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Verizon Enterprise Solutions response to Ofcom's Business Connectivity Market Review and Leased Line Charge Control consultations

Non confidential version

Verizon Enterprise Solutions ("Verizon") welcomes the opportunity to respond to Ofcom's Business Connectivity Market Review and Leased Line Charge Control consultations ("BCMR" and "LLCC" respectively).

Verizon is the global IT solutions partner to business and government. As part of Verizon Communications – a company with nearly \$108 billion in annual revenue – Verizon serves 98 per cent of the Fortune 500. Verizon caters to large and medium business and government agencies and is connecting systems, machines, ideas and people around the world for altogether better outcomes.

Summary

Verizon is, overall, disappointed with Ofcom's proposals emanating from these two consultations. The area of most concern is the suggestion that a cost orientation remedy is no longer appropriate. Given Ofcom's entirely proper conclusion that market conditions in the UK demand the imposition of charge controls on dominant providers in order to support competition in business markets, Verizon is at a loss to understand the rationale that has led Ofcom to propose the removal of the cost orientation remedy previously determined necessary to underpin the charge controls.

Verizon can see no justification for such a radical change given that market conditions have not changed significantly since the last market review and the fact that, as demonstrated by the number of disputes relating to charges during the previous review period, there is a clear need for tighter remedies and increased compliance monitoring rather than less in order to safeguard against excessive prices. Nothing Ofcom has said provides such a justification.

Verizon's strong view is that a cost orientation obligation should continue to be imposed on BT in these markets.



It is especially disappointing, given the time it has taken to finalise the consultations, that Ofcom has not “taken a step back” and looked at the broader picture of business connectivity in the UK, and what is needed to stimulate and sustain competition over the next three or so years. Ofcom’s review, as far as it is possible to tell from the consultation documents, appears to rely heavily on BT’s submissions and view of the competitive market. Submissions that Verizon and other Communication Providers (OCPs) have presented appear to have been largely overlooked. Verizon considers the current set of proposals will result in a less competitive market, and indeed possibly the exit of one or more players.

In Verizon’s view, what is needed to sustain and enhance competition in this market is, as a minimum:

- Business-grade (uncontended, robust, strong QoS) FTTP solutions, suitably regulated, that cater for providers without presence at BT’s exchanges;
- The ability to hold BT to account if it charges excessively, by means of both charge control and cost orientation remedies.

In essence, these points boil down to the need to be able to compete with BT (and OCPs) on a fair and transparent basis, in order to obtain the best deal for our customers and ultimately end users. Such aspirations should be mirrored by the requirement on Ofcom to meet its primary statutory duties to promote competition and further the interests of consumers.

Unfortunately, we see little to convince us that this will be the outcome if Ofcom continues down the path that it is proposing:

- On business-grade solutions, there is no substantive mention of business-grade solutions using NGA. Virtual remedies such as VULA, and passive remedies such as Dark Fibre, are not properly addressed in a meaningful way despite the clear benefits that they may bring to the business connectivity market; and
- On the ability to hold BT to account, losing cost orientation would be a step in the wrong direction for a whole host of reasons – not least it would allow BT undue flexibility given its past behaviour in these markets and would reduce the transparency that OCPs rely upon

Under Ofcom’s current proposals, Verizon (and OCPs) will have a far less fair and transparent relationship with BT. For example, we will in all likelihood lose the ability to scrutinise BT’s regulatory accounts that has proved so important in providing a mechanism for identifying excessive charging by BT.



Verizon regrets that Ofcom has not taken the opportunity to look strategically at how it can improve the regulatory environment to make the business market more competitive and work for alternative operators and users alike.

The remainder of this submission provides the detail to support our key concerns with the current proposals.

Interim pricing

BT's voluntary commitments

Ofcom has been unable to impose new price controls by the time that the current charge controls expire on 30 September 2012. After that date the industry is reliant on BT's voluntary commitments until the new price controls are finally introduced. This is expected to be during the Spring of 2013. During the period from 1 October 2012 until the new charge controls take effect (the "interim period"), BT will not be subject to ex-ante regulation in this market as Ofcom consider that it is not necessary. We strongly disagree with this view.

We set out in the cost orientation section below our view that BT has the ability and incentive to effectively "game" the charge control baskets. This as the proposed charge controls provide BT the flexibility to set prices in such a way as to maximise revenue for BT Group while restricting the ability of competitors to do likewise. Given BT's previous pricing behaviour there can be little doubt that the outcome will be a distortion of competition whereby particular products are priced excessively high or low.

In case there was any doubt about this, it is only necessary to look at BT's voluntary commitments during the interim period. In relation to Ethernet services, BT appears to be reducing Ethernet prices only for niche or rarely used products (eg WES 155 and 622), whereas it is making no changes for products where there is material demand, such as EAD 10 and 100. ✂. On the other hand, Openreach intends to make significant reductions on Ethernet 1 Gig services, where there is arguably the greatest competition from other carriers, and order volumes are comparatively low.

As BT is fully aware of which OCPs buy which wholesale products, it has the ability to discriminate by setting prices in a way which will particularly impact one provider, or a group of providers. ✂.

We are deeply disappointed that Ofcom does not see the need to engage with BT Openreach on this matter, despite our requests for them to do so. Ofcom seems content to rely on BT making token commitments without investigating their true impact.



Ofcom delay

This disappointment is compounded by the fact that the interim period has arisen due to the very considerable delay to Ofcom's publication of the BCMR and LLCC consultations. Ofcom issued a call for inputs back in June 2011, and yet it took a further year to publish its proposals for consultation. During this period the reasons for such delays were not adequately explained and there was no evidence of a desire to keep industry informed on a pro-active basis. We appreciate that this is a significant and complex piece of work. However we really hope that Ofcom has learned lessons from this and takes appropriate steps to better manage future projects and also its communication with its core stakeholders.

Unfortunately, Ofcom's delay means that the industry and end users are effectively penalised by having to rely on BT's highly unsatisfactory commitments until the final Statement is published. We sincerely hope that there will be no further delays in achieving this objective and that Ofcom does everything necessary to reach its final conclusions as swiftly as possible.

Length of charge controls

We would also urge Ofcom to consider setting charge controls which only expire once new charge controls take effect, to avoid future instances of an effectively unregulated "gap" between charge control periods. This would enhance regulatory certainty and consistency and would prevent BT making voluntary commitments which damage the interests of competition.

Cost orientation

Ofcom's proposals do not include a cost orientation remedy, which is a highly unexpected and somewhat baffling provisional conclusion.

Given the history of regulatory disputes brought successfully against BT, Verizon has grave concerns about the way Ofcom seems to have reached its conclusion and the rationale that it considers sufficient to make such a seismic change in this market. We set out details of these concerns below.

Statutory duties

Cost orientation is now a well-established remedy in the UK and well-understood by the relevant stakeholders. Ofcom now proposes to remove it, but has not provided an appropriate explanation as to why it has reached this conclusion.

We consider that Ofcom has failed to properly consider this proposal from the perspective of its statutory duties. In fact the only duty it mentions is proportionality (see below). If considered properly, Verizon holds the view that Ofcom would conclude that this major policy change is not consistent with its statutory duties for the following reasons:

- a. Ofcom's principal duty is "to further the interests of consumers in relevant markets, where appropriate by promoting competition." In terms of competition, the specific design of Ofcom's proposed charge control without any additional constraint will afford enough flexibility to BT to increase prices for services bought largely by its competitors, while keeping prices for services bought by its own downstream divisions relatively low. Whether BT chooses to behave in this way is another matter but it certainly has the ability and incentive to set prices across the baskets in a manner contrary to the interests of competition while remaining compliant with the charge controls as envisaged by Ofcom.
- b. There may also be a detrimental knock-on effect on consumers. In the recent PPC Disputes it was found that in breaching the Basis of Charges Conditions, BT had over-charged OCPs for PPC products which could have had an effect on the prices paid by end users of the services. We draw Ofcom's attention to the Competition Appeal Tribunal ("CAT") view on this specific point:

*"If BT's prices breach the constraints of Condition H3.1, then it follows that BT's customers [...] are paying more than they should for the services they are purchasing from BT and **may well pass these on to the ultimate consumers**"¹ [emphasis added]*

It is hard to see how the ultimate outcome of higher retail prices, for some if not all products, can be in the interest of consumers.

- c. Ofcom is under an obligation to have regard to consistency at section 3(3)(a) of the Communications Act 2003 (the "Act"). This change of policy is not consistent with what has gone before, nor is it backed up by good reason (see below). Indeed it appears that Ofcom has entirely

¹ Paragraph 3.23 of the main CAT judgment in the PPC dispute
http://catribunal.org/files/1146_BT_Judgment_CAT5_220311.pdf

failed to consider consistency or to seek to balance it with its other duties.

- d. Ofcom also fails to have due regard to the Community Requirements set out in Section 6 of the Act (of which the duty to promote competition is particularly important).

The meaning of “excessive pricing”

From the analysis that it has carried out, Ofcom has identified that there is a risk that BT may price excessively in the markets under consideration. Ofcom has therefore considered how to prevent this risk, and ultimately concludes that the risk will be sufficiently constrained by the charge control basket and sub-basket caps.²

However, it is striking that at no point in either the BCMR or LLCC consultation documents does Ofcom define exactly what it means by excessive pricing. Therefore the first observation under this heading is that it is impossible for any stakeholder to make a fully informed assessment of whether Ofcom proposals will meet their objectives.

It might be reasonable to assume that, in considering excessive pricing and how it might be avoided, Ofcom had in mind the first order test that it typically employs when assessing compliance with the current Basis of Charges obligation. In other words, prices that are set consistently above DSAC (on a non-mechanistic basis) might be considered excessive.

This view is supported by the CAT in recent statements on the matter:

*“It is clear, therefore, that there was an implicit expectation that if Condition H3.1 were to be breached by BT, adverse economic consequences would follow.[...] As we noted in the preceding paragraph, **the whole point of Condition H3.1 was to prevent BT from using its significant market power to maintain prices at an excessively high level.**”³ [emphasis added]*

The obvious question to ask is therefore, how will the proposed new regime constrain BT from charging prices that have previously been deemed excessive?

Ofcom’s view is that this constraint flows from the design of the charge control structure (including sub-baskets and sub-caps). However, it is not made clear how this will happen given that the structure is similar to that currently in effect

² Paragraph 5.12 of the LLCC consultation

³ Paragraph 323 of the main CAT judgment in the PPC dispute



and there do not appear to be any substantive changes within the structure of the charge control itself which are specifically aimed at providing this constraint.

It is also unclear from the documents whether Ofcom still considers that prices should be reflective of costs for each and every product, or whether it simply expects prices to be constrained when the overall basket is considered in aggregate. The economic analysis conducted on behalf of UKCTA sets out in detail why it is not realistic to expect the prices for each and every product to be constrained under the new proposals. Yet Ofcom has not provided any evidence or reasoning as to why it considers that it is no longer necessary to constrain prices in this way (if indeed it now holds this view).

Historical disputes on Basis of Charges Condition

The discussion on removal of cost orientation as a remedy in these markets needs to be seen against the backdrop of BT's previous behaviour in terms of compliance with its cost orientation obligations. Ofcom is of course well aware of the recent disputes in which it found that BT had overcharged OCPs for PPCs by huge amounts, and has provisionally reached similar conclusions in relation to Ethernet services at various bandwidths.⁴

In both cases BT showed a lack of regard bordering on contempt for the need to ensure that it was able to demonstrate to Ofcom its compliance with the Basis of Charges condition. This was compounded by its failure to provide accurate or timely regulatory reporting information. Before Ofcom was even able to assess compliance, it was therefore forced to conduct a wholesale review of the accounts, which led to significant adjustments and restatements. In short, BT has shown itself to be entirely unwilling to behave in an appropriate manner where it is subject to the constraints of a charge control and a cost orientation obligation.

Ofcom must surely appreciate that OCPs are therefore extremely concerned and indeed baffled by the proposal to remove any constraint on BT in the markets under review. Indeed if anything it should be enhancing its scrutiny and enforcement of BT's compliance with its obligations. We fail to see what specifically in the revised charge control structure will prevent BT engaging in the behaviour that was the subject of the recent disputes. The previous 2009 LLCC had a similar mix of sub-baskets and sub-caps, and it failed to prevent BT pricing excessively – so what is the silver bullet that will prevent it this time?

⁴ Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT's charges for partial private circuits

http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/ppc_final_determination.pdf

Draft determination of PPC higher bandwidth disputes:

http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet_services/summary/ppc.pdf

Draft Determinations to resolve disputes regarding BT's charges for Ethernet services:

<http://stakeholders.ofcom.org.uk/consultations/charges-ethernet-services/>

http://stakeholders.ofcom.org.uk/binaries/consultations/prov-deter-cw-bt-ethernet/summary/amended_010312.pdf

http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-verizon-bt-wes/summary/WES_Dispute.pdf



Charge controls in the absence of cost orientation

We consider that, given the changes in the UK business connectivity market that are envisaged by Ofcom, a charge control alone may not meet its desired objectives. We briefly describe our reasons for this view below.

First, by definition the charge control is speculative because it is forward-looking. It relies completely on costs being forecast accurately for the full period of the control. Ofcom and the industry hope that all of Ofcom's calculations and assumptions are correct, but there is simply no guarantee of this and it is by no means a foregone conclusion that prices will align fully with costs.

Second, the baskets are arguably wider than in the 2009 LLCC, in some cases extending across particular economic markets. Ofcom appears to place significant emphasis on the ability of BT to have maximum flexibility in deciding how to recover costs. While BT should not be constrained unduly, its previous behaviour suggests strongly that it will look to exploit the flexibility to the detriment of OCPs.

Ofcom has placed excessive weight on the desirability of allowing flexibility to BT, at the expense of the interests of competition and of end-users. In doing so, Ofcom has failed to pay sufficient attention to the risks in allowing BT flexibility. For example, for such flexibility to result in efficient (Ramsey-type) pricing outcomes, both Ofcom (in designing baskets) and BT (in implementing its pricing) would need to have excellent knowledge of the elasticities of different products. Yet there is no suggestion Ofcom has even considered this point. In *Calls to Mobiles (2003)*⁵ the Monopolies and Mergers Commission (MMC) noted that Oftel had not produced any econometric evidence of elasticities, in the absence of which it would be inappropriate to attempt to apply a Ramsey approach:

If prices... were to be set... at Ramsey levels, that is, at levels which reflect customers' price sensitivity to different products or services, then the relative price elasticities of these services would need to be established

Similarly, the MMC found that there was no reliable way of establishing price elasticities by the actual players in the market in such a way as could inform an efficient approach to pricing:

we were not satisfied that there was any way of establishing reliable estimates of elasticities of demand... with enough precision to inform

⁵ Monopolies and Mergers Commission: Vodafone, O2, Orange and, T-Mobile, Reports on references under section 13 of the Telecommunications Act 1984 on the charges made by Vodafone, O2, Orange and T-Mobile for terminating calls from fixed and mobile networks (published 18 February 2003). We note Ofcom's comments in the LLCC consultation (§6.23, FN185) about the CC's ruling on the last LLCC appeal; but those comments were made about baskets which were backed by a cost orientation obligation and are therefore distinguishable.



pricing decisions. Hence, we believe that there are problems in calculating reliable Ramsey prices

Note that this ruling was in the comparatively simple world of voice telephony services. The issues under consideration here – using multiple technologies, with a huge variety of end uses, and with baskets cutting across economic markets – are much more complicated. We would expect that Ofcom would need a very good reason indeed to depart from the approach set in this decision by the MMC. We would expect to see compelling evidence which would need to include:

- econometric analysis to back-up the basket structure and the values for X; and
- empirical data to support the idea that BT is in fact capable of pricing efficiently.

None of this is given in the consultations.

Third, we have concerns at the level of scrutiny and checks that BT may be subject to in order to determine whether it is meeting the envisaged glide path. It appears from the Annex to the LLCC⁶ that BT is required to take “all reasonable steps” to meet the controlling percentages, but it is not clear what this means in practice or how Ofcom intends to verify BT’s activity in this respect.

Rationale for Ofcom’s decision

As indicated above, the Basis of Charges obligation is well-established and understood by both BT and the rest of the industry. Indeed its meaning and practical application have been exhaustively scrutinised over the last few years. Ofcom’s proposal to remove it (or not to re-impose it) in the new price control package is a major change and signals a significant shift in thinking and policy. It signals that Ofcom intends to adopt a new tone in the way that it oversees and scrutinises operators with SMP, at least in the market under review. Without question, this is a major departure from where we are today, and its impact will be immediate and considerable. We are therefore greatly surprised and indeed alarmed by the striking lack of rationale for this proposal that Ofcom has set out in its documents. It is beyond belief that Ofcom considers the justification that it sets out is even close to adequate.

Ofcom’s arguments in support of such a radical change are, in the main, set out in a single paragraph of the LLCC – namely paragraph 5.72. These can be summed up as follows:

⁶ See page 145 of the LLCC Annex

- The absence of cost orientation will enhance regulatory certainty;
- The control is intended to bring prices in line with costs by the end of the control period; and
- The basket structure and sub-baskets can deal with excessive pricing and are focussed on areas where Ofcom believes there are specific excessive-pricing concerns; therefore imposition of cost orientation obligations would be disproportionate.

We consider that these are very weak arguments. Taking them in turn:

- In terms of certainty, we would argue that the Basis of Charges obligation is well understood and as indicated above it has been the subject of lengthy analysis not just by BT and industry, but by Ofcom and the courts. All relevant stakeholders are fully aware of how it works and what the respective obligations are. There is no basis to suggest that suddenly removing it will somehow improve certainty or that its continued inclusion would make things less certain. That is simply not the case.
- *"The control is intended to bring prices in line with costs by the end of the control period"*. This is more a factual statement rather than an argument as to why cost orientation should be omitted. In any event, as explained above, the charge control on its own does not effectively control prices at the beginning of the period; and it assumes that the forward-looking view, taken now, of BT's costs at end-March 2016 is correct. This is almost never going to be the case.
- *"The basket structure and sub-baskets can deal with excessive pricing, and cost orientation would be disproportionate."* This is highly inconsistent with Ofcom's previous approach to this matter in the 2009 LLCC. As explained above, the baskets proposed by Ofcom are not materially different from those of the previous price control, when Ofcom considered cost orientation was necessary. Further, the sub-baskets on the whole deal only with comparatively small parts of the control and prices could fluctuate significantly within the basket. For example, the overall Ethernet control is RPI-12%, but the Ethernet "all other services" sub-basket is RPI-RPI. Already, this leaves a potential 12% differential between some Ethernet services.



- Turning to proportionality; Ofcom has not explained why it considers cost orientation to be disproportionate. BT is well aware of its obligations and it should no longer be in any way problematic for BT to do what is necessary to comply. If it did so, there would no longer be the need for Ofcom to resolve the type of disputes that have arisen regarding the Basis of Charges obligation. In any event Ofcom should be considering what is in the interests of consumers and competition ahead of any burden that may fall on BT (or the regulator for that matter). If Ofcom is suggesting that it would be disproportionate to impose cost orientation on BT because it would further constrain its prices, it is only necessary to look at the gap between DLRIC and DSAC for most products. The gap provides plenty of flexibility, and indeed Ofcom points out that in some instances prices are currently below the DSAC level.

Ofcom has taken the time and effort to go into considerable detail about how and why it has reached its conclusions in most areas, even when addressing relatively minor points of analysis. Yet with arguably the biggest single conclusion it has reached, which will have a fundamental bearing on the future of the market (and potentially the number of players in the market), it offers less than one substantive page of (very weak) reasoning. This is truly incomprehensible and Ofcom needs to revisit how it arrived in this position as a matter of urgency.

Transparency

We are also aware that Ofcom issued a call for inputs earlier in the year on cost orientation and regulatory accounting (to which Verizon provided a response) – and that Ofcom intends to issue a consultation on one or both elements of this work shortly. We would be very concerned if Ofcom were to introduce new thinking on these areas which is omitted (either unintentionally or deliberately) from the BCMR and LLCC documents. If so, this would appear to raise very serious issues about Ofcom's processes, decision-making and transparency. It is essential, in order for Ofcom to meet its public law obligations in relation to consultation, that the matters being considered by Ofcom are considered in full in this consultation, so that stakeholders may comment on them.

We also are highly concerned that Ofcom's proposals will lead to an end to BT's publication of cost accounting information, which has historically proved crucial to industry in scrutinising BT's behaviour. We cannot understand why Ofcom is content to see BT providing less accountability in the future, given what has gone on in the past. Even if the cost orientation remedy falls away, there is a need for BT to provide adequate reporting, not only to Ofcom but also to the industry. To



do otherwise moves further away from the objective of regulatory certainty which Ofcom recognises is important in paragraph 5.72 of the LLCC document.

In this respect it is interesting to note that in the 2004 Regulatory Financial Reporting obligation statement, Ofcom also note the importance of such reporting obligations for charge controls as well as cost orientation:⁷

“Examples Ofcom requires good-quality financial information from dominant providers, in order to inform decisions and actions, include:

- the need for a dominant provider to demonstrate its compliance with conditions for cost orientation and non-discrimination;*
- investigations into potential breaches of conditions, including potential anticompetitive practices, either based on complaints received or on Ofcom’s own initiative;*
- monitoring obligations to ensure compliance with conditions, including deterring anti-competitive practices; and*
- **setting and monitoring price controls**” (emphasis added)*

It is not entirely clear whether BT’s cost accounting obligations will fall away as a result of Ofcom’s proposals. However it is difficult to see why, if BT does continue to produce cost accounting information for Ofcom’s purposes anyway, it should not be expected to disclose the information to other interested parties.

Geographic Markets – WECLA

Verizon strongly disagrees with Ofcom’s view on the degree of competition that exists in the Western, Eastern and Central London Area (WECLA). In our view, such an assessment is based on a flawed analysis of the competitive conditions in WECLA, largely due to distortions introduced by the approach Ofcom adopted in reaching such a conclusion.

By considering the entire WECLA as a single entity, Ofcom has misconstrued the competitive landscape by allowing the competitive conditions that appertain in the CELA to skew the overall competitive conditions that exist in the additional western zone of the newly designated WECLA. Ofcom should have undertaken a disaggregated analysis of the part of the WECLA which is not in the CELA, before considering whether competitive conditions across the WECLA as a whole were homogenous.

⁷ Paragraph 2.24 of the 2004 Regulatory Financial Reporting obligation statement.
http://stakeholders.ofcom.org.uk/binaries/consultations/fin_reporting/statement/finance_report.pdf



If Ofcom rejects this view then it should disclose disaggregated information about the extension area only in order to justify its findings. What is currently provided in the BCMR consultation document is data for the CELA as a whole and for the WECLA as a whole. What is required if Ofcom continues with its current proposals is for Ofcom to disclose the information which supports tables 25 and 26 of the BCMR consultation document but for the area of the WECLA which is not part of the CELA. Such a degree of transparency is necessary in order to demonstrate that the proposed de-regulation is based on solid facts and a true representation of the competitive landscape.

Verizon simply does not accept that there is a similar high density of business customers and network build by market players for the extended WECLA mapped out by Ofcom as there is in the Central and East London area.

We believe that a more accurate assessment of competitive conditions, based on a disaggregated approach, 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.

Dark Fibre

Verizon would urge Ofcom to give greater consideration to the general issue of passive remedies and in particular to the benefits that a regulated dark fibre offering would have for customers as a result of the increased level of competition.

With the emerging importance of 'cloud' services, the issue of access to data centres is becoming a critical issue and this is one area where a regulated dark fibre offering would be of particular value. For example, there are situations, and they are increasing as more and more data centres are developed, where access is required to data centres in areas where OCPs do not have infrastructure. In order to offer service in such situations the only available option, other than to extend the network which under most circumstances would not be cost effective, would be to rent a leased line product from BT/Openreach. However, such a solution could suffer from the issues of distance limitations and expensive connection and rental charges, in addition to the problem that a leased line may restrict the type of product that can be delivered to customers due to technical constraints. The ability to obtain dark fibre from BT would resolve all of these issues and the increased level of competition would result in a downward pressure on prices, greater consumer choice and ultimately better customer outcomes.

The option to extend the network mentioned above is, except in exceptional circumstances, not a viable option. Ofcom should clearly understand that dig decisions are not solely based on a simple matter of length of dig, which appears to be the major factor considered by Ofcom in the BCMR consultation. It is simply not the case that operators will base network build decisions on whether or not the dig distance required is less than 200 metres, such decisions; dig distances are one element for consideration but are not ultimately determinative.

RPI v CPI

We now consider the approach taken by Ofcom with regards to deciding in favour of an RPI-X price cap linked to the RPI inflation index. In comparison to the previous charge control review, a more thorough explanation as to why the charge control should continue to be linked to the RPI index was provided within the consultation document; however we disagree with the rationale for following reasons:

First, Ofcom's main reasons for retention of RPI remain focused on familiarity⁸ and continuity,⁹ regardless of the commercial and wider economic implications. (As something of an aside, it does not seem appropriate that Ofcom chooses to cite these factors given that it clearly does not see them as important in determining the merits of a cost orientation obligation). The WBA charge control statement calls for the "need for consistency "between the indexation of the price control and basis for establishing an allowed return"¹⁰.

However, the RPI is recognised as more volatile than the CPI (see point three below) and it is also a poorer indicator of trends. The graph¹¹ below (Fig.1) compares the percentage changes over 12 months between the RPI and CPI up until July 2012. It shows that the RPI increased by 0.4 percentage points between June and July 2012 compared with a rise of 0.2 percentage points for the CPI for the same period. The larger rise attributable to RPI is due to the weighting differences, the impact of mortgage interest payments and housing price depreciation, and other differences between the two indexes with regards to coverage of goods and services. The Bank of England has used the CPI to assess the level of inflation within the UK since 2003, as it facilitates a better reflection of the "changes in consumer spending patterns relative to changes in prices of goods and services"¹². It is therefore questionable as to why the price

⁸ Leased Line Charge Control Consultation, paragraph 3.15

⁹ Leased Line Charge Control Consultation, paragraph 3.19

¹⁰ WBA CC statement paragraph 4.9

¹¹ ONS Graph showing Retail Prices Index compared with Consumer Prices Index
<http://www.ons.gov.uk/ons/rel/cpi/consumer-price-indices/july-2012/stb---consumer-price-indices---july-2012.html#tab-Retail-Prices-Index--RPI--compared-with-Consumer-Prices-Index--CPI--->

¹² ONS Report on the Differences between the RPI and CPI Measures of Inflation, page 2 www.ons.gov.uk/ons/guide-method/user-guidance/prices/cpi-and-rpi/differences-between-the-rpi-and-cpi-measures-of-inflation.pdf

controls should continue to be linked to an inappropriate index which uses irrelevant factors such as the mortgage interest rates which contribute to its instability.

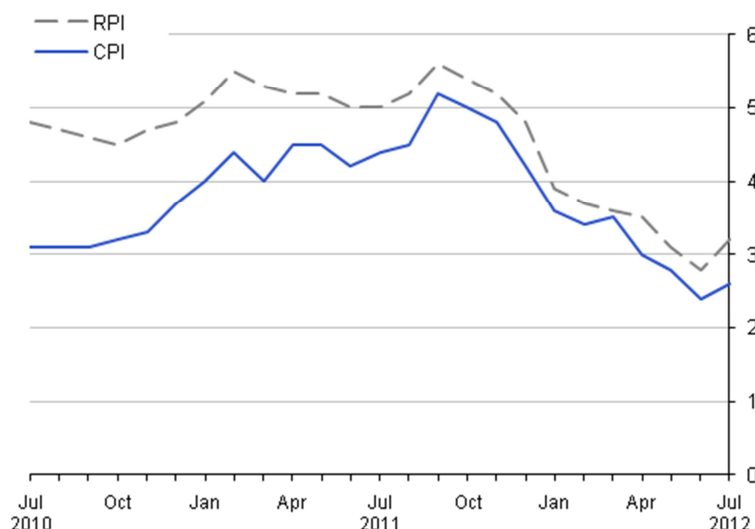


Figure 1 ONS Graph showing Retail Prices Index compared with Consumer Prices Index

Secondly, Ofcom seeks to support the argument in favour of maintaining stability by referring to a report by the Competition Commission (CC) in 2007. The report says that there is “no regulatory precedent in the UK for changing from the RPI index ... precedent favours RPI”¹³. However, the economic picture has greatly changed since 2007, for example, the Government has now changed the inflation indexation on pensions to be linked to the CPI.

Thirdly, CPI has recently been found to be an appropriate measure by the Court of Appeal. The decision taken by the Government to move the annual indexation of public service pensions to the CPI was challenged at the Court of Appeal and was found to be lawful. The Court of Appeal assessed the differences between the two inflation indexes and found CPI to be “used as an inflationary measure in many other European countries, and so it was a better measure of inflation than RPI a better measure of changes in prices than RPI less volatile than RPI, and unlike RPI it would not have produced an unrealistic negative inflation rate for the year to September 2009.”¹⁴ These clearly identify reasons in favour of moving away from the established status quo.

¹³ Competition Commission report paragraphs 3.21 & 3.22 - A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd) http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2007/fulltext/532

¹⁴ R. (on the application of Staff Side of the Police Negotiating Board) v SOS for Work and Pensions [2012] EWCA Civ 332 paragraph 73 <http://login.westlaw.co.uk/maf/wluk/app/document?&suppsrguid=ia744c09700000139438608a101a858d6&docguid=111156930747F11E1854A832195C87DDC&hitquid=IEF12075072EC11E186A3FF676EA0C302&spos=1&epos=1&td=1&crumb-action=append&context=4&resolvein=true>



Finally, Ofcom has sought to identify some supposed practical difficulties of moving away from RPI inflation indexation¹⁵ by reference to the RPI-X@20 review Recommendations Consultation document. This document highlighted that “corporate and government index-linked bonds continue to use RPI as the relevant index. We [...] use information on the yields from RPI-indexed bonds when we assess a fair level for the allowed return on the RAV.”¹⁶ However, the consultation document also said that “there is a case for moving to CPI”. We appreciate that there are practical issues that regulators must consider with a move to CPI, however when balanced against the economic gains we do not think that these difficulties should be the determining factor. We submit that despite the complexities of change, in the long run CPI inflation indexation would create a more stable economic outcome.

In terms of achieving a more accurate and representative measure of inflation, CPI appears far superior to RPI inflation indexation. We therefore strongly urge Ofcom to reconsider its approach on this matter.

Verizon Enterprise Solutions
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¹⁵ Leased Line Charge Control Consultation, paragraph 3.20

¹⁶ Ofgem Recommendation Consultation 'RPI-X@20 review and the RIIO model for network regulation' paragraph 5.9
<http://www.ofgem.gov.uk/NETWORKS/RPIX20/CONSULTDOCS/Documents1/RPI-X@Recommendations.pdf>