



Dispute between Verizon and BT relating to BT's charges for WES

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Section 1

Summary

- 1.1 This document (the "Provisional Conclusions") sets out for comment the main elements of our provisional reasoning and assessment of the matters in dispute.
- 1.2 This dispute (the "Dispute"), brought by Verizon¹ against BT (collectively the "Parties"), relates to BT's charges to Verizon for certain Wholesale Extension Services ("WES"), which are types of Ethernet services. Verizon alleges that between 1 April 2006 and 31 March 2011 (the "Relevant Period") BT failed to comply with its relevant cost orientation obligation (SMP Condition HH3.1), with the result that BT overcharged Verizon for the following WES services:
 - 1.2.1 WES/WEES² 10 rental (including Local Reach and Managed variants);
 - 1.2.2 WES/WEES 100 rental; and
 - 1.2.3 WES/WEES 1000 rental (including LAN/SAN and Extended Reach variants).
- 1.3 Verizon considers that BT should be required to repay the amount overcharged, plus interest.
- 1.4 We are already considering all of the services that are in dispute between BT and Verizon in resolving the *Disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services* (CW/01055/08/10) (the "Ethernet 1" disputes) and the *Dispute between Cable & Wireless and BT about BT's charges for Ethernet services* (CW/01708/11/11) (the "Ethernet 2" dispute). These disputes concern the level of BT's charges for certain WES and BES³ services over periods between 24 June 2004 and 31 July 2009 (Ethernet 1 disputes) and between 1 April 2006 and 31 March 2011 (Ethernet 2 dispute).
- 1.5 Where Verizon is in dispute with BT about the same services in the same years as we are considering in the Ethernet 1 and/or Ethernet 2 disputes, we have reached a consistent provisional conclusion on whether BT has overcharged Verizon, except in relation to WES1000 in 2010/11 (see paragraph 1.8 below). As set out in Table 1.1 below, Ofcom has reached provisional conclusions in the Ethernet 1 and/or the Ethernet 2 disputes in relation to whether BT overcharged for WES100 rental and WES1000 rental over the whole of the Relevant Period, and in relation to whether BT overcharged for WES10 rental in 2008/09.
- 1.6 Where Verizon is in dispute with BT in relation to years that we are not already considering, we are proposing to adopt the same approach to assessing overcharging that we have followed in the Ethernet 1 and Ethernet 2 disputes. In the Ethernet 1 disputes we analysed revenue and cost data for WES10 rental for the period 2006/07 to 2009/10 but we only reached a provisional conclusion in relation to

¹ Trading as Verizon Business.

² BT's website describes WEES (Wholesale End to End Services or Wholesale End to end Extension Services) as "an end user to end user version" of WES (<http://www.openreach.co.uk/orpg/home/products/ethernetservices/wholesaleextensionservices/wes.d>o). WEES is a link between two customer sites, whereas WES is a link between a customer site and the purchasing CP's network.

³ Backhaul Extension Services

2008/09 as the service was only in dispute in this year. We have not previously analysed financial data for WES10 rental in 2010/11.

- 1.7 Accordingly, much of the analysis in our Draft Determinations of the Ethernet 1 disputes⁴ (the "Ethernet 1 Draft Determinations") and Provisional Determination of the Ethernet 2 dispute⁵ (the "Ethernet 2 Provisional Determination") is also relevant to this Dispute and we refer to those documents throughout these Provisional Conclusions. Stakeholders are invited to comment on the Ethernet 1 Draft Determinations and Ethernet 2 Provisional Determination by 5pm on 20 April 2012.
- 1.8 As set out in Table 1.1 below, we provisionally concluded in the Ethernet 2 Provisional Determination that BT overcharged customers for WES1000 rental services in 2010/11. BT has since provided us with further information in relation to the adjustment for development costs that we proposed to make in the Ethernet 2 Provisional Determination. Following consideration of that information, we provisionally conclude in these Provisional Conclusions that we should not make an adjustment for development costs in 2010/11. Based on this revised financial information, we provisionally conclude that BT did not overcharge for WES1000 rental in 2010/11. We discuss the new information further at paragraphs 5.47-5.49.

Table 1.1 Provisional conclusions in Ethernet 1 Draft Determinations and/or Ethernet 2 Provisional Determination

Services disputed by Verizon	2006/07	2007/08	2008/09	2009/10	2010/11
WES10 rental	*	*	Overcharge Ethernet 1	*	**
WES100 rental	Overcharge Ethernet 1 and 2	Overcharge Ethernet 1 and 2	Overcharge Ethernet 1 and 2	Overcharge Ethernet 2	No overcharge Ethernet 2
WES1000 rental	Overcharge Ethernet 1 and 2	Overcharge Ethernet 1 and 2	Overcharge Ethernet 1 and 2	Overcharge Ethernet 2	Overcharge Ethernet 2

* In the Ethernet 1 Draft Determinations, Ofcom presented cost and revenue data for WES10 rental for the period 2006/07-2009/10, but only reached a provisional conclusion in relation to 2008/09 as this is the only year for which BT's WES10 rental charge is in dispute between the parties in that case.

** Ofcom has not previously assessed WES10 rental in 2010/11.

Ofcom's provisional assessment of the matters in dispute

- 1.9 Our provisional assessment in this Dispute is that:
- 1.9.1 BT has not demonstrated to our satisfaction that all its charges for the WES in dispute were cost orientated over the Relevant Period;
- 1.9.2 we have therefore undertaken our own assessment of whether BT's charges were cost orientated by first comparing charges with their relevant DSACs

⁴ Published on 9 February 2012. See:

<http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>

⁵ Published on 23 February 2012 and reissued on 1 March 2012 with additional data included. See http://stakeholders.ofcom.org.uk/binaries/consultations/prov-deter-cw-bt-ethernet/summary/amended_010312.pdf

and then taking account of other factors to avoid a mechanistic approach to our assessment;

- 1.9.3 where BT's charges for the services in dispute were not cost orientated, we consider that there has been an overcharge;
- 1.9.4 our provisional view is that BT has overcharged for some of the WES charges in dispute over the Relevant Period;
- 1.9.5 BT has overcharged Verizon a total of £[~~8~~]; and
- 1.9.6 BT is required to make a repayment to Verizon of the amount overpaid.

Structure of the remainder of this document

- 1.10 In line with Ofcom's Dispute Resolution Guidelines (the "Guidelines"),⁶ this document sets out for comment the main elements of our provisional reasoning and assessment in relation to the matters in dispute.
- 1.11 The introduction and background to this Dispute are set out in **section 2** and the analysis underpinning our provisional reasoning and assessment is set out in **sections 4-6**. **Section 7** sets out the overcharge and repayment. Our provisional determination is set out at **Annex 3**, relevant cost standards are explained at **Annex 4** and a glossary of terms is set out at **Annex 5**.

Next steps

- 1.12 Interested parties have until **5pm on 23 April 2012** to comment on this document. After considering any comments received, Ofcom will make a final determination. Details of how to respond are set out in **Annexes 1-2**.

⁶ *Dispute Resolution Guidelines*, 7 June 2011. See: <http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-resolution-guidelines/statement/guidelines.pdf>.

Section 2

Introduction and background

Issues in dispute

- 2.1 This Dispute was referred to Ofcom for resolution by Verizon on 22 February 2012.⁷ It concerns the level of BT's charges for certain WES Ethernet services over the Relevant Period.

Legal framework for resolution of the Dispute

- 2.2 The relevant legal framework is described in Section 2 of the Ethernet 1 Draft Determinations, with one difference. As the Dispute was referred to Ofcom and Ofcom decided it was appropriate to handle it after 26 May 2011, the Dispute falls under section 185(1A) of the 2003 Act, which was inserted into the 2003 Act by the Electronic Communications and Wireless Telegraphy Regulations 2011. This is because it concerns the terms on which BT provides Network Access⁸ to Verizon, and that network access is required to be provided by or under a condition imposed under section 45 of the 2003 Act (Condition HH3.1, set out below).

BT's cost orientation obligations

- 2.3 Section 4 of the Ethernet 1 Draft Determinations describes the history of BT's cost orientation obligations. Readers are referred to those sections, and we have included in paragraphs 2.4 to 2.8 below a shorter summary.
- 2.4 In its 2004 Leased Lines Market Review ("LLMR 2004")⁹, Ofcom found that BT had significant market power ("SMP") in the AISBO market (which includes the provision of wholesale Ethernet services). Ofcom therefore imposed SMP conditions on BT in that market ("Conditions HH"), including:
- 2.4.1 a requirement to provide Network Access on reasonable request (Condition HH1);
 - 2.4.2 a requirement not to unduly discriminate (Condition HH2); and
 - 2.4.3 a basis of charges (cost orientation) obligation (Condition HH3.1) which requires that:

"Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach"

⁷ Verizon supplemented its initial reference with additional submissions on 2 March 2012 and 13 March 2012.

⁸ As defined in section 151 of the 2003 Act.

⁹ *Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*: http://stakeholders.ofcom.org.uk/binaries/consultations/llmr/statement/state_note.pdf.

and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.”¹⁰

- 2.5 In December 2008, Ofcom published the Business Connectivity Market Review Statement (“2008 BCMR Statement”)¹¹ which defined two separate markets for AISBO services: a low bandwidth market (including Ethernet services up to and including 1 Gbit/s) and a high bandwidth market (including Ethernet services with bandwidths above 1 Gbit/s). Ofcom concluded that BT has SMP in the market for low bandwidth AISBO services and that no CP has SMP in the high bandwidth AISBO market.
- 2.6 In the 2008 BCMR Statement, Ofcom imposed a number of SMP conditions on BT in the low bandwidth AISBO market.¹² Conditions HH1, HH2 and HH3.1 were re-imposed on BT, but only in relation to the low bandwidth AISBO market. The wording of Condition HH3.1 remained as set out at paragraph 2.4.3.
- 2.7 Ofcom also concluded in principle that it was appropriate to impose a charge control in relation to low bandwidth AISBO services (Condition HH4). This charge control was set in a statement published on 2 July 2009 (the “2009 LLCC Statement”)¹³ and came into force on 1 October 2009.¹⁴
- 2.8 Condition HH3.2, imposed in the 2008 BCMR Statement, provides:
- “For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by Condition HH1 is for a service which is subject to a charge control under Condition HH4, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition HH3.1.”*
- 2.9 BT's low bandwidth WES (up to and including 1 Gbit/s) services have therefore been subject to Condition HH3.1 from 2004.

BT's financial reporting obligations and BT's LRIC model

- 2.10 BT is also subject to an SMP obligation to publish detailed financial statements, known as BT's Regulatory Financial Statements (“RFS”).¹⁵
- 2.11 Section 5 of the Ethernet 1 Draft Determinations describes in further detail BT's regulatory financial reporting obligations, and BT's LRIC model and its application.

¹⁰ Annex D to the LLMR 2004.

¹¹ <http://stakeholders.ofcom.org.uk/binaries/consultations/bcmr08/summary/bcmr08.pdf>

¹² From 8 December 2008, BT was no longer subject to SMP conditions in the high bandwidth AISBO market.

¹³ <http://stakeholders.ofcom.org.uk/binaries/consultations/llcc/statement/llccstatement.pdf>. The 2009 LLCC Statement was appealed to the CAT, which referred certain price control matters to the Competition Commission (“CC”). The CC issued a determination (http://www.competition-commission.org.uk/assets/bispartners/competitioncommission/docs/pdf/non-inquiry/appeals/communications_act/final_determination_excised_version_for_publication.pdf) which resulted in the CAT directing Ofcom to make a number of changes to the charge control. Ofcom published a revised charge control on 14 October 2010 (http://stakeholders.ofcom.org.uk/binaries/consultations/llcc/statement/LLCC_decision_final.pdf).

¹⁴ The starting charge adjustment to the price of 1 Gbit/s BES rental services came into force on 1 August 2009.

¹⁵ *The Regulatory Financial Reporting obligations on BT and Kingston Communications final statement and notification*, 22 July 2004:

http://stakeholders.ofcom.org.uk/binaries/consultations/fin_reporting/statement/finance_report.pdf

An understanding of these facts is also relevant to Ofcom's proposed conclusions in relation to this Dispute.

Wholesale Ethernet products

- 2.12 Section 6 of the Ethernet 1 Draft Determinations describes what BT's wholesale Ethernet service products are and how BT charges for WES products. WES can be provided in different bandwidths starting from 10 megabits per second, and the products are known by acronyms made up of the type of service and the bandwidth, e.g. "WES10" for 10 Mbit/s, "WES100" for 100 Mbit/s.
- 2.13 BT's charges for mainlink, connection and rental services for WES at different bandwidths have been set out individually in the Openreach Price List ("OPL") throughout the Relevant Period, e.g. separate WES100 rental charges and WES100 connection charges are listed. The Openreach Price List is publicly available on the Openreach website.¹⁶ Readers are particularly referred to paragraphs 6.14 to 6.20 of the Ethernet 1 Draft Determinations.¹⁷

Issues in dispute

Verizon's submission

- 2.14 In its dispute reference of 22 February 2012, Verizon stated that between 1 January 2007 and 31 March 2010 BT had "*failed to comply with the relevant regulatory obligations imposed on it for provision of WES, in particular cost orientation obligations*"¹⁸ and that "*As a result, BT overcharged Verizon*"¹⁹ for the WES services it purchased from BT.
- 2.15 Verizon stated that:
- "We consider that the issues raised in the [Ethernet 1 Draft Determinations], and Ofcom's provisional thinking on these issues, are directly relevant to Verizon's claim against BT and that Ofcom should adopt a similar approach in resolving the Dispute [between BT and Verizon]".*²⁰
- 2.16 Verizon notes the "*high degree of overlap*"²¹ between the services and periods in which it considers it has been overcharged by BT and those considered in the Ethernet 1 Draft Determinations. Verizon also notes that "*[i]t is not contested by BT that Verizon was one of its customers for these products during the period under consideration in the [Ethernet 1 Draft Determination]...it follows logically from Ofcom's provisional thinking that Verizon...are entitled to appropriate repayment for these products.*"²²
- 2.17 Verizon states that "*our approach to assessing BT's compliance has been to consider whether BT's prices exceeded the relevant DSAC figure per financial quarter*".

¹⁶ The OPL price list for WES is available at:

<http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=bj1iaqV2rmVhUxhJRV2ltZ6l6oCf3ew2ZeuZm4VRqG0IMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AIIISgtlFAKw%3D%3D>

¹⁷ The Ethernet 1 Draft Determinations considers charges for BES as well as WES. BES charges are not in dispute in this Dispute.

¹⁸ Verizon submission of 22 February 2012, paragraph 1.

¹⁹ Verizon submission of 22 February 2012, paragraphs 1 and 7.

²⁰ Verizon submission of 22 February 2012, paragraph 2.

²¹ Verizon submission of 22 February 2012, paragraph 23.

²² Verizon submission of 22 February 2012, paragraph 7.

Verizon submits its own calculations of the alleged overcharge, based on the extent to which BT's charges exceeded their relevant DSACs as published in BT's RFS.

- 2.18 Verizon states that, for the purposes of calculating the alleged overcharge, it *"only has access to publicly available information...(it is) therefore reliant to a significant degree on BT's RFS, and (does) not have the ability to consider other factors that Ofcom considers may be relevant"*.²³
- 2.19 On 23 February 2012 Ofcom published the Ethernet 2 Provisional Determination. On 2 March 2012, Verizon wrote to Ofcom asking us, in the current Dispute, to take account of the additional period considered in the Ethernet 2 Provisional Determination (i.e. the 2010/11 financial year). Verizon stated that *"it would not have been realistic for Verizon to include this period within [Verizon's submission of 22 February 2012] because it was not aware of the approach Ofcom would take to this later period"*.²⁴

Verizon's request for Ofcom to make a determination

- 2.20 Verizon requests that Ofcom resolve the Dispute under section 185(1A) of the Act and use its powers under section 190 of the Act to give a direction requiring BT to repay the sum Verizon considers it has been overcharged plus interest, or such other sum as Ofcom may consider appropriate.

BT's comments on Verizon's submission

- 2.21 Ofcom provided a copy of Verizon's submission of 22 February 2012 to BT. BT provided no comments on that submission.
- 2.22 Ofcom provided a copy of Verizon's letter of 2 March 2012 to BT. BT provided no comments on that letter.

Enquiry Phase Meeting

- 2.23 Before holding an Enquiry Phase Meeting ("EPM"), Ofcom issued a pre-EPM questionnaire, to which both parties responded with views on the potential scope of the Dispute. Both parties indicated that they did not consider alternative dispute resolution ("ADR") an alternative means of resolving the Dispute.
- 2.24 On 12 March 2012, Ofcom held an EPM with representatives of Verizon and BT, in order to clarify the principal arguments and facts raised by the Parties and to discuss views on the potential scope of the Dispute.
- 2.25 The parties confirmed that they were in disagreement as to what the relevant period of the Dispute should be.

Further submission and response

- 2.26 On 13 March 2012, Verizon wrote to Ofcom setting out its view that Ofcom should resolve the Dispute taking into account the entire period considered in the Ethernet 2 Provisional Determination, i.e. from 1 April 2006 to 31 March 2011.²⁵ Verizon stated

²³ Verizon submission of 22 February 2012, paragraph 26.

²⁴ Letter from John Hudson (Verizon) to Francesco Savino (Ofcom), 2 March 2012 (the "Verizon 2 March letter").

²⁵ The "Verizon 13 March letter"

that it had bought the relevant WES services from BT during this period and has been in dispute with BT about its charges for the whole period.

- 2.27 Ofcom provided a copy of Verizon's letter of 13 March 2012 to BT. BT provided comments on that letter, stating that *"the relevant period of the dispute must be limited to the period up to 31 July 2009...because it is BT's clear recollection and its understanding that the discussions it held with Verizon were limited to this time period."* BT submitted that *"at most"* the period should be that referred to Ofcom by Verizon on 22 February 2012.²⁶

Accepting the Dispute for resolution

- 2.28 Having considered Verizon's submission and subsequent comments made by both Parties, we were satisfied that the Dispute is a dispute between communications providers within the meaning of section 185(1A) of the 2003 Act.
- 2.29 On the basis of the evidence submitted to us and the discussion at the EPM, Ofcom was satisfied that the parties are in dispute in relation to the period between 1 April 2006 and 31 March 2011.
- 2.30 On 15 March 2012 we informed the Parties of our decision that it was appropriate for us to handle the Dispute for resolution in accordance with section 186(4) of the 2003 Act.

The scope of the Dispute

- 2.31 On 15 March 2012 we published details of the Dispute, including the scope, on the Competition and Consumer Enforcement Bulletin part of our website:

"The scope of the dispute is to determine:

Whether, from 1 April 2006 to 31 March 2011:

- *BT overcharged Verizon for the following rental charges:*
 - WES/WEES10
 - WES/WEES100
 - WES/WEES1000
- *by how much Verizon was overcharged for those services; and*
- *whether, and by how much, BT should reimburse Verizon in relation to the overcharge.*²⁷

Additional comments from the Parties

- 2.32 In response to stakeholder comments on the process set out in our Guidelines, which we have received since their publication, Ofcom now gives the parties to a dispute two weeks to make additional comments after we accept it for resolution.

²⁶ BT letter, dated 14 March 2012.

²⁷ http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01087/

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2.33 We therefore asked the Parties to make any further comments in relation to the Dispute by 30 March 2012.

2.34 We have not received any further comments from the Parties.

Key information relied upon in resolving the Dispute

2.35 In coming to our provisional conclusions, we have relied on submissions made by the Parties outlined above. Additionally we rely on the information provided by Parties in submissions and responses made to information requests as follows.

Information previously provided by BT

2.36 As set out at paragraph 2.39 of the Ethernet 2 Provisional Determination, BT has asked us to take into account in our consideration of the Ethernet 2 dispute all of the submissions and information it has provided to us in relation to the Ethernet 1 disputes. While BT has not made a similar request in relation to the current Dispute, we consider that the submissions and information that BT has provided to us in relation to the Ethernet 1 dispute are also relevant in this case. BT's principal arguments and Ofcom's responses to them are set out in full in the Ethernet 1 Draft Determinations and we refer to them as relevant in these Provisional Conclusions.

2.37 We have also used the following information provided by BT in relation to the Ethernet 1 dispute for the purpose of considering this Dispute:

2.37.1 BT's responses to the section 191 notice dated 22 October 2010 (the "22 October s191 notice");

2.37.2 BT's responses to the section 191 notice dated 16 June 2011 (which also related to the *Disputes between THUS, Cable & Wireless and others and BT regarding BT's charges for Partial Private Circuits* (CW/00992/06/08)) (the "16 June s191 notice");

2.37.3 correspondence between Ofcom and BT relating to a number of supplementary questions/points of clarification which arose from the above notices.

2.38 In addition, we have used the following information provided by BT in relation to the Ethernet 2 dispute:

2.38.1 BT's responses to the section 191 notice dated 22 December 2011 (the "22 December s191 notice");

2.38.2 BT's responses to the section 191 notice dated 20 January 2012 (the "20 January s191 notice");

2.38.3 BT's responses to the section 191 notice dated 24 January 2012 (the "24 January s191 notice");

Information request

2.39 On 20 March 2012 we sent Verizon a notice under section 191 of the 2003 Act (the "20 March s191 notice") asking for Verizon's internal billing data for the services in dispute for each year of the Relevant Period. This was to confirm which WES

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services Verizon bought from BT and over what periods. Verizon responded to this notice on 26 March 2012.

Interested parties

- 2.40 Three stakeholders, Cable & Wireless Worldwide plc, British Sky Broadcasting Limited, and Lancaster University Network Services Ltd have expressed an interest in the outcome of this dispute.

Section 3

Analytical approach

Introduction

- 3.1 The scope of this Dispute is to determine whether BT has overcharged Verizon for certain WES services during the Relevant Period.
- 3.2 As discussed in Section 2, BT is subject to a number of SMP conditions relating to its provision of Ethernet services. In particular, SMP Condition HH3.1 requires BT to secure, and to be able to demonstrate to Ofcom's satisfaction, that each of its charges for WES services is cost orientated.
- 3.3 Our proposed approach to resolving this Dispute is the same as the approach we are proposing to adopt in the Ethernet 1 Draft Determinations and Ethernet 2 Provisional Determination.
- 3.4 We propose to determine this Dispute by determining whether BT's has overcharged for the WES services in dispute.
- 3.5 In the remainder of this Section, we consider:
- 3.5.1 which services we need to consider in our analysis and which charges should be cost orientated; and
- 3.5.2 the approach we propose to take in our analysis of whether BT has overcharged for those services.

Which services are in dispute?

- 3.6 As we consider at Section 7 of the Ethernet 1 Draft Determinations, we first confirm that the Parties are in dispute in relation to the services listed in Verizon's submission.
- 3.7 Verizon's response to the 20 March s191 notice confirmed that it had bought each of the services listed in its submission in each year of the Relevant Period, as set out in Table 3.1 below.

Table 3.1: Services and years in dispute

	2006/07	2007/08	2008/09	2009/10	2010/11
WES10 rental*	X	X	X	X	X
WES100 rental**	X	X	X	X	X
WES1000 rental***	X	X	X	X	X

* includes WEES10, Local Reach and Managed variants

** includes WEES100

*** includes WEES1000 LAN/SAN and Extended Reach variants

Which charges should be cost orientated?

- 3.8 In assessing whether BT's charges in dispute were cost orientated, we go on to consider which charges must be cost orientated. We considered this issue in Section 8 of the Ethernet 1 Draft Determinations and readers are referred to that section.
- 3.9 In the PPC Judgment²⁸ the Competition Appeal Tribunal ("CAT") considered the appropriate level of aggregation for assessing BT's compliance with Condition H3.1, given the requirement (identical to that in HH3.1) that BT secure that "*each and every charge offered, payable or proposed for Network Access*" is cost orientated. The CAT found that Ofcom was correct to consider, discretely, the charges for each separate trunk service.²⁹
- 3.10 In its submission, Verizon refers to Ofcom's considerations in Section 8 of the Ethernet 1 Draft Determinations and to the CAT's findings in the PPC Judgment. Verizon notes the following:
- "We fully agree with Ofcom's clear views on aggregation, in particular its rejection of BT's arguments on the nascent state of the Ethernet market at the time, and the idea of aggregating rentals and connections or mainlink and connection charges. We also fully agree with Ofcom's provisional conclusion at paragraph 8.90 [of the Ethernet 1 Draft Determinations] that there is nothing to suggest that Ofcom should depart from the requirement clearly set out in Condition HH3.1 to resolve the disputes that were in front of it on the basis of a disaggregated assessment of each individual charge in dispute. We would suggest to Ofcom that there is also nothing in the substance of the Dispute that we now submit which would cause it to change its views on aggregation in this respect."*³⁰
- 3.11 BT considers services should be aggregated and that it is the charge for aggregated services that should be considered by Ofcom in assessing cost orientation. BT's arguments are set out in detail in paragraphs 8.17-8.30 of the Ethernet 1 Draft Determinations. In summary, BT argues that Ofcom should not read across the CAT's approach in the PPC Judgment to the Ethernet market. BT considers, first, that we should consider aggregation across the market as a whole. It considers the following factors are relevant in this regard: the absence of aggregation across markets; the absence of a charge control; aggregation in BT's RFS; and the nascent state of the market. Notwithstanding this position BT also argues that we should aggregate connection and rental charges for each bandwidth. BT additionally argues that we should aggregate main link and rental charges.
- 3.12 We propose to consider BT's charges on a disaggregated basis i.e. to consider whether BT has secured that each and every disputed charge is cost orientated. We consider this approach to be consistent with the explicit requirements of Condition HH3.1 and the precedent provided by the PPC Judgment. Ofcom's views, including its responses to the specific arguments made by BT, are set out in Section 8 of the Ethernet 1 Draft Determinations.

²⁸ The CAT's judgment of 22 March 2011 disposing of BT's appeal of Ofcom's determinations ("the PPC Final Determinations") of disputes about the pricing of Partial Private Circuits ("PPCs") (the "PPC disputes"). The PPC Judgment is available at www.catribunal.org.uk/files/1146_BT_Judgment_CAT5_220311.pdf and the PPC Final Determinations at http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

²⁹ See the Ethernet 1 Draft Determinations, paragraphs 8.7-8.13.

³⁰ Verizon submission of 22 February 2012, paragraph 18.

Has BT overcharged Verizon for the services in dispute?

- 3.13 In Section 9 of the Ethernet 1 Draft Determinations we set out how we planned to consider whether BT's charges are cost orientated or not, and how we will resolve the Ethernet 1 disputes if they are not, taking into account the arguments made by the parties. Our approach for resolving this Dispute is the same and readers are referred to the discussion in Section 9 of the Ethernet 1 Draft Determinations.
- 3.14 In summary, given the similarities³¹ between this Dispute, the Ethernet 1 and Ethernet 2 disputes and the PPC disputes, we consider it appropriate to adopt the same approach that we adopted in the PPC Final Determinations,³² which were upheld by the CAT in the PPC Judgment.³³ We consider in Section 9 of the Ethernet 1 Draft Determinations how we will address any differences in the factual circumstances.
- 3.15 In order to determine if BT has overcharged Verizon, we need to assess BT's compliance with its cost orientation obligation in respect of each of the distinct charges in dispute. Condition HH3.1 (like Condition H3.1 which was considered in the PPC Judgment) requires that:
- 3.15.1 first, each and every charge covered by Condition HH3.1 must:
- a) be reasonably derived from the costs of provision based on a forward looking long run incremental cost approach;
 - b) allow for an appropriate mark up for the recovery of common costs; and
 - c) include an appropriate return on capital employed.
- 3.15.2 second, BT must be able to demonstrate this to Ofcom's satisfaction.
- 3.16 In accordance with the PPC Judgment, our assessment of the alleged overcharge essentially involves answering two key questions:
- 3.16.1 has BT demonstrated to our satisfaction that its charges in dispute were cost orientated (i.e. were they based on an appropriate allocation of common costs)? If it has done so, then there is no overcharging. BT is afforded discretion in how it demonstrates that its charges are cost orientated, as long as it can demonstrate to our satisfaction that its chosen approach is appropriate; and
- 3.16.2 if it has not done so, we must ask whether BT's charges were nevertheless appropriate (i.e. based on an appropriate allocation of common costs).
- 3.17 Ofcom considers that DSAC is the appropriate cost benchmark for Ofcom to use in its assessment of whether BT's charges in dispute were cost orientated. BT's views on the use of DSAC as a cost benchmark, and ROCE as an alternative, are set out at paragraphs 9.23 and 9.37 (use of DSAC), and 9.65 to 9.66 (ROCE) of the Ethernet 1 Draft Determinations. Verizon states that having considered Ofcom's reasoning in

³¹ Notably the consistency of the wording of the relevant SMP conditions and the fact that the conditions were all imposed in the same market review for the same time period.

³² http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

³³ www.catribunal.org.uk/files/1146_BT_Judgment_CAT5_220311.pdf

Section 9 of the Ethernet 1 Draft Determinations, its view is that DSAC is the appropriate cost benchmark to use in assessing overcharging in this Dispute.³⁴

3.18 Ofcom considers, however, that the DSAC test should not be implemented in a mechanistic way. In the PPC Judgment the CAT concluded that, although Condition H3.1 (and therefore by implication Condition HH3.1) requires Ofcom to treat prices above DSAC as intrinsically excessive and in breach of the condition,³⁵ *"Ofcom must guard against the possible injustices of a mechanistic application of a test for the allocation of common costs."*³⁶ The CAT considered that *"Ofcom acted appropriately [37] in looking to other factors in addition to the mere fact that DSAC had been breached by BT's prices."*³⁸ Therefore, and consistent with the approach in the Ethernet 1 Draft Determinations,³⁹ we consider in particular:⁴⁰

3.18.1 **the magnitude and duration of the amounts by which charges exceeded DSAC.** As in the Ethernet 1 Draft Determinations,⁴¹ where charges exceeded DSAC in fewer than three financial years (three out of five years being the majority of the Relevant Period), we propose that BT's underlying reasons why BT's charges exceeded DSAC should be given more weight in determining whether it overcharged for its services. However, given the importance of the DSAC benchmark, in order to conclude that a charge that exceeds DSAC does not constitute overcharging due to the circumstances surrounding the pricing decision, we would need BT to provide us with a specific and evidence-based explanation of those circumstances.

3.18.2 **whether, and the extent to which, charges exceeded FAC.** As discussed in the Ethernet 1 Draft Determinations⁴² where charges are above DSAC, we also consider the relationship of charges to FAC to determine whether a charge is nonetheless cost orientated. The use of FAC in this manner can act as a useful cross-check. A charge being above FAC is not intrinsically an indicator that a charge is not cost orientated. However if a charge was above DSAC, and revenues were significantly above FAC, this evidence would corroborate a conclusion of overcharging.

3.18.3 **the rate of return on capital employed.** As discussed in the Ethernet 1 Draft Determinations⁴³ we consider rates of return to be a relevant factor in addition to a comparison of charges against DSAC although caution is needed in its application. We consider that the appropriate WACC is the "rest of BT" WACC (which was between 11% and 11.4% during the Relevant Period).

³⁴ Verizon submission of 22 February 2012, paragraph 19.

³⁵ PPC Judgment, paragraph 307(3).

³⁶ PPC Judgment, paragraph 305.

³⁷ In the PPC Final Determinations.

³⁸ PPC Judgment, paragraph 305.

³⁹ Ethernet 1 Draft Determinations, paragraphs 9.25-9.84.

⁴⁰ We note that the CAT concluded at paragraphs 327 and 329 of the PPC Judgment that *"the need to show economic harm – of any sort – is not a pre-requisite for a finding that Condition H3.1 has been breached"* and therefore *"we do not consider there to be a role for an economic harm test when Ofcom is seeking to assess whether BT has breached Condition H3.1"*. On the basis of the CAT's conclusions we do not consider economic harm in this Provisional Determination.

⁴¹ Ethernet 1 Draft Determinations, paragraphs 9.38 to 9.40.

⁴² Ethernet 1 Draft Determinations, paragraphs 9.49 to 9.64.

⁴³ Ethernet 1 Draft Determinations, paragraphs 9.65-9.83.

3.19 We set out below the three steps we propose to take in the assessment we carry out in Sections 4-6:

Step 1: In Section 4, consider whether the evidence provided by BT demonstrates to our satisfaction that each and every charge was cost orientated in accordance with its obligations under Condition HH3.1. If BT demonstrates this to our satisfaction, we do not need to proceed to carry out the other steps.

Step 2: If BT does not satisfy us in relation to step 1, we shall go on to consider whether BT's charges were nevertheless appropriate, comparing the relevant Ethernet charges with their respective DSACs to identify any charges exceeding DSAC. This is set out in Section 5.

Step 3: Before reaching any conclusions in relation to whether BT has overcharged for the services in dispute, we consider whether there are any other relevant factors which could affect our decision. We undertake this analysis in Section 6 and consider in particular the factors set out in paragraph 3.18 above.

3.20 Verizon states that it would expect Ofcom to follow "*broadly the three steps*" above in resolving the Dispute.⁴⁴

3.21 If we conclude that BT overcharged for the services in dispute, we will then calculate the level of overcharge. Our provisional conclusions are set out in Section 7.

⁴⁴ Verizon submission of 22 February 2012, paragraph 21.

Section 4

Has BT satisfactorily demonstrated that its relevant charges were cost orientated?

- 4.1 In Section 10 of the Ethernet 1 Draft Determinations, we considered whether BT had demonstrated to our satisfaction that each and every one of its charges in dispute was cost orientated during the Relevant Period. We carry out the same assessment – step 1 of our analysis – in this Section.
- 4.2 We summarise BT's arguments as to why it believes that its charges were cost orientated, which are set out in Section 10 of the Ethernet 1 Draft Determinations. Verizon did not make submissions in relation to these arguments, and so we then summarise Ofcom's views and provisional conclusions, which are set out in full in Section 10 of the Ethernet 1 Draft Determinations.

BT's views

- 4.3 As noted at paragraph 2.36, we have taken account of the submissions made by BT in relation to the Ethernet 1 disputes. BT's arguments made in those submissions as to why its charges were cost orientated are set out in Section 10 of the Ethernet 1 Draft Determinations. In summary, BT argues that:
- 4.3.1 analysis of rates of return at the AISBO market level demonstrates that its charges were cost orientated. This argument is set out in paragraphs 10.6-10.11 of the Ethernet 1 Draft Determinations.
 - 4.3.2 comparison of revenues relative to revised DSACs at an aggregate market (or sub-group of the market) level demonstrates its charges were cost oriented. This argument is set out in paragraphs 10.21-10.24 of the Ethernet 1 Draft Determinations.
 - 4.3.3 international benchmarking of charges shows UK consumers have benefited from lower retail prices for Ethernet services than consumers in other comparable countries, and these lower prices demonstrate its charges are cost orientated. This argument is set out in paragraphs 10.27-10.29 of the Ethernet 1 Draft Determinations; and
 - 4.3.4 no observable economic harm has occurred as a result of its charges. This argument is set out in paragraphs 10.36-10.39 of the Ethernet 1 Draft Determinations.
- 4.4 BT also argues that it can demonstrate that it took steps to ensure compliance historically, as shown through its interaction with Ofcom between 2004 and 2007, Ofcom's adjustment of only one starting charge in the 2009 LLCC Statement and BT's price reductions in 2008/09. These arguments (and Ofcom's response) are set out in paragraphs 10.49-10.101 of the Ethernet 1 Draft Determinations
- 4.5 Our review of pricing papers provided by BT in relation to the Ethernet 1 disputes showed that BT was aware of its obligation to ensure its charges were cost orientated, but the pricing papers we reviewed did not reveal any steps taken to

ensure the obligation was met.⁴⁵ In order to resolve the Ethernet 2 dispute, we asked BT for further information relating to the processes it followed to ensure prices were cost orientated.

Ofcom's views

4.6 In Section 10 of the Ethernet 1 Draft Determinations we provisionally conclude that BT has failed to demonstrate to our satisfaction that its WES charges in dispute were cost orientated. Having considered the submissions made by BT in relation to the Ethernet 1 disputes, we reach the same provisional conclusion in relation to this Dispute. We consider that the reasons why we reached that provisional conclusion in relation to the Ethernet 1 disputes apply equally to this Dispute. In summary:

- 4.6.1 we consider that BT has undertaken its ROCE analysis using an inappropriate level of aggregation and has therefore not satisfactorily demonstrated that its relevant charges were cost orientated;⁴⁶
- 4.6.2 we do not agree that BT's DSAC analysis demonstrates that its charges were cost orientated, as we do not consider that BT has used an appropriate level of disaggregation to consider the question of cost orientation.⁴⁷ In addition, BT bases its analysis on its revised DSACs for 2006/07 to 2009/10. As set out at paragraph 5.5 and as discussed in Section 11 of the Ethernet 1 Draft Determinations⁴⁸ we do not consider it to be appropriate to use the revised DSACs for these years;
- 4.6.3 we do not consider that BT's international benchmarking analysis demonstrates that BT's charges for the services in dispute are cost orientated, as it relates solely to prices and fails to give any consideration to possible cost differences between the services being compared. Furthermore, it is based on aggregated connection and rental charges rather than individual charges;⁴⁹ and
- 4.6.4 we disagree that BT's analysis that there was no economic harm as a result of its charges demonstrates that its charges are cost orientated because:⁵⁰
 - a) economic harm is not a pre-requisite for considering whether BT's charges are cost orientated;⁵¹ and
 - b) in any event, BT's analysis does not demonstrate that economic harm has not occurred.⁵²

4.7 We do not believe that any of our actions or omissions (or any actions taken by BT) constitute evidence that Ofcom considered, or gave BT grounds to believe it considered, that BT's charges for Ethernet services were cost orientated. Further, we do not think BT could ever have a legitimate expectation that Ofcom would not resolve a dispute about the cost orientation of BT's charges (in the light of an SMP

⁴⁵ Ethernet 1 Draft Determinations, paragraphs 10.100-10.101 and 10.103.4.

⁴⁶ Ethernet 1 Draft Determinations, paragraphs 10.15-10.20.

⁴⁷ Ethernet 1 Draft Determinations, paragraphs 10.25-10.26.

⁴⁸ See 11.74 to 11.80 of the Ethernet 1 Draft Determinations in particular.

⁴⁹ See paragraphs 10.30-10.35 of the Ethernet 1 Draft Determinations.

⁵⁰ See paragraphs 10.40-10.48 of the Ethernet 1 Draft Determinations.

⁵¹ As a result, we have not assessed whether economic harm may have arisen as a result of BT's charges in dispute.

⁵² Ethernet 1 Draft Determinations, paragraphs 10.44-10.48.

obligation) in accordance with its statutory functions. This view is set out in further detail in paragraphs 10.49-10.101 of the Ethernet 1 Draft Determinations (together with BT's arguments).

- 4.8 We note BT's arguments that it sought to reduce prices in 2008/09 and acknowledge that BT was unable to implement the price reductions for nearly ten weeks.⁵³ We consider that applying the DSAC test non-mechanistically allows us to take into account the prolonged duration of any breach.
- 4.9 We consider that none of the pricing papers provided by BT in relation to the Ethernet 2 dispute demonstrate that its charges relevant to this Dispute were cost orientated.
- 4.10 We therefore provisionally conclude that BT has failed to demonstrate that its charges for the WES services in dispute were cost orientated. We now carry out our own assessment of whether BT's charges were cost orientated.

⁵³ See paragraphs 10.89-10.99 of the Ethernet 1 Draft Determinations.

Section 5

Comparison of the disputed charges with their respective DSACs

- 5.1 In Section 4, we provisionally conclude that BT has failed to demonstrate that its charges for the services in dispute were cost orientated. We therefore move onto step 2 of our analysis.
- 5.2 In this Section first we consider the appropriate data for assessing cost orientation. Our analysis considers the following:
- 5.2.1 which is the appropriate DSAC data for assessing cost orientation; and
 - 5.2.2 BT's revenues and costs of providing the services in dispute, including:
 - a) the data we should use where BT is unable to provide us with sufficiently granular cost data; and
 - b) adjustments to BT's revenue and cost data.
- 5.3 We then provide a summary of the revenue and cost data we propose to use to assess whether BT has overcharged for the services in dispute, and we set out the results of the DSAC test for each of the services in dispute, comparing external revenues and external DSAC.

Which is the appropriate DSAC data for assessing cost orientation?

- 5.4 In Section 11 of the Ethernet 1 Draft Determinations, we explained how BT's LRIC model calculates DSACs and then set out BT's views on the appropriateness of its LRIC model and its proposed alternative methodology for calculating DSACs. Finally, we provided our assessment of BT's arguments and our provisional conclusion that we should use BT's published DSACs as the basis for our resolution of the Ethernet 1 disputes.
- 5.5 For the period between 1 April 2006 and 31 July 2009 (i.e. the part of the Relevant Period that overlaps with the period we considered in the Ethernet 1 disputes) we propose to adopt the same approach that we have adopted in the Ethernet 1 disputes, i.e. to use BT's published DSACs as the basis for our resolution of the Dispute. We propose to adopt the same approach, for the same reasons, for the period from 31 July 2009 to 31 March 2010 (i.e. for the remainder of the 2009/10 financial year).
- 5.6 The following paragraphs set out the approach we have taken for 2010/11, as set out in paragraphs 5.7 to 5.22 in the Ethernet 2 Provisional Determination.
- 5.7 BT's approach to generating DSACs for individual services involves, within the LRIC model, first calculating the costs associated with the individual components that the services consume. In turn, these component costs are built up from various (around 400) individual cost categories. The relevant costs from each cost category attributable to each component are generated using cost-volume relationships ("CVRs"). We explain this process in more detail in Section 11 of the Ethernet 1 Draft Determinations.

- 5.8 In preparing its 2010/11 RFS, BT altered its methodology for calculating DSACs.⁵⁴ Prior to 2010/11, 14 cost categories had been split into 28 sub-categories. BT's revised methodology removed the split cost categories by amalgamating sub-categories into single categories. This change therefore involves replacing, for each cost category, the two separate CVRs for the two sub-categories with one aggregated CVR for the combined cost category. As a consequence of revising the CVRs, the new methodology changes both the LRICs and common cost allocations for component DSACs. We explain this proposed change and its implications in more detail in Section 11 of the Ethernet 1 Draft Determinations.
- 5.9 BT has argued that in order to resolve the Ethernet 1 disputes (and therefore the Ethernet 2 dispute), we should use DSACs calculated on the basis of the new methodology, and not those originally published in its RFS, for the years prior to 2010/11.⁵⁵ BT's argument is also relevant to this Dispute.
- 5.10 We have considered BT's argument in the Ethernet 1 disputes and concluded that it would not be appropriate to use BT's recalculated DSACs to resolve those disputes for the years prior to 2010/11. For the same reasons we propose to do likewise in this Dispute for these years. Readers are referred to the analysis in Section 11 of the Ethernet 1 Draft Determinations.
- 5.11 As set out in the Ethernet 1 Draft Determinations,⁵⁶ we consider that unless there are errors in BT's RFS, or the methodology used in preparing the RFS was obviously inappropriate, Ofcom should rely on the RFS published at the time⁵⁷ for the purposes of determining the Dispute. As explained at paragraphs 12.30-12.41 in the Ethernet 1 Draft Determinations, while we have made adjustments to BT's published DSACs, these adjustments have been made to correct for volume errors and to ensure that revenues are appropriately matched to costs. We have not made adjustments to incorporate BT's revised methodology for calculating DSACs for the period 2006/07 to 2009/10 because BT has not demonstrated that the approach to calculating DSACs set out in its Long Run Incremental Cost: Relationships & Parameters document ("LRIC R&P") prior to 2010/11 is obviously inappropriate or there were errors in its implementation.
- 5.12 We have adopted the same approach in considering whether we should use BT's published DSACs for 2010/11, as derived using the new methodology. As we set out in paragraphs 11.31 and 11.42-11.62 of the Ethernet 1 Draft Determinations, there are different methods which BT could use to implement the DSAC cost concept. Our starting point for considering whether any of these various methodologies are obviously inappropriate is to consider whether they are consistent with the broad policy objective for setting floors and ceilings. We explain this policy objective in paragraph 11.36 of the Ethernet 1 Draft Determinations. In summary, it is to provide BT with an appropriately bounded degree of pricing flexibility over how it recovers common costs across the services that share those common costs. The revised methodology adopted by BT for calculating the DSACs reported in its 2010/11 RFS fulfils this broad objective and therefore, on this measure, does not seem to be obviously inappropriate. Further, we are not aware of any errors in BT's implementation of the revised methodology.

⁵⁴ See section 1.4 of the 2011 Long Run Incremental Cost Model: Relationships & Parameters available from

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2011/index.htm>

⁵⁵ Ethernet 1 Draft Determinations, paragraphs 11.18-11.23.

⁵⁶ Ethernet 1 Draft Determinations, paragraphs 11.30-11.73.

⁵⁷ We note that BT has restated its RFS for some years.

5.13 However, BT supplied us with a detailed explanation of its revised methodology, including the specific modelling assumptions and simplifications it employed, in the context of the Ethernet 1 disputes. Our review of this material has led to a number of observations around the new methodology and its robustness in generating DSACs.

5.14 First, BT told us that the new (i.e. aggregated) CVRs for the combined cost categories which are used to calculate its revised DSACs (and which replace the two individual CVRs for each of the previously split cost categories) are “*simplified*” estimates which provide “*indicative results*”:

*“The CVR is a simplified estimate to provide indicative results, and in order to get accurate results, a new CVR will need to be derived using engineering derivations, and the LRIC model re-run accordingly.”*⁵⁸

5.15 Second, some cost categories within BT's LRIC model are dependent upon the level of costs for other cost categories (e.g. if cost x increases, cost y also increases). BT's new methodology has not been implemented by changing the LRIC model itself. Rather, BT has made an off-line adjustment to the LRIC model outputs. BT explained to us that this approach reflects practical difficulties in altering the LRIC model.⁵⁹ As a consequence of this simplified approach, BT has not reflected the “ripple-through” effect that arises where other cost categories are dependent on the cost categories with revised CVRs. In principle, not including the ripple-through effect could give rise to some inaccuracies in the generation of DSACs under the revised methodology.

5.16 In our 20 January s191 notice, we asked BT whether it still considered its new CVRs to be “*indicative*” and what further work it had undertaken that gave it confidence that the CVRs were “*a very good proxy*”⁶⁰ for the output that would result if it re-ran the LRIC model using CVRs derived using engineering derivations. BT's response did not explain whether it considered the CVRs used in the preparation of its 2010/11 RFS to be indicative. Rather, it responded describing the process through which it had developed the new methodology, and setting out that this new methodology produced the expected relationship between LRIC, FAC and DSAC.⁶¹ BT stated that:

*“This methodology provides a better estimate of (D)LRIC and DSAC than the previous unadjusted method of calculation for the reasons that BT previously explained when the overlay model was introduced.[⁶²] The overlay model used to calculate DSACs for 2010/11 RFS incorporated the best available information at the time.”*⁶³

5.17 We also asked BT why it did not recalculate dependent cost categories to reflect the new methodology, and asked it to provide any analysis it had conducted of the effect that recalculating dependent cost categories might have had on reported DSACs of BES and WES services in 2010/11.⁶⁴ In response, BT again described the process through which it had developed the new methodology, and set out that this new methodology produced the expected relationship between LRIC, FAC and DSAC. It stated that the revised methodology was implemented as an overlay as additional delays would have resulted from reworking the LRIC model in full. In particular, it

⁵⁸ BT response to question 8 of the 16 June s191 notice.

⁵⁹ BT's response of 20 May 2011 to questions 6a and 7 of Ofcom's supplementary questions of 11 May 2011.

⁶⁰ BT's response of 20 May 2011 to question 6a of Ofcom's supplementary questions of 11 May 2011.

⁶¹ See Section 11 of the Ethernet 1 Draft Determinations.

⁶² That DSAC should always be above FAC (see Section 11 of the Ethernet 1 Draft Determinations).

⁶³ BT response to question 2 of the 20 January 2012 s191 notice.

⁶⁴ BT response to questions 4 and 5 of the 20 January 2012 s191 notice.

would have required a further delay to the publication of the RFS, which Ofcom did not agree to.⁶⁵ BT stated that its initial assessment showed that the differences for DSACs for WES and BES services if dependent cost categories were included in the adjustment were likely to be in the range of 0% to 2% (i.e. DSACs would have been 0% to 2% higher if the cost dependencies had been fully reflected in BT's revised DSACs).⁶⁶ It provided a spreadsheet showing the calculation of this range. While this spreadsheet seems to include columns for DSACs both with and without an adjustment for dependent cost categories, it does not include details of how these columns are estimated. BT's written submission also did not explain the basis for its calculations.

- 5.18 We are not fully satisfied that BT has addressed our questions about the robustness of its revised methodology. However, as we have noted above and in paragraph 11.31 in the Ethernet 1 Draft Determinations, BT has discretion over the methodology it uses to generate DSACs in its RFS. Unless we are satisfied that the chosen approach is obviously inappropriate, we expect to rely on BT's chosen methodology for considering its compliance with its cost orientation obligations.
- 5.19 In this case, while we have some observations on the detailed modelling assumptions and simplifications BT has adopted in implementing its revised methodology, on balance, we do not consider that these observations, and the evidence we have in relation to them, are sufficient to conclude that the new methodology is obviously inappropriate or its implementation contains errors.
- 5.20 Therefore, for 2010/11 we propose to use BT's DSACs as published in the 2011 RFS (subject to the adjustments discussed in paragraphs 5.57 to 5.63 below).⁶⁷
- 5.21 We therefore propose to use BT's DSACs published in its RFS at the time⁶⁸ as the basis of our analysis for the whole of the Relevant Period (subject to the adjustments discussed below). This means that the DSACs we are using for 2006/07-2009/10 were calculated using BT's former methodology (where cost categories are split into sub-categories as outlined in the LRIC R&P for each of these years) while for 2010/11 the DSACs are based on BT's new methodology (where categories are not split).

BT's revenues and costs of providing the services in dispute

- 5.22 As in Section 12 of the Ethernet 1 Draft Determinations, we now discuss the data available to us for assessing BT's compliance with its cost orientation obligation and the corrections and adjustments which we propose to make to that data.

⁶⁵ BT response to question 4 of the 20 January 2012 s191 notice.

⁶⁶ BT response to question 5 of the 20 January 2012 s191 notice.

⁶⁷ We do not have DSACs for 2010/11 calculated using the old methodology and so cannot tell exactly how much the change in methodology affects our assessment of the charges in dispute. However, BT provided DSACs for the services and period relevant to the Ethernet 1 disputes calculated under both the old and new methodologies. Based on these data, typically the change in methodology increases the DSACs of rental services by between 20% and 30% (while having no or almost no impact on connection service DSACs) in most years (as shown in Table 11.3 in the Ethernet 1 Draft Determinations). If we assume the change in methodology would have a similar scale of effect in 2010/11, then using DSACs calculated using the old methodology would not affect any of our proposed conclusions on whether there was overcharging for the services in dispute, although it would affect the level of the overcharge.

⁶⁸ We note that BT has restated its RFS for some years.

Data we should use where BT is unable to provide us with sufficiently granular revenue and cost data

- 5.23 BT's cost orientation obligation applies to "*each and every charge*" that BT levies for the services in dispute. In order for us to assess compliance with this obligation, the costs and revenues associated with each individual charge are relevant.
- 5.24 As set out in paragraphs 8.42-8.44 of the Ethernet 1 Draft Determinations, for the purposes of reporting financial data in its RFS, Ofcom has permitted BT to merge some "low value services" in order to reduce the regulatory burden on BT, but made clear that BT "*will however retain data at service level and make this available to Ofcom.*"⁶⁹ BT must be able to demonstrate to our satisfaction that those charges covered by a cost orientation obligation are compliant with that obligation. The fact that BT is not required to publish the information to demonstrate this in its RFS does not mean it need not be able to provide it if required.
- 5.25 BT's RFS include much of the data we rely on in resolving this Dispute, including revenues, volumes and costs of services which are subject to cost orientation obligations. However the RFS report the costs and revenues of WES services at different levels of aggregation for different years in the Relevant Period, and even where they include more disaggregated data they do not disaggregate data to the level contained in the OPL. For example, while the OPL sets out charges for each variant of WES1000 ('LAN/SAN', 'Managed Local Access' and 'Extended Reach'), BT's RFS only includes details on 'WES1000' rentals, i.e. BT aggregates the variants of WES1000 and reports them under the heading 'WES1000 rentals' in the RFS.⁷⁰
- 5.26 BT has provided price, volume and revenue data for each service listed in the OPL, which reconciles to the volume and price information reported in the RFS for the AISBO market in the period 2006/07 to 2010/11. However, BT has not been able to provide cost information at this level of disaggregation. BT has explained that cost information at the level of OPL does not exist in any system within Openreach.⁷¹ We have therefore been unable to obtain cost information for each individual service listed in the OPL. Instead, the cost information available to us is only disaggregated to the level published in the RFS.
- 5.27 In Section 12 of the Ethernet 1 Draft Determinations we explained that we were unable to robustly disaggregate the cost data that relates to the different bandwidth variants. We did not consider that this materially affected our ability to determine whether BT had overcharged for the services considered in the Ethernet 1 disputes⁷² and here, as in the Ethernet 1 Draft Determinations, we have not sought to disaggregate the data any further. In the Ethernet 1 disputes our provisional conclusions on overcharging were therefore based on the revenues and costs reported in the RFS, subject to certain adjustments.

⁶⁹ Paragraph 6.10 of "Proposed changes to BT's regulatory financial reporting framework" – Regulatory reporting May 2005.

⁷⁰ Limitations to the available data and their implications are discussed further at paragraphs 12.8 to 12.14 of the Ethernet 1 Draft Determinations.

⁷¹ BT's responses to the 22 October 2010 s191 notice, question 2 and 22 December 2011 s191 notice question 1.

⁷² Ethernet 1 Draft Determinations paragraph 12.14.

- 5.28 Consistent with the approach taken in the Ethernet 1 Draft Determinations⁷³ we propose to use the published revenue and cost data as a basis for resolving the Dispute.

Adjustments to BT's revenue and cost data

- 5.29 In the following paragraphs, as in Section 12 of the Ethernet 1 Draft Determinations, we set out the adjustments which we propose to make to BT's published data in order to correct for volume and revenue errors and ensure revenues and costs are appropriately matched.
- 5.30 We required BT to provide us with total revenue, total FAC and total DSAC for each service in the AISBO market over the Relevant Period.⁷⁴ The unit cost data provided for each service is the same as that published in the RFS for the years in question as BT was unable to provide more granular information.
- 5.31 Table 5.1 summarises the revenue, FAC and DSAC data for the services in dispute.

Table 5.1; Total revenue and cost data for the services in dispute for the period 2006/07 to 2010/11, £m

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental					
Revenue	79	62	101	113	88
FAC	123	73	85	94	133
DSAC	131	94	113	125	262
WES 100 rental					
Revenue	92	79	86	86	99
FAC	47	37	44	64	118
DSAC	52	49	57	86	229
WES 1000 rental					
Revenue	43	27	32	32	40
FAC	6	5	6	12	26
DSAC	8	7	7	17	47

Source: BT's responses to question 2 of the 22 October s191 notice and question 1 of the 22 December 2011 s191 notice.

Adjustments to the data provided by BT

- 5.32 In Section 12 of the Ethernet 1 Draft Determinations, we identified two types of adjustment that we propose to make to BT's data in order to ensure it can be relied upon for determining the Ethernet 1 disputes:

- 5.32.1 the first corrects for volume and revenue errors and associated issues in the RFS data; and

⁷³ Ethernet 1 Draft Determinations, paragraphs 12.9 to 12.14.

⁷⁴ BT's responses to question 2 of the 22 October s191 notice and question 1 of the 22 December s191 notice.

- 5.32.2 the second replicates a series of cost adjustments that were identified in the 2009 LLCC Statement,⁷⁵ to the extent that they are applicable to those historic disputes.
- 5.33 The first set of adjustments corrects for what we would consider straightforward errors in the RFS data. In particular they correct for misstatements of volumes and the associated impacts on revenues and costs. It is necessary to correct for these errors in order to ensure that the data is appropriate for determining the disputes.
- 5.34 The second set of adjustments aims to ensure that the revenues we are assessing are compared against the appropriate costs. It is not always possible to directly compare the revenues and costs reported in BT's RFS because the data for a service may include revenues and costs associated with a different service, or relevant revenues and costs may be reported elsewhere. This means that the costs of a service may not always be matched against the revenues to which they relate.
- 5.35 The 2009 LLCC Statement identified some particular areas where this mismatching of costs and revenues had occurred and recommended some adjustments to BT's RFS to enable a better comparison between revenues and costs to be made. In making adjustments when resolving the Ethernet 1 disputes we sought, where appropriate, to ensure consistency with the adjustments made in the 2009 LLCC Statement and we are proposing to take the same approach when resolving this Dispute.
- 5.36 For the purposes of resolving the Dispute, as for the Ethernet 1 disputes, we have modelled all corrections associated with volume errors as individual standalone changes to the base data. The adjustments in line with the 2009 LLCC Statement are based on the original RFS data but have been modified to take account of the volume corrections. For example, if a volume correction reduced the originally published FAC for a service by 10% then our adjustments in line with the 2009 LLCC Statement will also be reduced by 10% for that service.
- 5.37 The corrections associated with volume errors are the same as set out in the Ethernet 1 Draft Determinations to the extent they impact the WES rental services in dispute. The adjustments in line with the 2009 LLCC Statement are also the same as set out in the Ethernet 1 Draft Determinations with two exceptions – in 2010/11 the methodology behind the adjustments associated with transmission equipment and Equipment and Excess Construction Charges is different. This is explained further in paragraphs 5.44 to 5.49 and 5.53 to 5.56 below. In addition, we made an adjustment associated with 2010/11 development costs in the Ethernet 2 Provisional Determination which we have not made in these Provisional Conclusions. This is explained in paragraphs 5.47 to 5.49.

Corrections to the data provided by BT associated with volume and revenue errors

- 5.38 We have made the same corrections to the base data that we propose to make for the Ethernet 1 disputes to the extent they impact the WES rental services in dispute.⁷⁶ These are described in detail in paragraphs 12.42 to 12.48 of the Ethernet 1 Draft Determinations and address:

⁷⁵ The adjustments are explained in detail in Section 5 (paragraphs 5.42 to 5.76) and Annex 6 of the 2009 LLCC Statement.

⁷⁶ The two other corrections identified in the Ethernet 1 Draft Determinations at paragraph 12.42.3 and 12.42.4 do not impact WES rental services.

Provisional Conclusions concerning a dispute between Verizon and BT relating to BT's charges for WES

- i) 2006/07 and 2007/08 unit FACs and DSACs;
- ii) volume errors relating to WES services in 2006/07.

5.39 For each of the services in dispute, Table 5.2 sets out the total revenue, FAC and DSAC after making these corrections to BT's data.

Table 5.2: Corrected revenue, FAC and DSAC data for the services in dispute in the period 2006/07 to 2010/11, £m

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental					
Revenue	79	62	101	113	88
FAC	123	73	85	94	133
DSAC	131	94	113	125	262
WES 100 rental					
Revenue	92	79	86	86	99
FAC	47	37	44	64	118
DSAC	52	49	57	86	229
WES 1000 rental					
Revenue	43	27	32	32	40
FAC	6	5	6	12	26
DSAC	8	7	7	17	47

Source: Ofcom, based on data provided by BT

Adjustments to the corrected base data consistent with the 2009 LLCC Statement

5.40 In Section 12 of the Ethernet 1 Draft Determinations, we considered the following adjustments which were derived from the 2009 LLCC Statement.

5.41 Paragraph references in this list are to the relevant paragraphs of the Ethernet 1 Draft Determinations:

- 5.41.1 transmission equipment costs (in paragraphs 12.60-12.66);
- 5.41.2 21CN costs (in paragraphs 12.67-12.78);
- 5.41.3 ancillary services (excess construction charges) (in paragraphs 12.79-12.80);
- 5.41.4 payment terms (in paragraphs 12.81-12.84);
- 5.41.5 RAV adjustment (in paragraphs 12.97-12.100); and
- 5.41.6 treatment of holding gains/losses and current cost normalisation (in paragraphs 12.85-12.96).

5.42 We consider these adjustments in turn in relation to this Dispute.

Transmission equipment costs

2006/07 to 2009/10

5.43 Between 2006/07 and 2009/10 transmission equipment costs were recovered through upfront circuit connection charges. In the Ethernet 1 Draft Determinations

and Ethernet 2 Provisional Determination we proposed an adjustment to address the timing mismatch between the revenues and costs reported in the RFS for connection services.⁷⁷ We do not propose to make this adjustment in the current dispute as connection charges are not in dispute.

2010/11

- 5.44 In 2010/11 BT attributed the costs of transmission equipment to WES rentals rather than connections, leading to a large increase in the FAC of rental services and a corresponding decrease in FAC for connection services.
- 5.45 Some of the costs associated with transmission equipment that have been allocated to rentals in 2010/11 have already been recovered from connection charges in previous years and as a result there is a risk that BT is recovering those costs twice – once from connection charges and again from rental charges. We have therefore made an adjustment to remove from rentals the MCE and depreciation associated with transmission equipment that was acquired before 2010/11 because these costs appear to have already been recovered from connection charges.
- 5.46 After making this adjustment, the rental services still include MCE and depreciation relating to transmission equipment acquired in 2010/11. These costs arise due to new customers connecting in 2010/11, but are spread over all rental customers in 2010/11, regardless of whether they connected in 2010/11 or at some point in the past. We do not propose to make a further adjustment to reflect the impact of this averaging of costs between different types of customers for two reasons. First, we do not consider BT's treatment is inconsistent with Condition HH3.1. This is because Condition HH3.1 requires each and every *charge* to be cost orientated and not any payment by any customer. Second, the impact of any adjustment is relatively small compared to the adjustment to remove transmission equipment costs that are associated with connections made in previous years (as described in paragraph 5.45).

Development costs in 2010/11

- 5.47 In the Ethernet 2 dispute, BT told us⁷⁸ that development costs were attributed to rental services in 2010/11 rather than to connection services as in previous years. BT also told us that in previous years development costs had been included within the costs of electronic equipment⁷⁹. In the Ethernet 2 dispute we assumed that, as with transmission equipment, an element of MCE and depreciation costs associated with development costs in 2010/11 related to costs incurred prior to 2010/11 and, since BT had indicated that development costs had been included within the costs of electronic equipment, had already been recovered via connection charges. Therefore consistent with our adjustment for transmission equipment costs described in paragraphs 5.44 to 5.46 above, we made an adjustment to remove the MCE and depreciation costs associated with development costs that related to spend prior to 2010/11.

⁷⁷ See paragraph 12.62 of the Ethernet 1 Draft Determinations and paragraphs 5.69-5.71 of the Ethernet 2 Provisional Determination.

⁷⁸ BT response of 18 January 2012 to question 13 of the 22 December 2011 s191 notice.

⁷⁹ BT response of 18 January 2012 to question 13 of the 22 December 2011 s191 notice.

- 5.48 Since publication of the Ethernet 2 Provisional Determination, BT has provided us with further information⁸⁰ that indicates that the development cost adjustment set out at paragraph 5.47 should not have been made. BT has noted that development costs were not included within the adjustment for transmission equipment costs that Ofcom made in the 2009 LLCC Statement.⁸¹ We also understand that BT's connection charges in years prior to 2010/11 were only recovering the depreciation and ROCE element of development costs (and not the in-year capital costs as was the case for transmission equipment). Accordingly, BT argues that there should be no adjustment for development costs in 2010/11.
- 5.49 On the basis of the further information provided by BT, we consider that no adjustment is required for development costs in 2010/11. This is because while some costs associated with transmission equipment that have been allocated to WES and BES rentals in 2010/11 have already been recovered from connection charges in previous years, this is not the case for development costs. As a result, we provisionally conclude that revenue for WES1000 rental is slightly below DSAC in 2010/11,⁸² whereas in the Ethernet 2 Provisional Determination (in which the adjustment was made) we provisionally concluded that revenue for WES1000 rental was £0.9m above DSAC in that year.⁸³

21CN costs

- 5.50 In the Ethernet 1 Draft Determinations we propose to make two adjustments in relation to 21CN costs:
- 5.50.1 an adjustment to remove costs directly attributable to 21CN; and
- 5.50.2 a further adjustment to remove certain indirect 21CN costs
- 5.51 In relation to the first of these 21CN adjustments, we are proposing to make the same adjustment as set out in the Ethernet 1 Draft Determinations,⁸⁴ updated to take into account 2010/11. In 2010/11, BT has provided the percentage of 21CN costs that are specific to 21CN for both P&L and MCE related costs,⁸⁵ equivalent to the figures presented in Table 12.9 of the Ethernet 1 Draft Determinations. The resulting percentages, which we propose to use to make the 21CN adjustment, are shown in Table 5.3:

Table 5.3: Estimate of direct (specific) 21CN costs in the period 2006/07 to 2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
P&L	22%	22%	[X]	[X]	[X]
MCE	93%	93%	[X]	[X]	[X]

Source: 2006/07 to 2009/10: BT email dated 12 July 2011 in response to follow up question 21b to the 22 October s191 notice. 2010/11: BT response to question 19 of the 22 December 2011 s191 notice.

⁸⁰ BT responses of 7 March 2012 to our questions dated 27 February 2012, seeking clarification of BT's response to question 13 of the 22 December 2011 s191 notice and question 33 of the section 135 notice dated 4 July 2011 (sent in the context of the Leased Lines Charge Control ("LLCC") review).

⁸¹ BT demonstrated that the adjustment made in the 2009 LLCC Statement only related to transmission equipment and did not include any information relating to development costs.

⁸² See Table 5.6

⁸³ See Table 5.8 of the Ethernet 2 Provisional Determination.

⁸⁴ Ethernet 1 Draft Determinations, paragraphs 12.67 to 12.78.

⁸⁵ BT response to question 19 of the 22 December 2011 s191 notice.

- 5.52 In relation to the second of these 21CN adjustments, BT provided us with an estimate of the 21CN overhead costs within the AISBO market that had been allocated on the basis of MCE⁸⁶ in the period 2006/07 to 2010/11.⁸⁷ For the period 2006/07 to 2009/10, these estimates are the same as the ones we used in the Ethernet 1 Draft Determinations.

Excess construction charges

- 5.53 In the Ethernet 1 disputes, BT told us that the costs of Excess Construction Charges ("ECCs") were included within the base data of Ethernet services in the period 2006/07 to 2009/10.⁸⁸ BT provided us with an estimate of the costs associated with ECCs and we removed them from the relevant Ethernet services.
- 5.54 In relation to the 2010/11 RFS, BT has told us that the costs associated with ECCs are not shown within the service cost information, which is a different treatment compared to previous years.⁸⁹ BT said that in 2010/11 it estimated the ECC depreciation embedded within AISBO services and attributed this separately to a new component called AISBO excess construction.⁹⁰ This estimate of depreciation associated with ECCs was £4m, and this can be seen against "Equipment depreciation" on page 53 of the 2010/11 RFS.⁹¹ This estimate of £4m has been removed from the depreciation estimates included within AISBO services.
- 5.55 Given that a proportion of the depreciation embedded within AISBO services is actually associated with ECCs, it would appear to follow that a proportion of MCE embedded within AISBO services would also be associated with ECCs. If so, the MCE associated with ECCs should be removed from AISBO services since it relates to ECCs.
- 5.56 For the purposes of resolving this Dispute, we have assumed that, in 2010/11, a proportion of the MCE for each AISBO service is actually associated with ECCs. We have estimated the proportion of MCE that is associated with ECCs by assuming that the ratios of ECC MCE/AISBO market MCE and ECC depreciation/AISBO market depreciation are the same. We have apportioned the resultant estimate of MCE between services on the basis of volumes. If we receive more information from BT on how the costs of ECCs have been treated in 2010/11, either as part of this Dispute or as part of the current Leased Lines Charge Control review, we propose to reflect this in the final determination of this Dispute.

Payment terms

- 5.57 This adjustment was discussed in detail in paragraphs 12.81 to 12.84 of the Ethernet 1 Draft Determinations. We are also proposing to make this adjustment in resolving this Dispute in order to ensure that the notional debtors amounts included within the MCE reflect the payment terms for CPs that are purchasing Ethernet services.

RAV adjustment

⁸⁶ BT response to question 19e of the 22 December s191 notice.

⁸⁷ The second 21CN adjustment eliminates the majority of these 21CN overhead costs, based on the proportion of MCE removed as being directly incurred as a result of 21CN (see Table 12.9 of the Ethernet 1 Draft Determination).

⁸⁸ BT email dated 13 December 2010.

⁸⁹ BT response dated 27 January 2012 to Q4 of the 24 January s191 notice.

⁹⁰ This cost component can be seen on page 99 and 108 of the 2010/11 RFS.

⁹¹ <http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2011/CurrentCostFinancialStatements2011.pdf>

- 5.58 As in the Ethernet 1 Draft Determinations and for the same reasons,⁹² we do not consider that it would be appropriate to take account of the RAV adjustment for the purposes of assessing whether BT has been overcharging for the services in dispute.⁹³

Treatment of holding gains and losses/current cost normalisation

- 5.59 Current cost accounting ("CCA") requires the consideration of holding gains and losses. These are the changes in the replacement costs of an asset held during the year. Holding gains and losses can be caused by a variety of things such as changes to commodity prices, technical obsolescence and changes to valuation methods. For example, if the replacement cost of an asset increases during the year from £100 to £120 then there is a holding gain of £20. If reflected in the P&L, a holding gain in a given period would have the effect of decreasing costs (and increasing returns) for that period, while a holding loss would increase costs (reducing returns) for that period.

Treatment of holding gains/losses in the 2009 LLCC Statement

- 5.60 In the 2009 LLCC Statement we made an adjustment to forecast the changes to asset values that might arise from the CCA treatment of assets over the period of the charge control (we refer to this as "current cost normalisation"). A forecast value was included in the charge control model because historic CCA holding gains and losses are unlikely to provide a robust forecast for future years.⁹⁴ In the PPC Final Determinations we considered a similar adjustment but concluded that, since we were considering historic charges rather than the forward looking charges considered in the 2009 LLCC Statement, such an adjustment was not relevant.⁹⁵ As in the Ethernet 1 Draft Determinations, we consider that the same reasoning applies to this Dispute.
- 5.61 In the PPC Final Determinations we also discussed the treatment of holding gains and losses more generally and decided to use *"the actual holding gains and losses reported by BT in its regulatory financial statements"*. We considered replacing these with the holding gains and losses forecast by BT at the time that it set its prices but concluded *"Absent information that these actual gains and losses would not have been foreseen by BT, we have not made adjustments to the reported holding gains and losses"*.⁹⁶ As in the Ethernet 1 Draft Determinations, we have followed this approach here, except for the 2009/10 holding gain associated with duct which we discuss further below.

BT's estimate of the replacement cost of duct in 2009/10 and its treatment of the resulting holding gain

- 5.62 BT's RFS usually include all holding gains and losses within the reported market-level costs and also the unit costs for each service. However, BT's 2009/10 RFS

⁹² See paragraphs 12.97 to 12.100 of the Ethernet 1 Draft Determinations.

⁹³ This is also consistent with our approach in the PPC Final Determinations where we did not take account of the RAV adjustment. PPC Final Determinations, paragraphs 6.117 to 6.123.

⁹⁴ See Table A6.5 of the 2009 LLCC Statement, entry "#2".

⁹⁵ PPC Final Determinations, paragraph 6.113.

⁹⁶ PPC Final Determinations, paragraphs 6.114 and 6.115.

excluded a large holding gain relating to duct from the unit cost information and also presented market level returns with and without the duct holding gain.⁹⁷

- 5.63 As explained in the RFS,⁹⁸ this large holding gain arose following a change in accounting estimate reflecting BT's revision of how much it would cost to replace its duct network. The increase in BT's valuation of the duct network occurred as a result of BT revising one of the input assumptions forming part of the asset valuation rather than, for example, a significant increase in the cost of labour or materials associated with building duct. BT's RFS set out that *"whilst this large holding gain has been recognised in 2009/10 it does not represent a genuine periodic change in the valuation of the duct assets. BT believes that it results in an artificial upwards distortion of returns in the year"*.⁹⁹
- 5.64 In its consultation on the charge control review for LLU and WLR services dated 31 March 2011 (the "LLU and WLR 2011 Consultation")¹⁰⁰ Ofcom considered BT's estimate of the replacement cost of duct for the purposes of setting those charge controls. This document is discussed in paragraph 12.91 of the Ethernet 1 Draft Determinations. On 7 March 2012 Ofcom published a Statement on its Charge control review for LLU and WLR services (the "LLU and WLR Statement").^{101 102}
- 5.65 As we had proposed in the LLU and WLR 2011 Consultation, in the LLU and WLR Statement we concluded that the RAV methodology remains appropriate for setting the LLU and WLR charge controls.¹⁰³ Any pre-August 1997 duct is therefore valued on an indexed HCA basis and any post-August 1997 duct is valued on a CCA replacement cost basis. In the LLU and WLR Statement we replaced BT's estimate of the replacement cost of duct associated with post-97 assets with our own estimate of how much it would cost to replace post-97 duct assets.¹⁰⁴ We did this because we considered that BT's CCA estimate of post-August 1997 duct was not robust¹⁰⁵ although we made clear that we were not specifically challenging the valuation of total duct assets included in the audited RFS (which includes both pre-1997 and post-1997 duct assets and does not present figures on a RAV basis).¹⁰⁶

⁹⁷ 2009/10 Current Cost Financial Statements, page 18. Details of the duct holding gain are on pages 17 and 18 of the 2009/10 RFS:

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2010/CurrentCostFinancialStatements2010.pdf>

⁹⁸ RFS 2009/10, pages 17 to 18,

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2010/CurrentCostFinancialStatements2010.pdf>

⁹⁹ 2009/10 Current Cost Financial Statements, page 18.

¹⁰⁰ Charge control review for LLU and WLR

services: <http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/summary/wlr-cc-2011.pdf>

¹⁰¹ <http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/statement/statementMarch12.pdf>.

The "LLU and WLR Statement Annexes" are available at:

<http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/statement/annexesMarch12.pdf>

¹⁰² Ofcom previously published a draft LLU and WLR statement on 3 February 2012, on which the European Commission, the Body of European Regulators for Electronic Communications and other EU Member State national regulatory authorities had one month to comment. The Ethernet 2 Provisional Determination refers (at paragraphs 5.91-5.92) to the draft statement; the relevant text is the same in the LLU and WLR Statement.

¹⁰³ See A1.2 of the LLU and WLR Statement Annexes

¹⁰⁴ Our estimate was based on an RPI indexation of BT duct expenditure since 1997.

¹⁰⁵ See A1.128 of the LLU and WLR Statement Annexes and also paragraph 3.58 of LLU and WLR 2011 Consultation

¹⁰⁶ LLU and WLR 2011 Consultation, paragraph 3.81.

- 5.66 In the Ethernet 1 Draft Determinations at paragraph 12.94, we set out that for the purposes of those draft determinations we had not made any adjustment to BT's RFS duct valuation for 2009/10 but we were considering whether to do so. We considered these issues further as part of the Ethernet 2 dispute. As in the Ethernet 2 Provisional Determination we do not consider that an adjustment to BT's RFS duct valuation is required in order to resolve this Dispute, because in the LLU and WLR 2011 Consultation and LLU and WLR Statement we were not challenging BT's estimate of the replacement cost of the entire duct network (i.e. as reported in the audited RFS), but rather BT's estimate of the replacement cost of duct assets BT had acquired since 1997, which is required as part of the RAV methodology for setting forward looking charge controls. As set out in paragraph 5.57 and consistent with the Ethernet 1 Draft Determinations, we do not consider that it would be appropriate to make a RAV adjustment for the purpose of assessing whether BT has overcharged for the services in dispute. We are not, therefore, proposing to adjust BT's estimate of the replacement cost of duct in 2009/10 as it appears in the RFS.¹⁰⁷
- 5.67 The duct holding gain (as reported at a market level in the RFS) results from a change in accounting estimate rather than, for example, an in-year change in the cost of labour or materials associated with building duct. This change in accounting estimate is an attempt to reflect in the 2009/10 RFS a change in the environment for building duct and the consequent replacement cost, which may have arisen at any point prior to the publication of the 2009/10 RFS. Therefore the gain through holding the asset may not actually all have arisen during 2009/10 but could have occurred during any year or over a number of years in the past (including years prior to the Relevant Period). As a result, we consider there is merit in BT's assertion in the 2009/10 RFS that the combination of the nature and size of the holding gain would result in an artificial upwards distortion of returns in 2009/10 if it was reflected in the unit costs. Since we have not identified that BT's exclusion of the holding gains is either an error or obviously inappropriate, we are not proposing to change BT's reported treatment of the holding gain associated with duct in 2009/10.

Main link in 2006/07

- 5.68 In 2006/07, revenues and costs associated with main link rentals were included within the revenue and cost information for WES and BES rental services. If main link revenues were below DSAC in 2006/07 then aggregation of the main link and rental charges could suppress the amount of overcharging on the WES rental services in dispute. However, if main link revenues were above DSAC in 2006/07, and WES rentals were above DSAC, then aggregation of main link and rental charges would make no difference to the overall level of overcharging. In the Ethernet 1 Draft Determinations (where main link rentals were in dispute) we considered it likely that main link revenues exceeded DSAC in 2006/07 but concluded that there was no robust way of disaggregating the data.¹⁰⁸
- 5.69 As in the Ethernet 1 Draft Determinations,¹⁰⁹ our analysis indicates that the revenue for main link, WES100 and WES1000 rentals exceeded DSAC in 2006/07. Therefore, we do not consider there is a risk that the aggregation of main link and WES100 and WES1000 rentals in 2006/07 has masked the extent of any overcharging. However,

¹⁰⁷ The LLU and WLR Statement does not explicitly discuss the CCA valuation of duct as used in the RFS, but this is discussed in Annex 5 of the LLU and WLR 2011 Consultation, which is available at <http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/annexes/wlr-cc-annexes.pdf>, see A5.18 to A5.20 and A5.76 to A5.85 in particular.

¹⁰⁸ Ethernet 1 Draft Determinations, paragraph 12.104.

¹⁰⁹ Ethernet 1 Draft Determinations, paragraphs 12.101-12.107.

since we are proposing to base our assessment of overcharging in 2006/07 on the aggregated data from the restated RFS in 2006/07 (as adjusted above and consistent with the Ethernet 1 Draft Determinations), our assessment of overcharging for WES100 rental and WES1000 rental will include an embedded overcharge on main link which we are unable to disaggregate.

- 5.70 Revenues for WES10 rental in 2006/07 were around 66% of DSAC. Given that our analysis (as set out in paragraphs 12.101-12.107 of the Ethernet 1 Draft Determinations) indicates that this is likely to include an embedded excess of revenue over DSAC for main link rental, it is unlikely that excluding the main link costs and revenues would result in WES10 rental charges being above DSAC in this year. Therefore, we consider that the aggregation of main link and WES rentals in 2006/07 will not materially affect our resolution of this Dispute.

Results and impact

- 5.71 On the basis of the information currently available to us, we are proposing to make four adjustments to the corrected RFS data associated with transmission equipment costs, 21CN costs, costs associated with excess construction charges and payment terms. The adjustments to FAC are set out in Tables 5.4 and 5.5.

Table 5.4: Impact of the adjustments on the corrected FAC for each of the services in dispute in the period 2006/07 to 2009/10, %

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental	(9%)	(12%)	(12%)	(8%)	(15%)
WES 100 rental	(10%)	(12%)	(12%)	(9%)	(17%)
WES 1000 rental	(12%)	(17%)	(15%)	(18%)	(33%)

Source: Ofcom, based on information provided by BT

Table 5.5: Impact of the adjustments on the corrected FAC for each of the services in dispute in the period 2006/07 to 2009/10, £m

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental	(11.1)	(8.5)	(10.0)	(7.7)	(19.7)
WES 100 rental	(4.7)	(4.5)	(5.4)	(5.9)	(19.7)
WES 1000 rental	(0.8)	(0.8)	(0.9)	(2.2)	(8.6)

Source: Ofcom, based on information provided by BT

- 5.72 On the basis of the information currently available to us, we believe that the adjustments proposed above are necessary and result in a data set suitable for resolving the Dispute.

Adjusting BT's DSACs

- 5.73 Before assessing whether BT has overcharged Verizon for the services in dispute we need to identify how our proposed adjustments to BT's FAC data translate into adjustments to BT's DSAC data.
- 5.74 The issue was discussed in some detail in the PPC Final Determinations¹¹⁰ and summarised in paragraphs 12.110-12.118 of the Ethernet 1 Draft Determinations. We

¹¹⁰ PPC Final Determinations, paragraphs 6.131 to 6.179.

have adopted the same approach in this Dispute as in those disputes and adjusted DSAC in line with the absolute adjustment made to FAC.

Summary of revenue and cost data

5.75 As in paragraphs 12.118 and 12.119 of the Ethernet 1 Draft Determinations, we now set out a summary of the revenue and cost data we propose to use to assess whether BT has overcharged for the services in dispute.

5.76 Table 5.6¹¹¹ sets out the corrected and adjusted external revenue and external DSAC for the services in dispute in the period 2006/07 to 2010/11 on a £m basis. The table shows the difference between external revenues and external DSAC. A positive number indicates that external revenues were greater than DSAC.

Table 5.6 Corrected and adjusted external revenue and DSAC data for each of the services in dispute in the period 2006/07 to 2010/11, £m

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental					
External revenue	2.2	10.2	29.0	38.9	34.4
External DSAC	3.4	13.9	23.2	40.8	94.6
Difference	(1.1)	(3.7)	5.8	(1.9)	(60.2)
WES 100 rental					
External revenue	4.2	13.5	20.8	27.8	34.5
External DSAC	2.2	7.5	12.6	26.4	74.1
Difference	2.0	6.0	8.2	1.4	(39.6)
WES 1000 rental					
External revenue	1.2	3.1	6.4	8.4	12.8
External DSAC	0.2	0.7	1.4	4.0	12.8
Difference	1.0	2.4	5.1	4.4	(0.02)

Source: Ofcom, based on information provided by BT.

5.77 Table 5.7 shows the corrected and adjusted external revenue and external DSAC for the services in dispute on a unit (per local end) basis. The table shows the difference between external revenues and external DSAC. A positive number indicates that external revenues were greater than DSAC. As explained in paragraphs 13.7 and 13.8 of the Ethernet 1 Draft Determinations, the average revenue per local end reported below may be materially different from the charge listed in the OPL.

5.78 There are very minor differences between the external DSACs for some services in 2009/10 presented in this table and those presented in Table 13.2 of the Ethernet 1 Draft Determinations. These do not materially affect the extent of overcharging. They have arisen because of new information provided to us by BT with respect to BES other bandwidth rental services, which were not in dispute in the Ethernet 1 disputes. This new information has a small impact on the adjustment for Excess Construction Charges discussed in paragraph 5.53-5.56. Parties should be aware that we intend to reflect these minor differences in the final determinations of the Ethernet 1 and Ethernet 2 disputes and this Dispute.

¹¹¹ Which is similar to Table 12.16 in the Ethernet 1 Draft Determinations.

Table 5.7 Corrected and adjusted external revenue and DSAC data for each of the services in dispute in the period 2006/07 to 2010/11, per local end

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental					
Unit charge	£1,462	£1,146	£2,040	£2,006	£1,632
Unit DSAC	£2,210	£1,566	£1,631	£2,102	£4,491
Difference	(£749)	(£420)	£409	(£96)	(£2,860)
WES 100 rental					
Unit charge	£4,508	£2,936	£2,656	£2,273	£2,141
Unit DSAC	£2,328	£1,639	£1,613	£2,160	£4,594
Difference	£2,180	£1,297	£1,043	£114	(£2,453)
WES 1000 rental					
Unit charge	£15,736	£9,238	£7,569	£5,555	£5,500
Unit DSAC	£2,471	£2,195	£1,597	£2,643	£5,510
Difference	£13,265	£7,043	£5,972	£2,911	(£10)

Source: Ofcom, based on information provided by BT

Note: Unit DSACs, average revenue and prices are given per local end throughout the Relevant Period. BT's RFS data was generated per circuit in 2006/07 and 2007/08 and we have halved these results to give results per local end. Some WES circuits only require a single end so these figures may under-state the average charge and the DSAC per end for WES services, but the results per end are presented for comparative purposes only and would not affect the calculation of the extent of overcharging.

Results of the DSAC test

5.79 As in paragraphs 13.3-13.14 of the Ethernet 1 Draft Determinations, and in line with step 2 of our methodology set out at paragraph 3.19, we now compare the disputed charges with their respective DSACs to identify any charges exceeding DSAC. Table 5.8¹¹² compares external average revenues with the external unit DSACs for the services in dispute, based on data provided by BT as adjusted by Ofcom,¹¹³ and shows the unit charge as a percentage of DSAC. A percentage above 100% indicates that the charge exceeded DSAC.

Table 5.8: Comparison of BT's external Ethernet unit revenues with an estimate of external unit DSAC

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental					
Unit charge (per local end)	£1,462	£1,146	£2,040	£2,006	£1,632
Unit DSAC (per local end)	£2,210	£1,566	£1,631	£2,102	£4,491
Unit charge as % of DSAC	66%	73%	125%	95%	36%
WES 100 rental					
Unit charge (per local end)	£4,508	£2,936	£2,656	£2,273	£2,141
Unit DSAC (per local end)	£2,328	£1,639	£1,613	£2,160	£4,594
Unit charge as % of DSAC	194%	179%	165%	105%	47%
WES 1000 rental					
Unit charge (per local end)	£15,736	£9,238	£7,569	£5,555	£5,500
Unit DSAC (per local end)	£2,471	£2,195	£1,597	£2,643	£5,510

¹¹² Table 5.8 is equivalent to Table 13.2 in the Ethernet 1 Draft Determinations.

¹¹³ The base data provided in BT's responses to question 2 of the 22 October s191 notice and question 1 of the 22 December 2011 s191 notice as amended in line with the adjustments described in paragraphs 5.29-5.74.

Provisional Conclusions concerning a dispute between Verizon and BT relating to BT's charges for WES

Unit charge as % of DSAC	637%	421%	474%	210%	99.8%
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Source: Ofcom, based on information provided by BT

Note: Unit DSACs, average revenue and prices are given per local end throughout the Relevant Period. BT's RFS data was generated per circuit in 2006/07 and 2007/08 and we have halved these results to give results per local end. Some WES circuits only require a single end so these figures may under-state the average charge and the DSAC per end for WES services, but the results per end are presented for comparative purposes only and would not affect the calculation of the extent of overcharging.

5.80 Therefore, on the basis of the data set out in Table 5.8 above, the following charges were above DSAC:

5.80.1 WES10 rental in 2008/09;

5.80.2 WES100 rental in 2006/07, 2007/08, 2008/09 and 2009/10;

5.80.3 WES1000 rental in 2006/07, 2007/08, 2008/09 and 2009/10.

Section 6

Ofcom's assessment of whether BT's charges were cost orientated

- 6.1 In this Section, we continue our assessment of the cost orientation of the disputed charges, and consider whether other factors could indicate that any charges exceeding DSAC were nonetheless cost orientated - step 3 of our analysis as described in paragraph 3.19.
- 6.2 We carry out the same assessment in relation to the charges disputed in the Ethernet 1 disputes at paragraphs 13.15 to 13.74 of the Ethernet 1 Draft Determinations.
- 6.3 We first consider Verizon's and BT's arguments as to what other factors are relevant to our assessment.

Verizon's arguments

- 6.4 Verizon states that it would expect Ofcom to follow broadly the three steps set out in paragraph 3.19 in resolving the Dispute.¹¹⁴ Verizon notes that Ofcom *"may want to apply other factors to its consideration of the level of the overcharge, such as those outlined in section 9 of the [Ethernet 1 Draft Determinations]"*.¹¹⁵

BT's arguments

- 6.5 As summarised at paragraph 13.17 of the Ethernet 1 Draft Determinations, BT considers that we should take the developing nature of the AISBO market into account when considering whether its charges were cost orientated. BT argues that: it should be able to use market level data in assessing cost orientation; it is entitled to earn a higher ROCE given the developing nature of the market; and due to a lack of historic data, it cannot accurately forecast its future costs and therefore it *"cannot confidently predict whether and how it needs to change its prices."*¹¹⁶

Ofcom's view

- 6.6 We set out our views on BT's arguments in paragraphs 13.18-13.27 of the Ethernet 1 Draft Determinations. In particular, we do not rule out the possibility that BT may have experienced difficulties in forecasting costs and revenues for individual services in dispute and that these difficulties may have contributed to it failing the DSAC test. Should BT wish us to take the specific circumstances surrounding a charge into account when assessing overcharging, it needs to provide us with an explanation of the specific reasons why it encountered such difficulties. It should also provide supporting evidence of its original forecasts and the factors that it considered at the time. BT would need to demonstrate that its unit DSACs were lower than it reasonably expected. If, for example, this was a consequence of an error in forecasting volumes, it would need to provide us with details of the volume forecasts it used in setting prices, together with an explanation of why it considered these to be reasonable forecasts and why the deviation from forecast led to the failure of the DSAC test. A second possibility is that unit DSACs could be lower than expected due

¹¹⁴ Verizon submission of 22 February 2012, paragraph 21.

¹¹⁵ Verizon submission of 22 February 2012, paragraph 27.

¹¹⁶ BT's submission of 20 May 2011, paragraph 32.

to unexpected movements in costs. If this were the case, BT would need to explain why the cost movements could not have been reasonably forecast and evidence of its original cost forecast, together with the supporting reasoning for that forecast at the time. We would typically expect BT to include, at a minimum:

- 6.6.1 a detailed description of which specific cost category (or categories) contributed to the change in unit costs;
 - 6.6.2 an explanation of the underlying reason for these cost changes;
 - 6.6.3 an explanation of why BT therefore considered the level of the costs to be different to the level it had reasonably expected; and
 - 6.6.4 if the actual unit volumes that occurred were not expected, the volumes that BT used in setting its prices.
- 6.7 While BT has not provided us with sufficient evidence to date to allow us to place significant weight on its arguments in relation to its forecasting difficulties in our assessments below, we do not rule out that it could provide such evidence in response to this Provisional Conclusions document. If specific evidence were provided by BT, it could lead us to revise our proposed conclusions below in relation to the affected services.

Results of analysis

- 6.8 Unless explicitly stated otherwise, the data reported within this Section relates to the level of aggregation reported in the RFS and refers to external customers only. We include pricing data for years that services are outside the scope of the Dispute as it is relevant context to the general path of pricing BT took with each of its services. All the data reported includes Ofcom's adjustments as described in paragraphs 5.29 to 5.74. For each of the services listed in BT's RFS (which include a number of different service variants) we set out the following information:
- 6.8.1 revenue as a percentage of DSAC;
 - 6.8.2 revenue as a percentage of FAC;
 - 6.8.3 ROCE;
 - 6.8.4 unit DSAC;¹¹⁷ and
 - 6.8.5 the price listed in the OPL for the service that makes up the majority of revenue in the service as listed in the RFS.
- 6.9 We refer to this financial and pricing data in a number of different tables in this Section. In each table, we highlight in grey where: the revenue/DSAC ratio is over 100% (i.e. where revenues are greater than DSAC); the revenue/FAC ratio is over 100% (i.e. where revenues are greater than FAC); and where the ROCE is greater than the "rest of BT" WACC (which was between 11% and 11.4% during the

¹¹⁷ Unit DSACs, average revenue and prices are given per local end throughout the Relevant Period. BT's RFS data was generated per circuit in 2006/07 and 2007/08 and we have halved these results to give results per local end. Some WES circuits only require a single end so these figures may understate the average charge and the DSAC per end for WES services, but the results per end are presented for comparative purposes only and would not affect the calculation of the extent of overcharging.

Relevant Period¹¹⁸). As we have explained in Ethernet 1 Draft Determinations,¹¹⁹ a charge above FAC (and hence one where the rate of return is greater than the WACC) does not necessarily indicate that BT's charges are not cost orientated, but rather lends weight to a conclusion of overcharging where the charge is also above DSAC.

- 6.10 We consider the services in the order in which they are set out throughout this Provisional Conclusion.

WES10 Rental

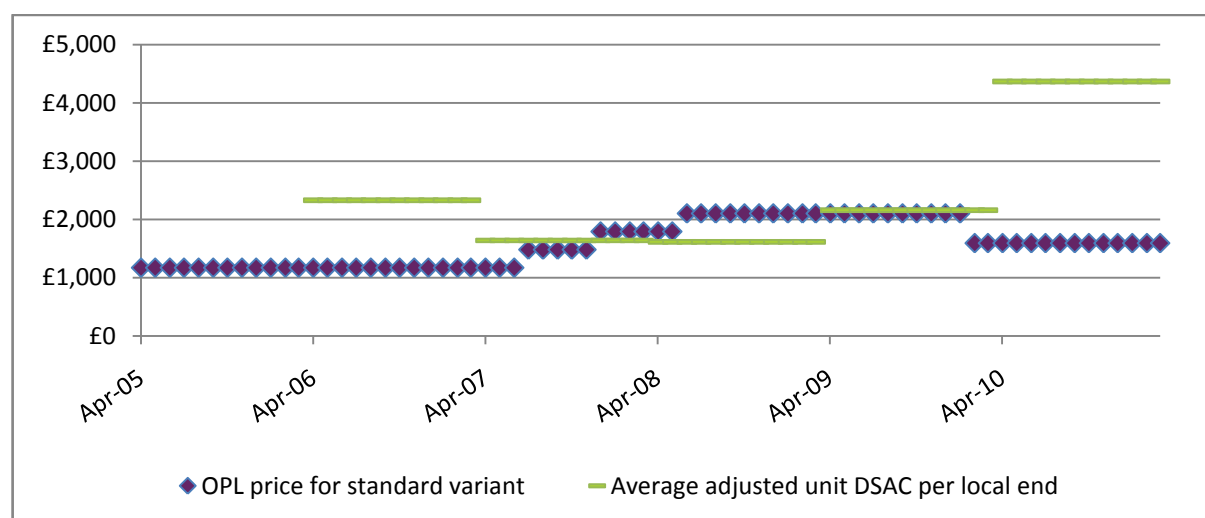
- 6.11 **Table 6.1** below shows the relevant comparisons of external DSAC, FAC and ROCE for WES10 rental over the Relevant Period. **Figure 6.1** shows the charge per local end for the standard service and the DSAC per local end for WES10 rental.

Table 6.1: Key financial measures for WES10 Rental, 2006/07 to 2009/10

Years	Revenue as % of DSAC	Revenue as % of FAC	ROCE
2006/07	66%	71%	1%
2007/08	73%	97%	10%
2008/09	125%	170%	32%
2009/10	95%	131%	22%
2010/11	36%	77%	(1%)

Source: Ofcom based on BT data

Figure 6.1: WES10 Rental, OPL price and unit DSAC per local end



Source: Ofcom based on BT data

- 6.12 In 2008/09, BT's charges exceeded DSAC. Revenues were also substantially above FAC in this year, resulting in a ROCE of 32%. This evidence would tend to support a conclusion of overcharging in 2008/09.
- 6.13 For all other years of the Relevant Period, revenues were below DSAC. We consider that this would support a conclusion of there being no overcharging in any financial years of the Relevant Period other than 2008/09.

¹¹⁸ The Rest of BT WACC was 11.4% in 2006/07, 2007/08 and 2008/09, and 11% in 2009/10 and 2010/11.

¹¹⁹ See paragraph 13.16 of the Ethernet 1 Draft Determinations.

- 6.14 As **Figure 6.1** shows, BT increased its charges three times for the standard variant WES10 rentals in June 2007, December 2007, and June 2008 from £1170 per local end to £2,100 per local end. This had a significant bearing on BT failing the DSAC test in 2008/09. Specifically, if BT had not increased its prices from the level in June 2007 then it would have passed the DSAC test for the whole period. This again appears to support a finding of overcharging in 2008/09.¹²⁰
- 6.15 However, as charges only exceeded DSAC for one year, if BT were able to supply us with specific evidence that demonstrates that it reasonably expected its charges in 2008/09 to be below unit DSAC, we may conclude that there was not overcharging in this year. As yet it has not provided such evidence.

Conclusion on WES10 Rental

- 6.16 We propose to conclude that BT has overcharged for WES10 rental services in 2008/09 on the basis that in that year:
- 6.16.1 revenues exceeded DSAC;
 - 6.16.2 revenues substantially exceeded FAC;
 - 6.16.3 BT's ROCE substantially exceeded its WACC; and
 - 6.16.4 BT breached its maximum cost ceiling as a result of increasing its charges three times.
- 6.17 BT has not provided any specific evidence as to why, despite its revenues exceeding DSAC, its charges were nonetheless cost orientated. If BT were able to provide us with this evidence, we may conclude that despite exceeding the DSAC ceiling its charges were nevertheless cost orientated.
- 6.18 In the Ethernet 1 Draft Determinations we did not reach a conclusion on overcharging in 2006/07, 2007/08 or 2009/10 as WES10 services were not in dispute.
- 6.19 Having now analysed the data for these years along with 2010/11 we propose to conclude that BT has not overcharged for WES10 rental services in 2006/07, 2007/08, 2009/10 and 2010/11 on the basis that its charges were below DSAC in all of these years.

WES100 rental

- 6.20 **Table 6.2** below shows the relevant comparisons of external DSAC, FAC and ROCE for WES100 rental over the Relevant Period. **Figure 6.2** shows the charge per local end for the standard service and the DSAC per local end for WES100 rental.

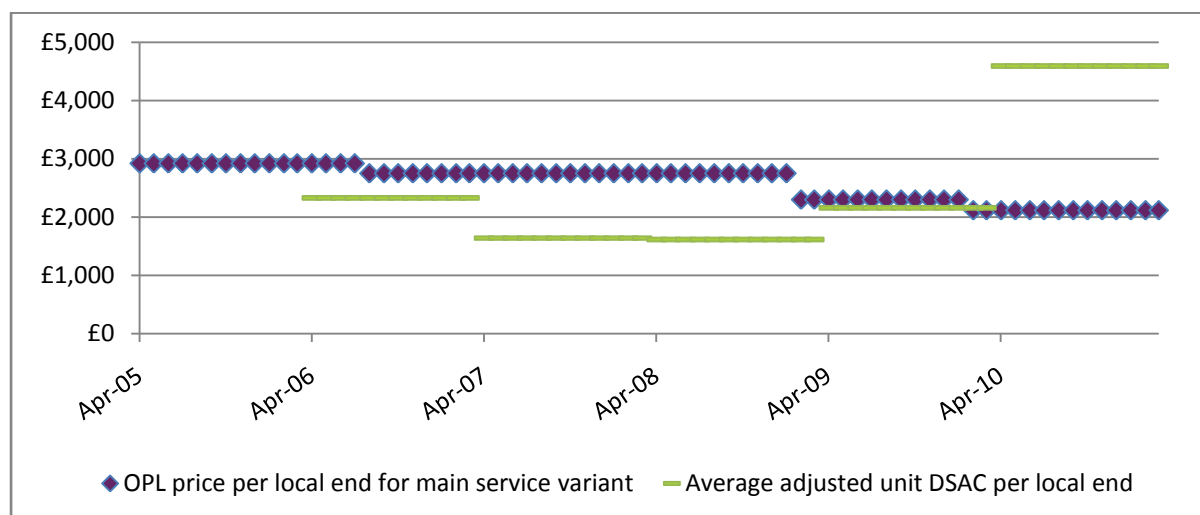
¹²⁰ In its November 2008 price change proposal, BT proposed no changes to WES 10 rental charges.

Table 6.2: Key financial measures for WES100 rental, 2006/07 to 2010/11

Years	Revenue as % of DSAC	Revenue as % of FAC	ROCE
2006/07	194%	217%	55%
2007/08	179%	244%	53%
2008/09	165%	221%	47%
2009/10	105%	146%	27%
2010/11 ¹²¹	47%	100%	11%

Source: Ofcom based on BT data

Figure 6.2: WES100 rental, OPL price and unit DSAC per local end



Source: Ofcom based on BT data

- 6.21 We considered whether BT was overcharging for WES100 rental from 2006/07 to 2008/09 in the Ethernet 1 disputes. As discussed there,¹²² our provisional conclusion is that BT overcharged for WES100 rental services in 2006/07, 2007/08 and 2008/09. Given the overlap between this Dispute and the Ethernet 1 disputes, we propose to adopt the same provisional conclusion in this Dispute.
- 6.22 Revenues also exceeded DSAC in 2009/10, but by considerably less than in the earlier three years.¹²³ This was partly due to an increase in DSAC in that year, and partly due to a reduction in average revenue due to price reductions in early 2010. However, this was not sufficient to bring revenue below DSAC in 2009/10. On this basis, it appears that BT's charges were persistently above DSAC for the period 2006/07 to 2009/10. As we explain in paragraph 9.33 of the Ethernet 1 Draft Determinations, we would normally expect charges above DSAC for this length of time to indicate that BT had failed to take action to alter its charges appropriately.
- 6.23 In 2010/11 revenue was below DSAC. This was largely because DSAC increased significantly in 2010/11, from around £2200 to £4600 per local end. However, average revenue also fell in 2010/11 such that, even without this increase in DSAC,

¹²¹ The financial data for 2010/11 are not the same as that used in the Ethernet 2 Provisional Determination for the reasons set out at paragraphs 5.44 to 5.50.

¹²² Ethernet 1 Draft Determinations, paragraphs 13.61-13.64.

¹²³ Similarly, the amount by which revenue exceeded FAC in 2009/10 was considerably lower than in the preceding years. Consistent with this, BT's ROCE was above its WACC for this year but also by a significantly lower amount than in the earlier years.

the reduction in revenue in 2010/11 would have brought prices into line with the DSAC. As a result of the removal of the adjustment for development costs (discussed in paragraphs 5.47 to 5.49), the costs data for 2010/11 used in these Provisional Conclusions are different from that used in the Ethernet 2 Provisional Determination. However, the revised costs data still lead us to reach the same provisional conclusion that BT did not overcharge for WES100 rental in 2010/11.

Conclusion on WES100 rental

6.24 As in the Ethernet 1 Draft Determinations, we provisionally conclude that BT overcharged for WES100 rental services in 2006/07, 2007/08 and 2008/09 on the basis that in each of those years:

6.24.1 revenues exceeded DSACs;

6.24.2 revenues exceeded FACs;

6.24.3 BT's ROCE was more than twice its WACC in all years; and

6.24.4 BT's price reductions over the period were insufficient to bring its charges below unit DSAC.

6.25 As in the Ethernet 2 Provisional Determination, we provisionally conclude that BT also overcharged for WES100 rental services in 2009/10 on the basis that:

6.25.1 revenues exceeded DSACs in this year;

6.25.2 revenues exceeded FACs in this year;

6.25.3 BT's ROCE was more than twice its WACC in this year; and

6.25.4 BT's price reductions in January 2010 were insufficient to bring its charges below unit DSAC.

6.26 As in the Ethernet 2 Provisional Determination, we provisionally conclude that BT did not overcharge for WES100 rental services in 2010/11 on the basis that revenues were less than DSAC.

6.27 Accordingly, we propose to conclude that BT overcharged for WES100 rental services in 2006/07, 2007/08, 2008/09 and 2009/10, on the bases set out above.

WES1000 rental

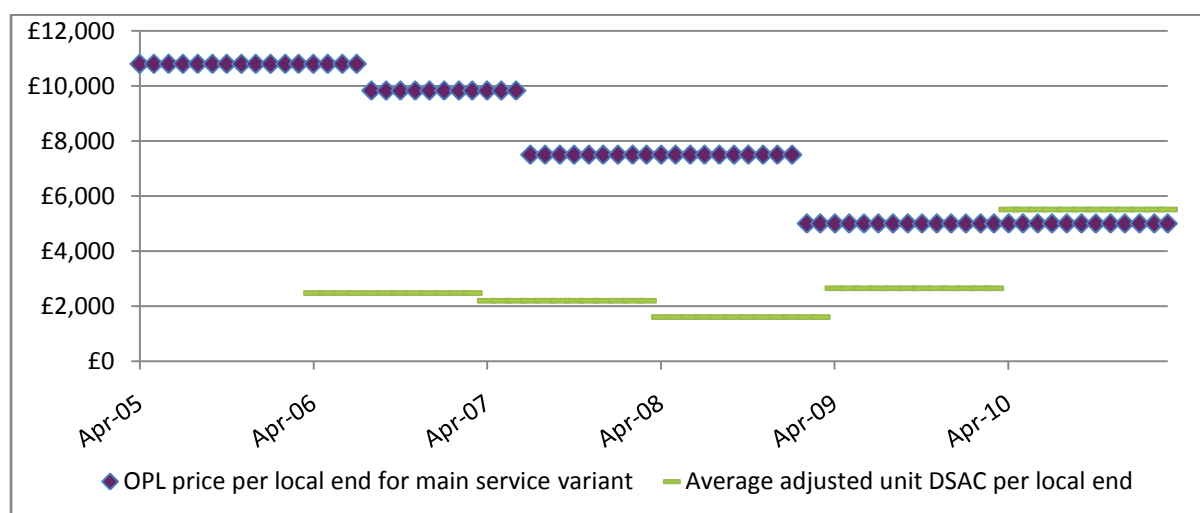
6.28 **Table 6.3** below shows the relevant comparisons of external DSAC, FAC and ROCE for WES1000 rental over the Relevant Period. **Figure 6.3** shows the charge per local end for the standard service and the DSAC per local end for WES1000 rental.

Table 6.3: Key financial measures for WES1000 rental, 2006/07 to 2010/11

Years	Revenue as % of DSAC	Revenue as % of FAC	ROCE
2006/07	637%	758%	277%
2007/08	421%	675%	212%
2008/09	474%	616%	160%
2009/10	210%	325%	95%
2010/11 ¹²⁴	99.8%	220% ¹²⁵	73%

Source: Ofcom based on BT data

Figure 6.3: WES1000 rental, OPL price and unit DSAC per local end



Source: Ofcom based on BT data

- 6.29 We considered whether BT was overcharging for WES1000 rental from 2006/07 to 2008/09 in the Ethernet 1 Draft Determinations¹²⁶. As discussed there,¹²⁷ our provisional conclusion is that BT has overcharged for WES1000 rental services for 2006/07, 2007/08, and 2008/09. We propose to adopt the same provisional conclusion in this Dispute.
- 6.30 In 2009/10, as discussed in paragraph 6.47 of the Ethernet 2 Provisional Determination, BT's revenues also exceeded DSAC, although by less than in the previous years. BT's revenues also substantially exceeded FAC, resulting in ROCE substantially above its WACC in this year.
- 6.31 In the Ethernet 2 Provisional Determination we provisionally concluded that in 2010/11, revenues were again above DSAC (see paragraph 6.48 of the Ethernet 2 Provisional Determination). As a result of the removal of the adjustment for development costs (discussed in paragraphs 5.47 to 5.49), the costs data for 2010/11 used in these Provisional Conclusions are different from those used in the

¹²⁴ The financial data for 2010/11 are not the same as that used in the Ethernet 2 Provisional Determination for the reasons set out at paragraphs 5.44 to 5.50.

¹²⁵ Due to a transcription error in Table 6.7 of the Ethernet 2 Provisional Determinations, this revenue/FAC ratio for WES 1000 rental was stated to be 166% when it should have been 264%. However, as a result of not making the development cost adjustment, revenue as a % of FAC is reduced to 220% as set out in the table above.

¹²⁶ We also showed the information for 2009/10, but did not draw any conclusions in this year as it was not in the scope of the Ethernet 1 disputes.

¹²⁷ Ethernet 1 Draft Determinations, paragraphs 13.66-13.70.

Ethernet 2 Provisional Determination. On the basis of the revised cost data, we provisionally conclude that revenues for WES1000 rental services in 2010/11 did not exceed DSAC. Accordingly, our provisional conclusion is that BT did not overcharge for WES1000 rental services in 2010/11.

Conclusion on WES1000 rental

- 6.32 As in the Ethernet 1 Draft Determinations, we provisionally conclude that BT has overcharged for WES1000 rental services for 2006/07, 2007/08 and 2008/09 on the basis that:
- 6.32.1 revenues exceeded DSAC in each of those years;
 - 6.32.2 revenues substantially exceeded FAC in each of those years;
 - 6.32.3 ROCEs were substantially above the WACC in each of those years; and
 - 6.32.4 BT's price reductions over the Relevant Period were insufficient to bring its charges below unit DSAC.
- 6.33 As in the Ethernet 2 Provisional Determination, we provisionally conclude that BT also overcharged for WES1000 rental services in 2009/10 on the basis that:
- 6.33.1 revenues exceeded DSAC in that year;
 - 6.33.2 revenues substantially exceeded FAC in that year; and
 - 6.33.3 ROCEs were substantially above the WACC in that year.
- 6.34 We provisionally conclude that BT has not overcharged for WES1000 rental services in 2010/11 as revenues were below DSAC. For the reasons set out in paragraphs 5.44-5.50 above, this differs from our conclusions in the Ethernet 2 Provisional Determination.
- 6.35 Accordingly, we propose to conclude that BT overcharged for WES1000 rental services in 2006/07, 2007/08, 2008/09, and 2009/10 on the bases set out above. We propose to conclude that BT did not overcharge for WES1000 rental services in 2010/11.

Section 7

Overcharge and repayment

- 7.1 Having provisionally established the years in which BT overcharged for specific services in Section 6, in this Section we go on to consider the extent of that overcharging. We then consider whether we should direct BT to make a repayment to Verizon, and if so what the level of any such repayment should be.
- 7.2 We provisionally conclude that BT has overcharged Verizon for WES services over the Relevant Period as set out in Table 7.1:

Table 7.1 Ethernet services where overcharging has been identified

	2006/07	2007/08	2008/09	2009/10	2010/11
WES10 rental	N*	N*	Y	N*	N*
WES100 rental	Y	Y	Y	Y	N
WES1000 rental	Y	Y	Y	Y	N**

Source: Ofcom based on BT data

Key – Y = Provisionally conclude overcharging, N = Provisionally conclude no overcharging. * New provisional conclusion not previously reached in the Ethernet 1 or Ethernet 2 disputes. ** Different provisional conclusion to that reached in Ethernet 2 dispute.

Establishing the level of overcharge

- 7.3 As in paragraphs 13.75-13.79 of the Ethernet 1 Draft Determinations, having provisionally established the years in which BT overcharged for the services in dispute, we go on to consider the extent of that overcharging. We establish the level of overcharge by comparing actual charges with the maximum charge under which we would have considered BT not to have overcharged for its services. The maximum charge that would have been permissible is normally at the level of DSAC, so where we conclude that BT has overcharged for a service, we consider that the extent of overcharging is the extent by which BT's charges exceeded DSAC.
- 7.4 The level of overcharging we calculate for each service is:
- 7.4.1 zero if charges were lower than DSAC;
- 7.4.2 zero if charges were above DSAC, but we nonetheless consider that they were cost orientated; or
- 7.4.3 the difference between charges and DSAC, if charges were above DSAC and we consider that they were not cost orientated.
- 7.5 We summarise the levels of overcharging in Table 7.2 below. We calculate the level of overcharging with respect to all of BT's external customers.

Table 7.2: The degree of overcharging to BT's external customers, £m¹²⁸

	2006/07	2007/08	2008/09	2009/10	2010/11
WES 10 rental	-	-	5.8	-	-
WES 100 rental	2.0	6.0	8.2	1.4	-
WES 1000 rental	1.0	2.4	5.1	4.4	-

Source: Ofcom based on BT data

Is BT required to make repayments to Verizon for the overcharge?

- 7.6 We have provisionally concluded that BT has overcharged for the services in dispute for periods of between one and four years over the Relevant Period as summarised in Table 7.2 above.
- 7.7 We now consider whether we should exercise our discretion under section 190(2)(d) of the 2003 Act to direct BT to make a payment to Verizon by way of adjustment of an overpayment, and if so what the level of any such repayment should be. We carry out this assessment in relation to the Ethernet 1 disputes in Section 14 of the Ethernet 1 Draft Determinations.
- 7.8 In deciding whether it is appropriate to give such a direction, we have been guided by our duties and Community obligations under sections 3, 4 and 4A of the 2003 Act (as amended). We have also taken account of guidance provided by the CAT and comments made to us by the Parties.
- 7.9 As in the Ethernet 1 Draft Determinations, we first consider whether we should require payment by BT to Verizon; if so, we consider what the level of any repayment should be.

Verizon's views

- 7.10 Verizon considers that BT should be required to repay the amount overcharged, plus interest.¹²⁹

BT's views

- 7.11 We set out BT's views on the remedy that Ofcom can grant under section 190(2)(d), and whether it should grant a remedy in the case of the Ethernet 1 disputes, at paragraphs 14.12 to 14.19 of the Ethernet 1 Draft Determinations.

Ofcom's views

- 7.12 Consistent with our views set out in the Ethernet 1 Draft Determinations at paragraphs 14.24-14.30 we consider that, given the evidence of overcharging that we have identified and in light of the guidance provided by the CAT, we should direct that BT repay Verizon for the full amount of the overcharge.

Calculating the level of repayments

- 7.13 As in the Ethernet 1 Draft Determinations, to calculate repayments to Verizon for each year, we propose to use BT's billing data for each service in dispute to calculate

¹²⁸ Figures are rounded to the nearest £100,000.

¹²⁹ Verizon submission of 22 February 2012, paragraph 1.

the relative share of total external spend that is attributable to Verizon. On the basis of this proposed methodology, we set out in Table 7.3 below the proposed repayments to Verizon for each service in each year (rounded to the nearest £1000).

Table 7.3: Repayments due to Verizon in £ split by year and service

	2006/07	2007/08	2008/09	2009/10	2010/11	Total
WES 10 rental	[X]	[X]	[X]	[X]	[X]	[X]
WES 100 rental	[X]	[X]	[X]	[X]	[X]	[X]
WES 1000 rental	[X]	[X]	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]	[X]	[X]

Amounts to nearest £thousand. Totals have been calculated by summing the rounded data.

Source: Ofcom, based on data supplied by BT

Interest on repayments

Verizon's comments

- 7.14 Verizon's submission states that *"interest should be payable on the repayment that is due"* because *"BT has been unjustly enriched as a result of overcharging for [the services in dispute]. It has avoided the need to have working capital to the extent of the overcharging."* Verizon notes that conversely *"Verizon has had to raise extra working capital which it should not have had to do."* Verizon considers that *"to allow BT to benefit in this way sends the wrong signals and simply encourages the same behaviour in the future."*¹³⁰
- 7.15 Verizon notes that the contracts under which the services in dispute were purchased by Verizon do not provide for interest in this context and contends that this is *"a breach of the requirement to offer fair and reasonable terms"*.¹³¹ It refers to Ofcom's determination of the *Dispute between THUS and BT about payment terms for PPCs, IECs and IBCs* (the "PPC payment terms dispute"),¹³² in which Ofcom directed BT to make a repayment that had been calculated on the basis of the total cost of capital which BT avoided as a result of BT's reduced working capital requirements caused by THUS' early payment for certain products and services.¹³³ Verizon notes THUS' submission in that dispute that the payment terms *"simply reflect what BT was able to impose on its customers... by virtue of its significant market power"*¹³⁴ and considers that *"This situation exactly reflects the position in the current dispute"*.¹³⁵
- 7.16 Verizon submits that Ofcom should require BT *"to compensate Verizon for effects in relation to working cost of capital."* It considers that the compensation should be calculated by reference to the designated WACC for BT Openreach at the relevant times or on the basis of a benchmarked interest rate (e.g. from BT's Standard Interconnect Agreement) or with reference to the relevant BT cost of capital.¹³⁶

¹³⁰ Verizon submission of 22 February, paragraph 28.

¹³¹ Verizon submission of 22 February, paragraph 29.

¹³² See http://stakeholders.ofcom.org.uk/binaries/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_916/thusbt.pdf

¹³³ Verizon submission of 22 February, paragraph 30.

¹³⁴ PPC payment terms dispute, paragraph 2.5.

¹³⁵ Verizon response to question 12 of the pre-EPM questionnaire, 9 March 2012.

¹³⁶ Verizon submission of 22 February, paragraph 32.

Ofcom's view

- 7.17 As noted by Verizon in its submission (see paragraph 7.15 above), the contracts applicable to the services in dispute¹³⁷ exclude interest on any repayments due to either party as a result of recalculation or adjustment of a charge with retrospective effect under a direction (or other requirement) of Ofcom.

12.3. If any charge is recalculated or adjusted with retrospective effect under an order, direction, determination or requirement of Ofcom, or any other regulatory authority or body of competent jurisdiction, the parties agree that interest will not be payable on any amount due to either party as a result of that recalculation or adjustment.

- 7.18 The PPC payment terms dispute concerned specifically whether BT's payment terms for the provision of certain products and services¹³⁸ were in accordance with SMP conditions requiring BT to provide those products and services on fair and reasonable terms, conditions and charges. Ofcom determined that they were not, and required BT to change its payment terms and to pay THUS a sum by way of adjustment for the overpayment of charges for the products and services to cover the loss incurred through early payment.
- 7.19 This Dispute, however, concerns whether BT's charges for certain WES services were cost orientated; whether the contractual terms on which BT provided the services were fair and reasonable is outside the scope of this Dispute.
- 7.20 Ofcom therefore proposes to direct that interest should be paid on the repayments in accordance with the contractual provisions entered into by the Parties. This is consistent with our previous determinations and the Ethernet 1 Draft Determinations and Ethernet 2 Provisional Determination.¹³⁹ In this case, the relevant contractual provisions provide that interest will not be payable.

Ofcom's statutory obligations and regulatory principles

- 7.21 We have considered our general duties in section 3 of the 2003 Act and the six "Community requirements" set out in section 4 of the 2003 Act, which give effect, among other things, to the requirements of Article 8 of the Framework Directive.
- 7.22 We consider that this Provisional Determination is consistent with these duties and we would highlight in particular the following statutory obligations and regulatory principles as relevant to our proposed decision to require BT to make repayments by way of adjustment of overpayments in this Dispute.
- 7.23 Accepting the Dispute for resolution fits with Ofcom's regulatory principle to intervene where there is a specific regulatory duty to do so.
- 7.24 Ofcom considers that to require BT to make a repayment to Verizon by way of adjustment of an overpayment supports its obligation to further the interests of consumers, where appropriate by promoting competition, as it encourages BT to

¹³⁷ From 2004 until March 2009 WES services were provided under BT's contract for Wholesale Extension Services; from March 2009 to March 2010 they were provided under a consolidated contract for Backhaul and Wholesale Extension Services; and since March 2010 they have been provided under BT's Contract for Connectivity Services.

¹³⁸ PPCs, interconnection extension circuits ("IECs") and intra building circuits ("IBCs")

¹³⁹ Ethernet 1 Draft Determinations, paragraphs 14.36-14.37.

comply with its SMP obligations (the purpose of which is to promote competition). It promotes competition more generally by enabling other providers to compete with BT in the provision of retail leased lines to businesses. Promoting competition in this case leads to benefits for businesses in the form of increased choice, downward pressure on retail prices and improved quality of service.

- 7.25 Requiring BT to make a repayment as set out in Table 7.3, supports Ofcom's principal duty at section 3(1)(b) of the 2003 Act as well as its duty under section 4 of the 2003 Act, to promote competition in communications markets in accordance with the Framework Directive.
- 7.26 In addition, Ofcom considers that requiring BT to make a repayment to Verizon by way of adjustment of an overpayment supports its obligation at section 3(2)(b) of the 2003 Act to secure the availability of a wide range of communications services, as well as its duty under section 4 of the 2003 Act to encourage the provision of network access (here, Ethernet services) for the purposes of securing efficiency and sustainable competition, for the benefit of consumers.
- 7.27 Finally, Ofcom considers that its proposal to require BT to make a repayment to Verizon by way of adjustment of the overpayment is in line with Ofcom's duty and regulatory principles to ensure that its regulatory activities are transparent, accountable, evidence-based, proportionate, consistent and targeted.
- 7.28 Ofcom considers that this document clearly sets out BT's and Verizon's arguments and Ofcom's reasoning that leads to this proposed conclusion, thereby supporting Ofcom's duty and regulatory principle to ensure that its decision making process is evidence-based, proportionate and consistent. BT and Verizon will have an opportunity to comment on Ofcom's proposals, supporting Ofcom's duty to ensure that its regulatory activities are transparent, accountable, evidence-based and consistent. Ofcom considers that its proposed determination is proportionate, in that it strikes a fair balance between the Parties to the Dispute, and targeted in that it is limited to the matters in dispute and binding on the Parties.

Summary of proposed resolution of the Dispute

- 7.29 Based on the analysis set out in Sections 3-7, Ofcom proposes to determine that:
- 7.29.1 BT has overcharged for a number of the services that are the subject of this Dispute;
 - 7.29.2 BT has overcharged Verizon a total of £[REDACTED] during the Relevant Period; and
 - 7.29.3 BT should refund Verizon the amount overpaid.

Next steps

- 7.30 Stakeholders are invited to comment on Ofcom's proposed resolution of this Dispute by **5pm on 23 April 2012**.

Annex 1

Responding to the Provisional Conclusions

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 23 April 2012**.
- A1.2 We would be grateful if you could assist us by completing a response cover sheet (see Annex 2), to indicate whether or not there are confidentiality issues.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email francesco.savino@ofcom.org.uk attaching your response in Microsoft Word format, together with a response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below:
- Francesco Savino
4th Floor
Competition Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7783 4109
- A1.5 Note that we do not need a hard copy in addition to an electronic version.
- A1.6 It would be helpful if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues raised in this document, or need advice on the appropriate form of response, please contact Francesco Savino on 020 7981 3259.

Confidentiality

- A1.8 In line with our Dispute Resolution Guidelines,¹⁴⁰ as part of publishing a final determination, Ofcom may publish non-confidential versions of responses. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.
- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. For the avoidance of doubt, Ofcom

¹⁴⁰ *Dispute Resolution Guidelines - Ofcom's guidelines for the handling of regulatory disputes (June 2011)*. See: <http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-resolution-guidelines/statement/guidelines.pdf>.

does not regards submissions on legal or regulatory policy to be confidential and any such submissions will normally be disclosed publicly. Further, Ofcom will sometimes be required to publish/disclose information marked as confidential in order to meet legal obligations.

- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/accoun/disclaimer/>.

Next steps

- A1.11 Following the end of the period for comment, Ofcom intends to publish a final determination.
- A1.12 Please note that you can register to receive free mail updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm.

Annex 2

Response cover sheet

- A2.1 In the interests of transparency and good regulatory practice, we will publish all responses in full on our website, www.ofcom.org.uk.
- A2.2 We have produced a coversheet for responses and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A2.3 Publishing responses before the period for comment closes can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the period for comment has ended.
- A2.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A2.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response

BASIC DETAILS

Title of provisional conclusions document:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing

☐

Name/contact details/job title

☐

Whole response

☐

Organisation

☐

Part of the response

☐

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the period for comment has ended, please tick here.

☐

Name

Signed (if hard copy)

Annex 3

Provisional Determination to resolve the dispute between BT and Verizon

Determination under sections 188 and 190 of the Communications Act 2003 ("2003 Act") for resolving a dispute between Verizon UK Limited ("Verizon") and British Telecommunications Plc ("BT") concerning BT's charges for wholesale Ethernet services.

WHEREAS—

(A) Section 188(2) of the 2003 Act provides that, where Ofcom has decided pursuant to section 186(2) of the 2003 Act that it is appropriate for it to handle a dispute, Ofcom must consider the dispute and make a determination for resolving it. The determination that Ofcom makes for resolving the dispute must be notified to the parties in accordance with section 188(7) of the 2003 Act, together with a full statement of the reasons on which the determination is based. Ofcom must publish so much of its determination as (having regard, in particular, to the need to preserve commercial confidentiality) it considers appropriate to publish for bringing it to the attention of the members of the public, including to the extent that Ofcom considers pursuant to section 393(2)(a) of the 2003 Act that any such disclosure is made for the purpose of facilitating the carrying out by Ofcom of any of its functions;

(B) Section 190 of the 2003 Act sets out the scope of Ofcom's powers on resolving a dispute which may include, in accordance with section 190(2) of the 2003 Act:

- a) making a declaration setting out the rights and obligations of the parties to the dispute;
- b) giving a direction fixing the terms or conditions of transactions between the parties to the dispute;
- c) giving a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
- d) for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties to the dispute to the other, giving a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment;

(C) On 24 June 2004, Ofcom published a statement called "*Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*"¹⁴¹ (the "2004 LLMR Statement") which found that BT held significant market power ("SMP") in a number of markets, including the wholesale alternative interface symmetric broadband origination ("AISBO") market at all bandwidths within the United Kingdom but not including the Hull Area;

¹⁴¹ See: http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

(D) In the 2004 LLMR Statement, Ofcom imposed a series of SMP conditions on BT in the AISBO market under section 45 of the Act, including a basis of charges obligation which requires:

“HH3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.

HH3.2 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

(E) On 8 December 2008, Ofcom published the conclusions of its second review of the markets for retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments in the 2008 Business Connectivity Market Review Statement (the “2008 BCMR Statement”).¹⁴² Ofcom concluded that two separate markets should now be defined for AISBO services: a low bandwidth AISBO market for services with bandwidths up to and including 1Gbit/s and a high bandwidth AISBO market for services with bandwidths above 1Gbit/s. Ofcom concluded that BT continued to have SMP in the market for low bandwidth AISBO services outside the Hull area but that no communications provider had SMP in the high bandwidth AISBO market.

(F) In the 2008 BCMR Statement, Ofcom imposed SMP conditions on BT in relation to the low bandwidth AISBO market (services with bandwidths up to and including 1Gbit/s), including a basis of charges obligation. Ofcom additionally concluded that BT should in principle be subject to a charge control in relation to low bandwidth AISBO services, the scope and form of which was considered in a separate consultation published alongside the BCMR Statement. The basis of charges obligation requires:

“HH3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.

HH3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by Condition HH1 is for a service which is subject to a charge control under Condition HH4, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition HH3.1.

HH3.2 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”

¹⁴² See <http://stakeholders.ofcom.org.uk/binaries/consultations/bcmr08/summary/bcmr08.pdf>.

(G) On 22 February 2012, Verizon referred a dispute with BT to Ofcom for dispute resolution requesting a determination that BT has overcharged Verizon for certain wholesale Ethernet services, known as Wholesale Extension Services ("WES") (which depends on whether or not BT's charges for those services were cost orientated) and, if so, by how much Verizon has been overcharged and should therefore be reimbursed. The dispute concerns the period between 1 April 2006 and 31 March 2011;

(H) Having considered the submissions of the parties to the dispute, Ofcom set the scope of the issues in dispute to be resolved as follows-

"The scope of the dispute is to determine:

Whether, from 1 April 2006 to 31 March 2011:

- *BT overcharged Verizon for the following rental charges:*
 - *WES/WEES10*
 - *WES/WEES100*
 - *WES/WEES1000*
- *by how much Verizon was overcharged for those services; and*
- *whether, and by how much, BT should reimburse Verizon in relation to the overcharge";*

(J) In order to resolve this dispute, Ofcom has considered (among other things) the information provided by the parties and Ofcom has further acted in accordance with its general duties set out in section 3 and the Community requirements set out in sections 4 and 4A of the 2003 Act;

(K) A fuller explanation of the background to the dispute and Ofcom's reasons for making this Determination is set out in the explanatory statement accompanying this Determination; and

NOW, THEREFORE, OFCOM MAKES, FOR THE REASONS SET OUT IN THE ACCOMPANYING EXPLANATORY STATEMENT, THE FOLLOWING DETERMINATION FOR RESOLVING THE DISPUTE:

I Declaration of rights and obligations, etc.

1. BT has overcharged Verizon for the provision of the services which BT calls WES10 rental, WES100 rental, WES1000 rental.
2. The level of that overcharge is determined at £[X].
3. Ofcom gives a direction to BT to pay to Verizon, by way of adjustment of an overpayment for WES10 rental, WES100 rental, WES1000 rental in the period between 1 April 2006 and 31 March 2011, the sum of £[X] plus interest calculated at the rate specified in the Agreements.

II Binding nature and effective date

4. This Determination is binding on BT and Verizon in accordance with section 190(8) of the 2003 Act.

5. This Determination shall take effect on the day it is published.

III Interpretation

6. For the purpose of interpreting this Determination—

- a) except as otherwise defined in this Determination, words or expressions used in this Determination (and in the recitals hereto) shall have the same meaning as they have been ascribed in the 2003 Act;
- b) headings and titles shall be disregarded; and
- c) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.

7. In this Determination—

- a) “2003 Act” means the Communications Act 2003 (c.21) (as amended);
- b) “Agreements” means the contract for Wholesale Extension Services, the contract for Backhaul and Wholesale Extension Services, and the Contract for Connectivity Services that Verizon has entered into with BT;
- c) “BT” means British Telecommunications plc, whose registered company number is 01800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, as defined by section 1159 of the Companies Act 2006;
- d) “Verizon” means Verizon UK Limited, whose registered company number is 02776038;
- e) “Ofcom” means the Office of Communications.

Neil Buckley
Director of Investigations

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

[Date]

Annex 4

Relevant cost standards for Ofcom's analysis

- A4.1 As set out at **paragraph 2.4.3**, the cost orientation obligations imposed on BT in the AISBO markets require BT to secure that *"each and every charge offered, payable or proposed for Network Access covered by Condition HH3.1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed"* (emphasis added).
- A4.2 This obligation requires Ethernet charges to be LRIC-based and to provide for the recovery of an appropriate share of common costs. The key cost measures relevant to these Disputes and the common terminology used are summarised in the table below. This annex is the same as Annex 6 of the Ethernet 1 Draft Determinations.

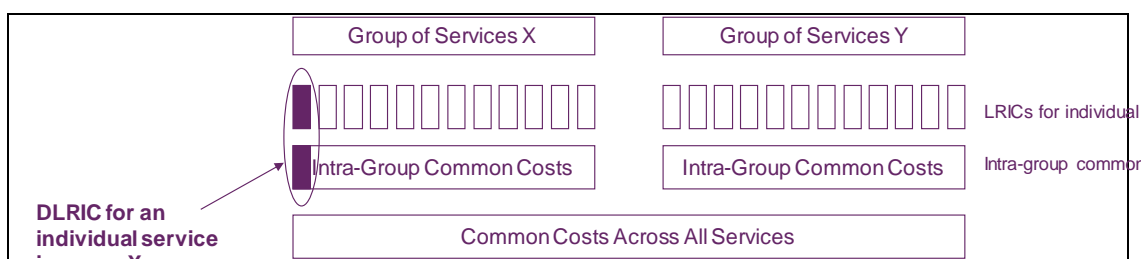
Incremental cost is the cost of producing a specified additional product, service or increment of output over a specified time period. In many cases, the relevant increment may be the entire output of a particular service or group of services. The incremental costs of a service are then those costs which are directly caused by the provision of that service in addition to the other services which the firm also produces. Another way of expressing this is that the incremental costs of a service are the difference between the total costs in a situation where the service is provided and the costs in another situation where the service is not provided.

Long Run Incremental Cost ("LRIC") is the incremental cost over the long run, i.e. the period over which all costs can, if necessary, be varied.

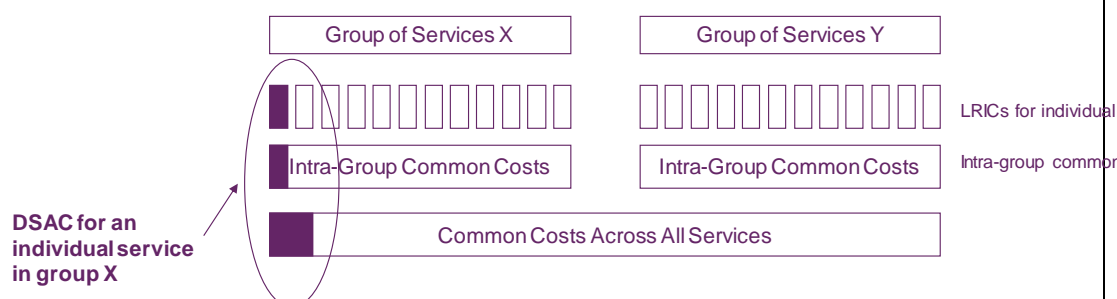
Common costs are those costs which arise from the provision of a group of services but which are not incremental to the provision of any individual service. Common costs may be identified in the following way: if the incremental costs of each service are removed from the total cost of providing all services, what are left are the common costs (i.e. those costs which are shared). Where there are no common costs, incremental cost and SAC are the same. Where there are common costs, the SAC of a service is the sum of the incremental cost of the service plus all of the costs which are common between that service and other services.

Stand Alone Cost ("SAC") is the cost of providing that particular service on its own, i.e. on a stand-alone basis.

Distributed Long Run Incremental Cost ("DLRIC") is a cost measure related to the LRIC of a component. Within BT's network, groups of components are combined together to form what is known as a "broad increment". Two of these "broad increments" are the core network and the access network. The DLRIC of a component is equal to the LRIC of a component plus a share of the costs that are common between the components within the "broad increment", these costs are known as "intra-group" common costs. The common costs are shared between the components by distributing them on an equi-proportionate mark up (EPMU) basis. The sum of the DLRICs of all the components in the core is equal to the LRIC of the core itself. This is represented in the diagram below:



Distributed Stand Alone Cost (“DSAC”) is a cost measure related to the LRIC of a component. As described above, there are components within the “broad increment” of the core. As an example the DSAC of a core component is calculated by distributing the SAC of the core between all the components that lie within the core. Each core component therefore takes a share of the intra-group common costs, and the costs that are common to the provision of all services. The sum of the core components DSACs is equal to the SAC of the core. This is demonstrated in the diagram below:



Fully allocated cost (“FAC”) is an accounting approach under which all the costs of the company are distributed between its various products and services.

Fixed and variable costs: when considering which costs are fixed and which are variable the time period is key. In the short-run some costs (particularly capital costs) are fixed. The shorter the time period considered, the more costs are likely to be fixed. In the long-run, all costs are (by definition) considered variable.

Current Cost Accounting (“CCA”) is an accounting convention, where assets are valued and depreciated according to their current replacement cost whilst maintaining the operating or financial capital of the business entity.

Weighted average cost of capital (“WACC”): a company's WACC measures the rate of return that a firm needs to earn in order to reward its investors. It is an average representing the expected return on all of its securities, including both equity and debt.

Annex 5

Glossary

2003 Act: Communications Act 2003.

21st Century Network (21CN) BT's network programme which aims to provide a new simplified and higher capacity UK core network to manage the growing volumes of digital media traffic being consumed by end users.

Additional Financial Statements (AFS) Financial statements which BT produces in addition to the RFS, provided to Ofcom on a confidential basis. They give a breakdown of the published accounts information by individual service.

Alternative interface symmetric broadband origination (AISBO) A form of symmetric broadband origination service providing symmetric capacity between two sites, generally using an Ethernet IEEE 802.3 interface.

BT British Telecommunications plc, whose registered company number is 1800000.

Backhaul Extension Services (BES) A wholesale Ethernet service which provides high speed, point-to-point data circuits. Each one provides a secure link from a customer's premises, to a Communications Provider's Digital Subscriber Line Access Multiplexer and the Communications Provider's site. Please refer to Section 6 of the Ethernet 1 Draft Determinations for further explanation.

Bandwidth The physical characteristic of a telecommunications system that indicates the speed at which information can be transferred. In analogue systems, it is measured in cycles per second (Hertz) and in digital systems in bits per second (Bit/s).

Common Costs See Annex 4.

Communications Provider (CP) A person who provides an Electronic Communications Network or provides an Electronic Communications Service (as defined by section 32 of the Communications Act 2003).

Cost Volume Relationships (CVR) LRICs are derived using a CVR. A CVR is a curve which describes how costs change as the volume of the cost driver changes. The costs associated with an increment can be of several types:

- Variable with respect to the increment being measured;
- Fixed but increment specific; and
- Fixed but spanning several increments.

Current Cost Accounting (CCA) See Annex 4.

Customer Premises Equipment (CPE) Sometimes referred to as customer apparatus or consumer equipment, being equipment on consumers' premises which is not part of the public telecommunications network and which is directly or indirectly attached to it.

Distributed LRIC (DLRIC) See Annex 4.

Distributed SAC (DSAC) See Annex 4.

Equi-Proportionate Mark Up (EPMU) A method of allocating Fixed and Common Costs in proportion to the LRICs.

Ethernet Access Direct (EAD) A wholesale Ethernet product which offers permanently connected, point-to-point high speed data circuits that provide a secure and un-contended access service for Communications Providers. EAD is a next generation network compatible service designed to complement Openreach's Ethernet Backhaul Direct (EBD) and Bulk Transport Link (BTL) products already offered within the Connectivity Services portfolio.

Ethernet Backhaul Direct (EBD) A wholesale Ethernet product which offers permanently connected, point-to-point high speed data circuits that provide a secure and un-contended backhaul service for Communications Providers.

Electronic Communications Network (ECN) A transmission system for the conveyance, by the use of electrical, magnetic or electro-magnetic energy, of signals of any description.

Fixed and common costs (FCC) See Common costs.

Fully allocated cost (FAC) See Annex 4.

Gbit/s Gigabits per second. A measure of speed of transfer of digital information.

HCA (historical cost accounting) depreciation The measure of the cost in terms of its original purchase price of the economic benefits of tangible fixed assets that have been consumed during a period. Consumption includes the wearing out, using up or other reduction in the useful economic life of a tangible fixed asset whether arising from use, effluxion of time or obsolescence through either changes in technology or demand for the goods and services produced by the asset.

kbit/s kilobits per second. A measure of speed of transfer of digital information.

LAN Extension Service (LES) A communications service that enables the connection of two Local Area Networks together.

Leased line A permanently connected communications link between two customer premises, or between a customer's premises and the CP's network, dedicated to the customers' exclusive use.

Long Run Incremental Cost (LRIC) See Annex 4.

LLU (Local Loop Unbundling) The process where the incumbent operators make their local network (the copper cables that run from customers' premises to the exchange) available to other companies. CPs are able to upgrade individual lines using DSL technology to offer services such as always on high speed Internet access, direct to the customer.

Mbit/s Megabits per second. A measure of speed of transfer of digital information.

Next Generation Network (NGN) A Network utilising new technology such as Ethernet and IP to provide an array of services to end-users.

Openreach Price List (OPL) The price list published by BT for services provided by Openreach.

Partial Private Circuit (PPC) A generic term used to describe a category of private circuits that terminate at a point of connection between two communications providers' networks. It is therefore the provision of transparent transmission capacity between a customer's premises and a point of connection between the two communications providers' networks. It may also be termed a part leased line.

Points of Connection (POC) A point where one communications provider interconnects with another communications provider for the purposes of connecting their networks to 3rd party customers in order to provide services to those end customers.

Regulated Asset Value (RAV) The RAV relates to the valuation of Openreach's access assets deployed before August 1997 on a historic costs accounting (HCA) basis, and assets deployed since August 1997 on a current costs accounting (CCA) replacement cost basis.

Regulatory Financial Statements (RFS) The annual financial statements that BT is required to prepare and publish in order to demonstrate compliance with its regulatory obligations.

Stand Alone Cost (SAC) See Annex 4.

Symmetric broadband origination (SBO) A symmetric broadband origination service provides symmetric capacity from a customer's premises to an appropriate point of aggregation, generally referred to as a node, in the network hierarchy. In this context, a "customer" refers to any public electronic communications network provider or end user.

Traditional interface symmetric broadband origination (TISBO) A form of symmetric broadband origination service providing symmetric capacity from a customer's premises to an appropriate point of aggregation in the network hierarchy, using a CCITT G703 interface.

Verizon Verizon UK Limited whose registered company number is 02776038

Weighted Average Cost of Capital (WACC) See Annex 4.

Wholesale End-to-End Service (WEES) A type of Ethernet product which allows a CP to provide its customers with a dedicated fibre optic high bandwidth data circuit between two different sites.

Wholesale Extension Service (WES) A wholesale Ethernet product that can be used to link a customer premises to a node in a communications network. Please refer to Section 6 of the Ethernet 1 Draft Determinations for further explanation.