The cost orientation obligation would prevent prices from diverging from an appropriate range while allowing BT to efficiently recover the common costs it actually incurs across services.

VI. We refute Ofcom's suggestion that imposing a cost orientation obligation would be disproportionate because it would lead to increased regulatory uncertainty for rival communications providers. This is simply not the case and in fact, in the absence of a cost orientation obligation, rival CPs would face significant uncertainty over their input costs, since BT would be under no obligation to relate its individual charges to costs. If the charge controls and cost orientation obligations are applied in a complementary manner, as is currently the case, then there is no argument to be made regarding certainty, or lack of it.

VII. Likewise Ofcom seems to be under the misapprehension that applying a cost orientation obligation instead of charge controls may enable BT to earn excess returns. However, the relevant conclusion to draw from this is not that the cost orientation should not be applied, but rather that a charge control would need to be imposed (potentially alongside a cost orientation obligation) in order to ensure returns are not excessive at the aggregate level.

VIII. As an evidence based regulator, Ofcom has failed to make a convincing case to support its decision not to impose a cost orientation condition in its LLCC proposals. The charge controls and sub-caps which it has proposed may not offer sufficient protection against excessive pricing (certainly not for all products) or anti-competitive pricing below costs for leased line services.

IX. Furthermore, the particular justifications put forward by Ofcom to support its decision not to impose a cost orientation obligation as part of the 2012 LLCC are in stark contrast to its previous LLCCs conclusions, with no material change in the facts, save for a series of investigations concluding (or provisionally concluding) that BT has breached it cost orientation obligation. The arguments, such as they are, are essentially based on speculation about what stakeholders want, the current levels of DSAC and the adequacy of the charge control structure in combatting excessive pricing. There is no discussion at all within the consultation about the advantages and disadvantages of imposing a cost orientation remedy, and why on balance it is not necessary. This is the bare minimum that stakeholders would expect and indeed it is highly unusual for Ofcom not to recognise this. With no detailed evidence or analysis in support of its removal UKCTA believes that any decision to remove the condition is unsound.

Ofcom's Approach to Decision Making

Ofcom has also failed to take into account its own ongoing policy work on cost orientation. In November 2011 it initiated a Cost Orientation and Regulatory Accounting consultation, issuing a Call for Inputs, followed by meetings with UKCTA during early 2012. The main consultation document has not been published yet (although we understand that it is imminent). A Call for Inputs is just that, providing an opportunity for stakeholders to respond in brief at the broadest level to a range of mostly high-level issues. As a matter of regulatory good practice Ofcom should have completed this policy project first and not sought to reach a conclusion on this matter before the main policy consultation concerning this issue has even been published. Therefore Ofcom cannot have any confidence that it has reached a sound policy conclusion on this matter which takes into account the views of stakeholders. This is evident not least from Ofcom's mistaken assumption that rival CPs consider that cost orientation reduces certainty to an unacceptable level, which is absolutely not the case. Ofcom has therefore not only undermined its forthcoming policy project consultation on Cost Orientation, but also breached its own consultation guidelines[2] as well as good regulatory practice.

On this occasion Ofcom has tackled the issues in the wrong order, and Ofcom are fully aware that the overarching policy decision should have been decided upon first in the context of its own standalone policy consultation, followed by Market Review decision(s) which build on the policy conclusions reached as a result of a rigorous and evidence based policy focused consultation

We would urge Ofcom to re-consider the ordering of how a conclusion on this issue is to be reached, with the cost orientation obligation maintained in all relevant market reviews until such time as a firm policy conclusion has been reached, and with the enactment of the decision in each market left to the subsequent market review after the policy project has concluded. Ofcom has an obligation under s.3(3) of the Act to have regard to consistency in its decision-making. Given that Ofcom concluded that cost orientation was appropriate following the previous market review, we consider that the current proposals fail to meet Ofcom's consistency obligation. Such a divergence in policy must be supported by far better analysis than has been provided by Ofcom in the latest BCMR and LLCC consultation documents. Ofcom must assess the cost orientation question again, taking account of their statutory duties carefully, which to date they have singularly failed to do.

Need for RFS Output

Within the consultation document Ofcom highlights the present relationship between cost orientation and regulatory accounting obligations, concluding that removal of cost orientation naturally is followed by the removal of regulatory accounting obligations. We wholeheartedly disagree. Even if the cost orientation obligation were to fall away there are very sound reasons to retain a cost accounting publication obligation in these key SMP markets. Ofcom should consider the following points before reaching any conclusions about RFS obligations in these markets:

[2] In UKCTA's view Ofcom have breached their own consultation guidelines in respect of the requirement to:

- involve, as far as possible, all those whose voices need to be heard, whether big companies or small ones, industries, consumer and community groups or just individuals;
- explain fully the different options that we are considering before we make our decision;
- help those with views to respond fully and in an informed way; and listen to those responses and use them to help understand the effect of any action we take.

I. There are compelling arguments for ensuring the continuity of publication each year, as it is crucial to both aiding the understanding of the accounts and preserving their integrity from one year to the next. A snapshot of the accounts every third year would not suffice and it would make it very difficult for stakeholders to understand or critique what was before them. Indeed in reviewing Ofcom's current LLCC models it is apparent just how reliant we are on prior year numbers to provide context and understanding to cost and revenue changes.

II. BT continues to make fundamental changes to the basis of preparation of the accounting (e.g. restating prior year numbers or changing fundamental assumptions). Unless we have the information flowing from one year to the next then we are not able to make sense of BT's actions or indeed the consequences of them.

III. Within the Ethernet 1 dispute decision Ofcom itself was at pains to highlight the shortcomings of allowing BT to change its accounting output in order to generate figures that are favourable to BT's own commercial interests[3]. By removing the RFS publication obligation Ofcom will make it far easier for BT to do just that.

IV. It is stakeholders and not Ofcom who have historically held BT to account on their obligations. By removing RFS output Ofcom will be setting the industry back many years and undermining the current balance within the regulatory regime. The only CP who would gain from this move would be BT. The removal of accounting requirements, together with the reduction in transparency, sends entirely the wrong signals to a dominant operator, an operator with a proven history of breaching cost orientation obligations.

V. We note that Ofcom has previously stated the importance of regulatory accounting obligations to monitor not just cost orientation obligations but also compliance with charge controls.[4]

We would urge Ofcom to reconsider this issue, as even if Ofcom concludes (wrongly in our view) that a cost orientation obligation is unnecessary, RFS publication remains vital.

[3] http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf (see para 1.19)
[4] See paragraph 2.24 of the Regulatory Financial Reporting Obligations on BT at http://stakeholders.ofcom.org.uk/binaries/consultations/fin_reporting/statement/finance_report.pdf

Access Obligations

UKCTA is concerned that Ofcom has incorrectly proposed its network access obligation (Condition 1) for BT and KCOM. At paragraph 10.65 Ofcom states:

> "*We consider that it is appropriate in cases where a CP has SMP to impose an access obligation on that provider requiring it to meet all reasonable requests for network access within the relevant wholesale market, irrespective of the technology required, on fair and reasonable terms, conditions and **charges**.*"[emphasis added].

However, the condition proposed[5] specifically excludes charges from the obligation to provide access ("*provided on fair and reasonable terms and conditions (***excluding charges***)*"). The SMP Condition, as drafted, therefore fails to implement the remedy identified as required to address the competition problem. Ofcom should ensure that the final Condition 1 is drafted in a manner consistent with intent in paragraph 10.64, and consistently with other Network Access obligations imposed on other markets.

This is particularly important as other SMP Conditions (e.g. Condition 2, no undue discrimination) only apply to Access that is regulated under Condition 1.

This matter was raised with Ofcom in the context of an UKCTA meeting on 25 July 2012. Ofcom undertook to respond subsequently with their comments, and by an email dated 21 August 2012 implied that the wording of proposed Condition 1 as drafted was intentional. Ofcom stated "*As we have explained in the LLCC consultation we consider that we can address the competition concerns about pricing with the proposed charge control. We do not consider that an obligation for charges to be fair and reasonable is also necessary.*"

We are most concerned that the response runs directly counter to the position that was consulted upon in the consultation document at paragraph 10.85. If Ofcom's policy position is truly that an access condition should not extend to include reasonable charges, this would be a departure from the consultation position, and one on which stakeholders will not have had an opportunity to see Ofcom's developed thinking, nor to respond.

[5] SMP Condition 1 – Network access on reasonable request; clause 1.2(b). Part 3 of Schedule 2 to Draft Legal Instrument at page 726 of Annex 14

Additionally, it is of particular note that the BCMR markets are alone in proposing to apply this modified wholesale access condition which explicitly excludes charges from being set on a fair and reasonable basis. Ofcom must have regard to the principle of consistency in regulation. Consistency with other markets, in this context, would allow all stakeholders a clear idea of what each remedy was designed to regulate, and how. There is no explanation in the document as to why market conditions in the BCMR markets differ from each of the other regulated markets which would justify this difference of approach, nor what the effect of the different wording would be.

Indeed, the potential effect may well be significant. Other conditions (such as Condition 2: no undue discrimination) apply to access as regulated under Condition 1; it could be argued that there is no obligation constraining potentially discriminatory pricing even where the "general" SMP Conditions are applied to a market. This level of uncertainty is not acceptable, and should be resolved by aligning the wording of the Condition to that imposed in other markets, which would also address the competition concern identified by Ofcom.

MISBO-

Ofcom proposes to find a new market for very high bandwidth services. Ofcom finds that BT has SMP in MISBO with the exception of the WECLA area. However where BT has SMP, Ofcom relies solely upon the obligation of EoI when it comes to pricing of these services. Given the importance that Ofcom has placed on the need for price certainty and that it has stressed how the charge controls for TI and AI may address this need, we would also expect these key MISBO services to be subject to controls that would provide price certainty. We propose that in the absence of a charge control, Ofcom relies upon cost orientation obligations.

Ofcom proposes that BT does not have SMP in the WECLA area. UKCTA members have differing views on these proposals however we are united in our concerns regarding whether Ofcom has appropriately reflected the competitive differences for access and backhaul of MISBO services. Ofcom does not propose to find distinct backhaul and access markets for Ethernet services within the BCMR, however we consider that there are important differences between these services, in particular differences in the characteristics of demand – where backhaul services require resilient supply, and differences in purchasing patterns – where CPs and BT purchase different backhaul products to meet their backhaul requirements. It is essential that Ofcom is absolutely certain that all the affected exchanges in the WECLA zone will be subject to effective competition (e.g. that there are two or more external suppliers of backhaul services available at a specific exchange). We request that Ofcom either conducts this analysis or provides confirmation that such analysis has been undertaken and underpins its competitive assessment for MISBO WECLA services.

Ofcom proposes that BT is obliged to provide MISBO circuits with one circuit end within the WECLA area. The detail of this requires clear specification within the SMP obligations. We do not believe this is clear from the proposed wording of the SMP conditions in the consultation document.

The treatment of EDB services within the MISBO market

Ofcom refers to the MISBO product market as "multiple interface services with bandwidth greater than 1Gbit/s, and services of any bandwidth delivered with WDM equipment at end-users' premises."[6] In relation to the EDB service available from Openreach, Ofcom refers to this being "WDM-based".[7] UKCTA agrees that the EDB service uses WDM technology. In relation to the proposed remedies for the MISBO market, Ofcom proposes to introduce a charge control on "single-service Ethernet products."[8] More specifically, Ofcom says it is proposing "a price control limited in scope to single-service Ethernet products only, and excluding services delivered with WDM equipment at customers' premises."[9]

The Annex to the proposed charge control SMP condition (Condition 5.3) lists all EBD services and thus brings them under the scope of the charge control (at the proposed level of RPI-12%). This seems appropriate but we are concerned about potential confusion in Ofcom's conclusion that WDM services will not be subject to the charge control, whereas SMP condition 5.3 in fact lists EBD services that are based on WDM technology. For the avoidance of any doubt (now or in the future), we believe the SMP condition needs to be clarified to state that all EBD services are covered by the charge control even if they use WDM technology.

TI trunk proposals

Ofcom proposes to find two distinct trunk markets – a regional trunk market and a national trunk market. UKCTA disagrees that two functioning trunk markets exist. Purchasers of TI services continue to rely upon the availability of trunk services from BT in sufficiently large proportion to consider that BT has overall SMP in the combined market. Indeed Ofcom finds that in combination (regional and national trunk) BT holds a market share of 49%.

6 See, e.g., BCMR consultation document, paragraph 1.14.
7 BCMR consultation document, paragraph 11.38.
8 See, e.g., BCMR consultation document, paragraph 1.52.
9 BCMR consultation document, paragraph 12.75.

Ofcom considers that national trunk has greater prospects for competition. Ofcom does not consider the nature of trunk as a legacy service market in the later stages of its lifecycle. We consider that Ofcom's geographic analysis has effectively uncovered the status of CPs historic trunk purchasing. Moving on from such "state of the nation" analysis we consider that Ofcom is wrong to conclude that the market share difference between hypothetical regional and national trunk service is evidence of a competitive market. Or indeed, that these hypothetical markets have areas where there may be a greater prospect for competition compared to a single trunk market.

It is quite probable that Ofcom's findings that CPs are less reliant upon "national trunk" in comparison to "regional trunk" is reflective of the fact that CPs / end users will have sought to migrate more expensive long distance TI circuits supplied by BT to other services as a priority. Ofcom needs to engage in this type of detailed analysis comparing the nature of national trunk circuits in installation over the course of the proceeding review – those supplied by CPs themselves and those supplied by BT - to bottom out this understanding. Had Ofcom attempted to analyse geographic trunk markets in 2009 would market shares across the possible two markets have differed? If BT's market share has decreased is this due to CPs switching trunk supply of terminating PPC usage per se? Ofcom has not pointed to any evidence of increased competitive entry into the national trunk market since the last market review. It is these detailed considerations, beyond evidence of current market share, that need to be explored. Indeed Ofcom's analysis during the PPC POH consultation concluded that CPs were not investing in new POH handover – which would be necessary if CPs were competing with BT for national trunk business and in fact only 3 POH had been installed since 2010/11.

The consequence of Ofcom's proposals is to put at commercial risk a proportion of trunk conveyance that CP/ end users are unlikely to find it commercially sensible to rearrange to alternative / new handover points or to seek provision from alternative PPC trunk providers. Neither end users nor CPs wish to incur avoidable costs for the supply of legacy TI circuits. Focus is better placed upon migration away from TI entirely.

UKCTA concludes that a single trunk market continues to exist and rejects Ofcom's conclusions that there is the potential for a regional and national trunk market to function independently of one another.

WECLA Geographic markets

UKCTA has significant concerns with Ofcom's proposal to identify a separate geographic market in London referred to as WECLA (effectively an extension of the current CELA area). For the record, UKCTA also opposed the creation of CELA in the previous BCMR market review.

WECLA is materially different from the CELA from a competition point of view. Whereas some UKCTA members have a network presence across WECLA, it is not of the same extent and reach as in CELA. Indeed by Ofcom's own admission, WECLA includes postcodes which fail its own network reach test.[10] By way of illustration, a substantial part of WECLA appears to be a backbone route for network to Heathrow. Even allowing for the possibility for breakout to business-dense areas and data centres along this route, much of this network is not easily susceptible to use for local connections. Figure 30 of the consultation document clearly implies diverse routing along routes between central London and Heathrow. Although there is network along these routes, it will not generate connections in to buildings easily. As such UKCTA members are concerned that Ofcom has significantly over estimated the network availability underpinning its views on the extent of competitive conditions in the WECLA (excluding CELA).

UKCTA has three specific areas of concern relating to WECLA as a separate geographic market:

(i) The data Ofcom has relied upon in determining BT's market share (BT's submissions on circuit count);

(ii) Ofcom's reliance on postcode sectors as a means of identifying areas of the UK where competitive conditions are sufficiently distinct from the rest of the UK; and

(iii) Ofcom's assumptions in relation to dig distances.

We deal with each of these issues in turn below.

1. Market share analysis

UKCTA would question Ofcom's market share findings for WECLA on the following basis:

- On its face, it conflicts with the experience of UKCTA members who have a good feel for the market and relative market shares. We do not believe BT's market shares have reduced since the last market review.

[10] Paragraph 5.132

- We note that Ofcom's data shows there are two operators who have very high coverage in actual buildings although we cannot verify this information since the names of the operators are redacted. However, what is clear is that Ofcom's data relates to the CELA as a whole and the WECLA as a whole (tables 25 & 26) and fails to provide disaggregated information about the extension area only. UKCTA would suggest that the competitive environment is very different in the extension area compared to CELA and that this is likely to be borne out by disaggregated market shares.
- We note that Ofcom concedes that the market data supplied by different operators is not fully comparable given the difficulty in ensuring that operators' measure and report on the same basis, particularly with regard to self-supply. This lack of reliable date undermines Ofcom's market share findings for WECLA.
- It appears that BT has compiled its circuit data utilising a revised methodology for counting circuits. We are concerned that BT's approach bears no resemblance to the approach adopted by UKCTA members when submitting responses to Ofcom's information requests, and as such has resulted in Ofcom underestimating BT's market share and hence its dominance in WECLA.

As there is significant doubt over the accuracy of BT's market share figures, which Ofcom has significantly relied upon in reaching its market findings, UKCTA considers that the underlying data supporting the figures should be made available. At the very least greater transparency of the methodology applied should be provided to ensure that the industry has confidence and trust in Ofcom's analysis.

2. Postcode Sectors as a reference area

Whilst we understand Ofcom's desire to use a unit of analysis at a more aggregated level than individual premises, we believe that aggregation at postal sector level is not sufficiently granular to provide a true picture of competitive conditions

Factors such as building size, occupancy, number of floors, number of CPs already supplying services to the building, geographic features of the surroundings all have an influence on decisions whether or not to tender for business, and so have an influence on the competitive conditions.

Accordingly, competitive conditions vary, not only from one building to another but even from one floor to the next. None of these factors appear to have been considered by Ofcom, where the main focus has been on the number of commercial buildings in a given postcode sector.

3. Assessment of competition based on assumed acceptable dig distances

UKCTA does not agree with Ofcom's conclusion that competitive constraints exist when 2 or more alternative operators have network flexi points within 200m of a potential business customer.

We note that Ofcom requested information from UKCTA members regarding the dig distances of network extensions. It is not the case that the presence of an alternative operator 200m away in a straight line means that only 200m of digging is required to reach that operator. Ofcom acknowledge in the consultation that their analysis does not take full account of the obstacles that CPs face when directly connecting customers[11], making it clear that Ofcom have placed insufficient weight on this factor when concluding their analysis.

The dig distance is only one of many considerations made by an operator when considering whether to extend its network. A wide range of factors will be taken into account when deciding whether or not to expand the network, for example the bandwidth of the service required, the value of the contract, the dig distance, the potential for additional business (either from the same customer or others in the same building). Ofcom does not appear to have taken these wider considerations into account which is a flaw in Ofcom's analysis.

<u>WECLA Summary</u>

Whilst Ofcom's model may well demonstrate the theoretical possibility of competitive conditions, it does not reflect the reality of the competitive landscape in the entire WECLA. While it may be the case that there are pockets of true competition in areas of central London boasting a high density of business customers and extensive network builds by market players, this is certainly not the case across the entire WECLA area mapped out by Ofcom. We appreciate that Ofcom must balance granularity and practicality in its assessment, but we are concerned that its approach has led to flawed assumptions. UKCTA members certainly do not recognise the competitive landscape described by Ofcom throughout the whole of the WECLA. We believe that a more accurate assessment of competitive conditions would inevitably lead to a conclusion that there is no justification to extend the existing geographic market in London.

We therefore do not agree with Ofcom that a separate geographic market exists in WECLA, apart from the area designated in 2007/8, i.e. the existing CELA.

[11] In BCMR PARA 5.198: Ofcom state that "*an operators ability to serve a particular customer may be affected by natural obstacles such as rivers, which are not reflected in the network reach analysis*" adding that this is accounted for by a cross check with service share.

Competitive conditions in city areas outside London and Hull

UKCTA notes BT's call for Ofcom to identify more geographic deregulation and also to consider deregulation at a much more granular level, citing individual business premises consuming significant amounts of bandwidth such as data centres. UKCTA supports Ofcom's reasoning for rejecting any extension to the number of geographic markets.

Such a finding is consistent with the EC's stated policy, as none of the EC's additional criteria for supporting a finding of a geographic market have been satisfied.

Furthermore, we also agree with Ofcom that there is no objective case for treating data centres differently. Indeed, it is vital that Ofcom applies consistent remedies and that such remedies are included in SMP conditions to ensure the necessary safeguards are clearly communicated to all parties.

In summary, UKCTA considers that Ofcom's modelling of the competitive conditions in the market provides an inaccurate assessment. UKCTA suspects that this may be due in part to the methodology that BT has used to calculate circuits (which differs from the methodology used by the rest of industry) and resulting flawed assumptions made in reconciling data provided by industry.

BT's Geographic Discount Policy

Ofcom carried out analysis during its market review which led it to conclude that for the geographic markets where it has proposed SMP, the underlying costs and competitive conditions would not be completely homogenous throughout the UK (even outside the WECLA). It considers that some freedom to charge in the way that reflects more accurately these different conditions would be efficient, and that BT would be hampered in its ability to compete if it were required to maintain nationally uniform prices.

A relevant question therefore is how such discounts should be treated within charge controls. Ofcom has not previously allowed geographic discounts to apply toward meeting basket caps, and it proposes to maintain this approach in the current LLCC proposals. Ofcom's concern is that allowing BT to credit such discounts toward meeting the cap would encourage it to offer significant geographic discounts (in more competitive areas) while charging higher prices to customers in less competitive areas. This is a reasonable concern and Ofcom's approach in this regard is appropriate.

One outcome of Ofcom's proposed approach is that any geographic discounts that BT may offer during the upcoming charge control would need to be self-financing at the margin. For example, such discounts would need to lead to an increase in volumes since the discounts would not otherwise be recoverable through the charges cap. This contrasts, for example, to a price reduction for a potentially competitive service within a tariff basket (which, as noted in Section 3, would enable BT to raise prices for other services).

Although Ofcom does not propose that BT would be able to count geographic discounts toward meeting its charge control obligations, it does propose to permit existing actual discounts to be included within the starting year actual revenues. This impact of this is that the X factor required to deliver a given target level of revenue by the end of the charge control period will be reduced. Potential issues with Ofcom's approach to the treatment of geographic discounts in this regard are described below:

- First, Ofcom has not addressed whether the extent and nature of existing geographic discounts are appropriate (i.e. justified by cost savings that may be achieved by BT) even though it recognises that BT has targeted the discounts to areas which are most competitive. Ofcom's approach therefore risks unduly encouraging BT to target discounts to geographic areas where competition is stronger even if this has no overall cost-justification and limits the dynamic benefits associated with greater entry;

- Second, Ofcom has not considered whether its proposed treatment of geographic discounts would risk incentivising BT to increase its use of such discounts in the expectation that, even if it cannot apply these discounts towards price caps in the current charge control period, they would nonetheless contribute towards a lessening of the required X factor in future. This is because the X factor (under Ofcom's proposed framework) is a function of the net revenue earned by BT after discounts. If the same approach to geographic discounts proposed by Ofcom in this charge control is expected to be retained, BT would in effect recover some of the costs associated with targeted geographic discounts during future charge controls;

- Third, Ofcom considers that its approach would be unlikely to lead to scope for BT to enhance its rate of return through unwinding of existing geographic discounts. It suggests that BT would only have an incentive to offer a geographic discount where this is self-financing. However, this may raise a gaming concern since if BT were to systematically increase geographic discounts in the base year it would be able to over-recover during subsequent years of the charge control; and

- Fourth, Ofcom considers that the primary risk associated with failing to adjust the X factor to allow for geographic discounts is that this might lead BT to earn less than its cost of capital by the end of the charge control period. However, Ofcom does not recognise that the relevant measure of the returns to BT over the charge control period is whether the rate of return would meet (or exceed) the cost of capital across the period as a whole. Depending on the initial level of prices relative to costs, the glide path approach adopted by Ofcom may provide a significant degree of headroom to BT's returns across the charge control period. This would suggest that Ofcom's concerns regarding BT's ability to meet its WACC, and the related issue of its incentive to invest, would be overstated.

In conclusion, Ofcom should reconsider whether the full extent of existing geographic discounts should be included within the starting base year costs for the upcoming charge control. Its current approach risks creating undue incentives for BT to target competitive areas with discounts whether this is cost-justified or not and to game the charge control framework in future.

Service Migration

UKCTA members agree with the principle that it would be efficient to have everyone on the latest technology with the lowest costs and that, if such an outcome were feasible, the charge control proposals should encourage and reflect such an outcome. However, the reality is that this is not currently feasible and that any migration gains are outweighed by the costs and disruption caused by moving to the newer technology.

Accordingly, the current Ofcom charge control proposals unduly favour BT and will ultimately reduce competition. Ofcom mentions at paragraph 5.5 of the LLCC that it seeks to "uphold the principle that customers should not be disadvantaged by technological change", however, under the current proposals, UKCTA members and our customers will be significantly disadvantaged. If legacy services are retained, and in some scenarios there is no alternative, CPs costs will increase substantially due to the proposed charge control rises.

As mentioned above, under certain circumstances there is no migration path available, for example, where PPCs are used in order to provide voice services for which there is no migration path to move away from

TDM. Even BT has radically scaled down the scope of its 21CN project and has cancelled plans to migrate away from the TDM platform. Even in those situations where migration is feasible, CPs will incur considerable additional migration costs whilst their customers face significant disruption, all for an outcome with no discernible benefit to them.

Accordingly, the ability to migrate legacy services is a pressing issue for UKCTA members. BT has plans afoot to close down both the sub 2Mbit/s PPC network – the DPCN and also the legacy WES and BES service portfolio.

While BT is constant and clear with its proposals for network closure it is less forward or planned out with migration proposals for effected services. Until very recently the only option for CPs has been a costly ceasing of the legacy service and the "re"-connection of the replacement modern service. This is highly onerous, and is not a simple "migration" from one service to another. It also causes a high degree of disruption to business customers, who are understandably averse to any threat to their continuity of service.

Latterly for WES to EAD BT has made available "migration" by way of discounted connection to the new EAD service. This migration controversially required the CP to take up a new service with a higher bandwidth thus whilst BT offered discounted migration the trade-off benefit BT saw was higher on-going rentals of the new higher bandwidth service. This type of migration clearly has limited application[12].

With timescales for legacy platform / service closures closing in it is essential that business orientated migration products (or in the alternative commercial wrap around the migration costs attractive to all parties) are urgently developed.

Many UKCTA members have a pressing requirement for legacy WES services to be able to migrate to EAD LA. BT has proceeded extremely slowly to develop this migration option despite first capturing and tabling the requirement in January 2011 within the BT originated SoR. Only recently, after waiting over a year for the arrival of this migration option, has BT declared that it will not be offered. Why? Because it does not make commercial sense to BT. This is due, we presume, to the following reasons:

- BT's own services have migrated already via a paper rearrangement process not applicable to CPs

[12] This refers to legacy WES migrating to EAD http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-waiver/statement/statement.pdf

- BT will lose revenue when CPs switch to LA supply rather than standard WES or EAD
- BT will face greater competition once CPs are able to switch to LA and enjoy a comparable cost base to BT

CPs are therefore alone in their requirement for a WES to EAD LA migration solution. We consider that Ofcom must take action in concluding the BCMR to resolve this issue, ideally through a standalone consultation into the issue of migration. There isn't enough time within the current BCMR project to address this issue properly, so a focused and swift follow-on consultation is the best way to address this important issue.

The status quo is failing consumers and helping BT gain market share as the lack of effective migration solutions for CPs encourages users to take service from BT lines of business due to perception that they will be able to deal more effectively with future migration needs. With so many consumers due to migrate within the next market review period, Ofcom can't leave this issue to chance. A standalone migration consultation would also be ideally suited to discuss solutions for ensuring that there is no recurrence of this very unsatisfactory outcome. We would like to see future migration solutions being built into all new BT products at the design stage if the products are considered a direct replacement for an existing offering. We hope to work further with Ofcom over the immediate period to develop potential regulatory supported solutions.

Migration Credit

In what we regard as a related consideration UKCTA notes Ofcom's proposals for a migration credit and proposes that this is appropriately targeted to ensure that BT is forced to use it to enable all types of migration but in particular those that may be specific to CPs rather than BTLoB.

Ofcom proposes to adopt a modern equivalent asset ("MEA") valuation approach to the costs of Ethernet services.[13] This is consistent with its view that the costs of new Ethernet services can be identified and the use of these costs in the charge control would allow an efficient operator to recover its costs. Ofcom's approach is to allow for a glide path in which Openreach's prices will be brought into line with costs of the new Ethernet technologies only at the end of the charge control period.

[13] Ofcom LLCC Consultation, §6.101.

Ofcom notes that if there remain un-depreciated legacy assets, these might suffer holding losses when re-valued at MEA. It proposes to allow for recovery of these holding losses within the charge control on the basis that such holding losses do not arise due to inefficiency on the part of BT (assuming that the previous legacy investments were efficiency incurred at the time they were made).

Alongside the adoption of the MEA approach to the treatment of Ethernet costs, Ofcom proposes to allow for BT to recover migration credits totalling £43m. These reflect the costs that BT might be expected to incur in offering discounts in order to encourage migration from legacy products (such as WES and BES) to new Ethernet products such as EAD, EBD and BTL.

In considering whether Ofcom's approach to the treatment of new Ethernet service costs is reasonable, the following factors should be taken into account:

- *Overall impact of approach on returns*: While Ofcom is right to ensure that BT has incentives for efficient migration to lower cost technology, there may be a risk that under its proposed framework it goes further than required to meet this objective. BT may already have commercial incentives to encourage migration to lower cost technology where this would lead to cost savings over the period of the charge control. The presence of existing discounts on connection charges would be consistent with the view that BT does indeed already have this commercial incentive. In addition Ofcom does not appear to have considered the extent to which the glide path may permit over-recovery of the initial investments in new Ethernet services, and how this may compare with any investments it may need to make to encourage migration. As Ofcom highlights in Figure 6.4 of the LLCC, BT will be in a position of being able to earn prices above actual costs during the upcoming charge control. This might suggest that it will be in BT's interests to migrate customers to the new, cheaper technology. Ofcom should therefore consider whether these returns should be used (wholly or in part) to fund the migration credits, or whether regulatory support should be limited to discounts on connection charges beyond those it already provides for commercial reasons.

- *Consistency with future charge control framework*: Ofcom notes that the migration credit is limited to the current charge control and does not propose that it would be extended indefinitely.[14] This would appear to be a sensible approach, particularly

[14] Ofcom LLCC Consultation, §6.106.

given that Ofcom's approach provides for a significant sum of revenue which is not in fact linked explicitly to any requirement to offer discounts to customers. Ofcom should therefore review whether its policy has been effective in encouraging efficiency and value to customers (including discounted fees for connection) and be prepared to adjust its approach in light of findings at the end of the charge control period.

- *Treatment of holding losses*: It is important that a consistent approach to the treatment of holding gains and losses is provided. So, to the extent that BT is protected when the use of the MEA approach leads to holding losses on legacy assets, Ofcom should ensure that any holding gains experienced elsewhere are also used to offset regulated charges.

- *Assessment of risk*: In addition, Ofcom should ensure that the approach to setting the cost of capital for access to bottleneck telecommunications assets, relative to other regulated sectors, reflects the degree of protection afforded to BT in relation to the impact of fast-changing technology on legacy asset values. In particular this should reflect the use of delay in moving from an anchor pricing method to an MEA method to ensure that BT has the opportunity to recover investments in the new services; the glide path (which also leads to an increase in returns to new services); and the recovery of any holding losses experienced on legacy assets, all of which might be expected to reduce the risks associated with new investment.

- *Assessment of capital efficiency*: In assessing the costs to allow for in respect of Ethernet services Ofcom argues that it needs only to identify an efficiency assumption to Ethernet operating costs. It suggests that capital efficiency is already captured within its framework since it proposed a glide path to MEA values for Ethernet assets, while asset price changes are applied to certain assets, such as copper and duct. The use of an MEA approach will capture the efficient level of costs at a given point in time. However, given Ofcom's glide path approach there is a risk that further efficiency savings leading to ongoing reductions in MEA are not taken into account. This risk would occur if Ofcom uses the current estimate of the MEA cost base and applies this to 2015/16.

In summary we are concerned that the proposed Migration credit is overly generous to BT and does not have an in-built mechanism to ensure that it performs the function it is designed to achieve. There remains a great deal of confusion around the operation of the credit, especially given that the overwhelming majority of difficulties and costs from a move to new services will be experienced by OCPs and their customers, not BT. For instance, OCPs and their customers may have to deal with new contracts and order processes, significant disruption to service, new connection charges and network re-configuration. We would therefore welcome a rethink of the proposals to ensure that any migration assistance credit is targeted at CPs wishing to move services and not just provided to BT to act as a cushion in meeting their charge control obligations. CPs should be able to move to the products they wish to purchase, not those favourable by BT for them to purchase. Ofcom should be mindful of BT's ability to incentivise migration to products that further perpetuate their hold on the access market and should consider carefully not just the magnitude of the credit, but how it is applied in order to prevent BT from exercising choice in which services other communication providers migrate to.

Attractiveness of VULA as a Business Connectivity Remedy

UKCTA is concerned that Ofcom exaggerates the ability of VULA to be or become a meaningful constraint on BT's SMP position in the business connectivity markets and that Ofcom needs to devote more regulatory attention to ensuring that that BT develops a "business-grade" VULA product.

In the Consultation Ofcom points out some key reasons why it believes a VULA remedy is so attractive to industry, regardless of the market it is aimed at:[15]

- It allows the user to deliver services over BT's NGA network, using the FFTC/FTTP infrastructure, with a degree of control that is similar to that achieved when taking over the physical line;
- It is service agnostic;
- It offers an uncontended Ethernet connection; and
- It is capable of supporting leased lines.

Ofcom also suggests that VULA (rather than PIA) is likely to be the primary focus of NGA-based competition[16], and notes that its attractiveness is further enhanced given that it does not require re-engineering of existing processes.[17]

[15] BCMR consultation document, paragraph 3.135.
[16] BCMR consultation document, paragraph 8.87
[17] BCMR consultation document, paragraph 11.142

The above comments mirror those made by Ofcom in the WLA consultation document, including the following:

- The underlying objective of requiring BT to provide this form of access (VULA) was to support competition and investment in the supply of NGA-based products in downstream markets. As such, we set out that the access should be flexible and capable of supporting innovation.[18]
- As a technology neutral remedy, VULA would be relevant to both FTTC and FTTP deployments which means that, based on current roll-out plans, it could support competition in up to 66 per cent of the UK.[19]
- Our product market definition concluded that there is a single market for WLA lines which are used to support business and residential services. We, therefore, fundamentally accept that VULA should be able to support NGA services for business use.
- In terms of faster repair times and SLAs/SLGs, in principle we consider that CPs should be able to request this and should be able to negotiate suitable commercial terms with BT.[20]

UKCTA strongly supports Ofcom's comments above and were therefore disappointed to read Ofcom's conclusion in the BCMR consultation document that:

> *"On a forward looking basis, over the duration of this review, we consider that there will only be limited take-up of leased line VULA-based solutions. The availability of VULA is limited to the areas where BT has deployed infrastructure (about 66% of the UK by the end of 2014) and the bandwidth available and the ability to support additional service features is limited by the technology deployed by BT, as highlighted in Table 10. Further, VULA is predominantly focused on the residential market, and it is likely that VULA services would require additional investment to support enterprise customers with more stringent quality of service requirements."*[21]

We believe Ofcom is missing the point with regard to the use of VULA in wholesale business markets:

- Whether or not the current VULA product is deemed to be fit-for-purpose and fully available (this is subject to debate), we believe that product development bottlenecks in Openreach are likely to mean that business-grade solutions will remain purely "aspirational" without strong regulatory incentive on BT. In addition, we would question whether BT has any incentive to progress a business grade VULA product swiftly because it would "cannibalise" its own leased line revenue.

[18] Paragraph 8.7
[19] Paragraph 8.10
[20] Paragraph 8.153
[21] BCMR consultation document, paragraph 3.136.

- The areas that BT has / is deploying VULA are those areas where providers would naturally see an opportunity to take advantage of a leased-line VULA solution – i.e. high density urban areas with a large natural business customer base. Therefore CPs would not be deterred from taking advantage of VULA on the basis that it is not yet fully national.
- In relation to Ofcom's argument about lack of demand, UKCTA would suggest that this is precisely why Ofcom should consider mandating VULA rather than leaving it to commercial negotiation. Of course it will require investment, but that would be set against the benefits that such a remedy would bring. It is very disappointing that Ofcom has chosen not to do this analysis.
- At the very least we would expect Ofcom to have carried out a proper-evidence based assessment of the impact that VULA could have on competition, innovation and investment in the business connectivity market set against the costs of developing a business-grade solution. It is highly frustrating to see this remedy set aside in such an arbitrary manner.

Given the time it has taken Ofcom to complete the BCMR, and the amount of thinking it has clearly done, we would have expected a more strategic approach to remedies than is evident in the BCMR– i.e. looking at what industry really needs to compete rather than tweaking charge controls or indeed removing important existing remedies. We are concerned that Ofcom should do more than broadly support the roll-out of business-grade products. It is not enough to say (as we might expect) "VULA is already available as a remedy in WLA and there is nothing to stop anyone using it for business purposes, SoRs could be submitted for business grade repair, providers should seek commercial terms with BT etc." As explained above there is no incentive for BT to develop such a product and indeed every incentive not to do so. The normal response from Openreach to industry's SORs is that they are rejected on the basis that "Openreach sees no commercial benefit". It requires regulatory intervention by Ofcom to change this approach.

Detailed implementation

Over recent market reviews it has become apparent that BT considers only the text of the SMP condition when determining its obligation requirements. Any sentiment or explanation provided by Ofcom within the consultation document or final statement is not considered relevant by BT. We therefore consider that where Ofcom regards it necessary for BT to carry out certain activities, it should either make this clear on the face of the SMP condition or issue a direction to that effect.

The charge control obligation is the only SMP obligation which Ofcom sets with a predefined duration and an explicit end date. All other SMP conditions continue until they are either amended, reconfirmed or removed by the replacement market review decision. To date where the LLCC has been delayed in coming into force following expiration of the previous control (true of the 2009 control and the now expect 2013 control for leased lines) we have had the cost orientation obligations as a fall back. Ofcom proposals to not impose the cost orientation remedy create the likely risk that services will be subject to absolutely no ex ante regulation and CPs will have absolutely no cost certainty. Should Ofcom carry out its proposals not to include a cost orientation remedy we consider that it is relevant and appropriate for Ofcom to review the manner in which the charge control obligations are put in place and seek to resolve the issue of the obligation ceasing prior to the next control being ready to adopt. UKCTA therefore proposes that Ofcom whilst modelling the control on a three year adoption does not explicitly include an end date for the controls enabling them to continue if necessary until the new controls or other remedies take effect.

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