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Dear Lawrence,

Dispute between TalkTalk Group ("TTG") and Openreach relating to the 'interim' MPF rental charge

We are pleased to set out in the following TTG's comments on Ofcom's provisional reasoning and assessment of the matters in dispute.

We are naturally disappointed in Ofcom's provisional assessment that Openreach is compliant with all relevant SMP obligations by levying an MPF rental charge of £91.50 during the period when there are no charge controls in place. We were equally disappointed in the reasoning that Ofcom has adopted; as we explain below we consider that the implication of Openreach's provisional reasoning is that in absence of a charge control Openreach has wide leeway to set too high prices to the detriment of consumers and Ofcom is unwilling and/or unable to act to prevent this from happening.

We make the following comments.

Cost orientation test – relevant cost method

Ofcom states that BT is not required to base its charges on FAC and that in any event FAC is likely to be below DSAC so would satisfy the requirement to use DSAC "*as a primary cost benchmark for cost-orientation.*" It is somewhat unclear what Ofcom is trying to say here (since DSAC is a 'first-order test' not a 'primary benchmark') but it appears to TTG that Ofcom is provisionally concluding that Openreach is compliant with Condition FAA4.1 as long as the MPF rental charge is below DSAC.

We accept that a first-order test when considering whether a charge is cost-orientated is to assess whether it is below DSAC (and indeed above DLRIC). Ofcom has applied this test in several cases before and the test was considered to be a reasonable first order test by the CAT in the PPC judgment.¹ However, the problem with Ofcom's reasoning is

¹ British Telecommunications Plc v Office of Communications (Partial Private Circuits), [2011] CAT 5.

that it stops there. Ofcom needs to ask itself the further question, if the charge passes the DSAC first-order test, are there any factors that justify additional tests as to whether a particular charge is cost-orientated? Ofcom fails to consider this question in its provisional conclusions and rather simplistically suggests that as long as the MPF rental charge is below DSAC, it passes the cost-orientation test.

TTG submits that there are other relevant factors that warrant further analysis in the specific circumstances of this dispute when assessing whether the charge is cost-orientated in a compliant way. Ofcom suggests that basing the cost orientation test on FAC would be '*at least as restrictive as the requirements of a charge control*'.² That may well be the case but is not a stand-alone reason for not adopting a FAC-based price in this dispute for the following reasons:

- (i) Openreach has already accepted that the price should be based on FAC costs because it has itself based its interim price on a FAC figures from the 2009 model for the year 2011/12 (updated to reflect revisions by the Competition Commission);
- (ii) Ofcom has already accepted that a FAC-based price is appropriate by announcing in December 2010 that Openreach had adopted a reasonable approach; and
- (iii) It is an undisputed fact that Openreach has SMP in this market and that a charge control should be imposed on MPF line rental. The mere fact that Ofcom has failed to impose a charge control for the financial year 11/12 is not a reason to not adopt a FAC-based approach in the interim period. On the contrary, there is all the more reason in this particular dispute to adopt a FAC-based approach, based on the most recent economic evidence, to ensure that consumers are not harmed by Openreach's pricing behaviour. Indeed, by declaring that a FAC-based price would be as restrictive as a charge control, Ofcom appears to concede that if a charge control would have been in place this financial year (2011/12) then this would have meant that the MPF rental charge may well have been no higher than £90.00 (or, based on more up-to-date data, £88.70³).

On the above basis we would argue that FAC is the most appropriate test of whether the price is consistent with and whether Ofcom has met its duties under the Communications Act 2003 especially Section 3(1)(b) thereof which requires Ofcom "*to further the interests of consumers in relevant markets, where appropriate by promoting competition.*" Ofcom's failure to impose a price control on Openreach means in essence that consumers have to pay more than they should for telephony and broadband services during the 2011/12 financial year.

² Paragraph 3.22 of the dispute consultation.

³ On 23 November 2011 Ofcom published a second consultation on the LLU and WLR charge control. This corrected for two erroneous mis-allocations with the result that the mid-case MPF rental charge for 2011/12 would be about £88.70.

Although it is far from clear in the consultation document, Ofcom may argue that it did not apply solely a first-order test but that it took into account the reasoning put forward by Openreach when setting the MPF rental charge at £91.50 (that is Ofcom's 2009 charge control statement and the Competition Commission's revisions to this). However, the provisional conclusions appear to say that Openreach's price is only one of many prices that would satisfy the cost-orientation requirement because it passes the first-order test of being below DSAC. This would mean that Ofcom is giving the green light to Openreach that charging to a DSAC ceiling will always be compliant with a cost-orientation obligation. This is not satisfactory and Ofcom must explain exactly why it believes that the Interim Price is a compliant cost-orientated price and not simply that it is "broadly ok" because it is below DSAC.

Cost orientation test – measurement of DSAC

Even if DSAC were the correct ultimate (i.e. not just first-order) basis to assess cost orientation then a second question arises of how much is the DSAC cost? Ofcom seems to have relied wholly on the 2010/11 RFS as the basis for DSAC (though even this simple issue is vague). We contend that this calculation of DSAC is unsound for many reasons:

- It is based on 2010/11 data not 2011/12 (which is evidently the correct data to assess compliance of the 2011/12 charge). Ofcom should have at least adjusted the 10/11 data to create an estimate for 11/12;
- The RFS data is based on valuing assets using CCA whereas Ofcom consider that a hybrid approach of CCA and RAV is appropriate;⁴
- The 2010/11 RFS accounts are highly distorted by significant one-off holding gains that are not relevant and would not occur in 2011/12;
- The data is not audited (one of the benefits of using FAC is that it is audited); and
- The data is based on an out-dated assumption of the appropriate cost of capital.

Use of out-dated information

Openreach have based its Interim Charge on the 2009 Statement (updated to reflect the Competition Commission's determination). We do not consider this is the appropriate evidence base because more appropriate and up-to-date economic evidence emerged through the current consultation work stream by Ofcom. Ofcom may well have considered that using 2009 data was a "reasonable approach" to take at the time (in December 2010) when the Interim Charge was announced but we fail to understand how Ofcom could continue to hold that view when it knew that more appropriate and up-to-date economic evidence was readily available.

Ofcom argues that this more up to date evidence is not "settled" and that Openreach could therefore ignore this information. We fail to understand why an Ofcom analysis from early 2009, even if updated in 2010 to reflect the Competition Commission

⁴ A new pricing framework for Openreach, Ofcom statement, 22 May 2009.

decision, should take precedence over an up-to-date analysis in 2011. Ofcom knows that its previous two-year-old analysis is out-of-date by some margin but still chooses to ignore it simply because Openreach has chosen to use older data and refused to update its calculations with the most recent evidence. Ofcom have provided no reason to justify its preference for using this out-of-date information.

The error of Ofcom's approach is particularly stark in respect of the cost of capital. In the 2009 decision the cost of capital for MPF charges was set at 10.1%. In the March 2011 consultation the relevant costs of capital for MPF was proposed at 8.6%. In July 2011 (in the WBA Charge Control Statement) the cost of capital for MPF was confirmed at 8.8%. Indeed Ofcom stated that *"the cost of capital estimates for BT [...] have been calculated for the purposes of the WBA charge control which will apply to 2013/14. However, we intend to apply these rates to other relevant charge controls. In the case of the forthcoming WLR/LLU charge controls, for example, we note that the charge control statement is likely to be published towards the end of 2011."*⁵ There is no proper reason and Ofcom certainly has not advanced one as to why it is right to use out of date and incorrect assumptions for cost of capital as Ofcom has done.

In any case, we also note that in resolving disputes the CAT has made clear that it is incumbent on Ofcom to take into account best available data even if this data is still subject to consultation and further review. Ignoring such data as Ofcom appears to do in this dispute would be a serious error in approach.⁶

Ofcom's 'statement' in December 2010 was final

Ofcom emphasises that it was *"clear in our view to all parties at the time that the Interim Charge would be in place until 31 March 2012"* and that Openreach did not receive any comments or objections from industry when they notified the Interim Charge. Ofcom seems to use that this was 'the position that we took' as a justification for making no changes.⁷ We disagree.

Openreach is a monopoly supplier and, while providers clearly need to know what they will be charged, it is equally important that they can be certain that the charge is always based on efficiently incurred costs (as assessed by the regulator). When Openreach notified the Interim Charge, TalkTalk had no option but to assume that the charge was efficiently incurred because it was based on the 2009 model (updated) though we were unable to actually see the model. We are forced to rely on Ofcom to make sure that Openreach's MPF rental charge is accurate in this sense.

We believe Ofcom has given its previous statement about the Interim Charge undue weight in resolving this dispute. The fact that Ofcom made its statement has limited

⁵ WBA charge control, Ofcom statement, 20 July 2011, paragraph 6.7.

⁶ Cable & Wireless and others v Office of Communications (Termination Rate Disputes) [2008] CAT 12, paragraph 150.

⁷ Paragraph 3.28 of the dispute consultation.

relevance. We consider that Ofcom is erroneously elevating the need for 'certainty' to the same binding status as might be appropriate, for instance, in the case where a charge control has been set for several years by means of a regulatory order on the basis of detailed and up to date analysis. Any need to ensure commercial certainty for Openreach cannot take precedence (or even afford equal importance) over the prevailing duty to ensure that prices by a monopoly provider are not too high. In the specific circumstances of this dispute, Ofcom does have updated cost information at hand and would normally have imposed a charge control on the MPF rental charge. Ofcom has a duty to act on this evidence and ensure that prices are based on efficiently incurred costs and best available cost evidence and this must outweigh the exaggerated importance of certainty and/or the binding nature of Ofcom's 'position'.

Need for certainty

Ofcom argues that keeping the charge set at the level set in December 2010 provides *"beneficial certainty for all affected stakeholders for the period between the old and the new charge control."* We disagree.

As we described above at the time of the Dec 2010 decision we were not aware of the additional information that may subsequently come to light. Once it had come to light (in March 2011) and/or when Openreach had been notified that its prices were inappropriate the certainty argument falls away. Openreach could have changed the price at that point (or following a short notification period). Pleading certainty as a reason for no change now plays into the hands of Openreach since they know that if they drag out a dispute they can retain the supranormal profit from levying excessive charges.

In any case, and if Ofcom consider certainty so important it could require (as a resolution of this dispute) that MPF prices going forward (following a short notification period) are set at £88.70.

Increased impact due to Ofcom's delay

Ofcom has recently announced that the publication of its next consultation document has been delayed further and it seems unlikely therefore that any new charge controls would not take effect before 1 April 2012. This means that Openreach would not have been the subject of formal price controls for whole year despite the fact that it has SMP in the wholesale access market and that Ofcom has said that a further control would be necessary. Therefore the excessive level of charges paid by competitors / consumers will persist for an even longer period. We consider that this fact increases the onus on Ofcom to ensure that the MPF charge is based on a proper level.

Notification period

Ofcom mentions the 90 day notification period but does not subsequently take a position.⁸ Notwithstanding, in the case where notification period is appropriate (and

⁸ Paragraphs 3.5.2 and 3.31 of the dispute consultation.

that is not clear at all), a 28 day notification period (or less) would be appropriate. Ofcom has previously waived notification periods or set them at less than 90 days (for example, recent new provide price reduction⁹ and when 2009 charge control was set on 22 May 2009¹⁰).

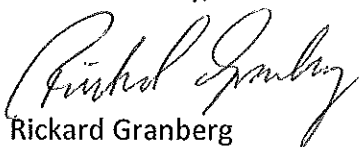
Conclusions

In conclusion, we believe Ofcom's conclusions are highly unsatisfactory from a downstream competition and consumers' perspective. It seems to us that according to Ofcom's flawed interpretation of its duties Openreach holds all the cards in this situation since Ofcom deems that the cost orientation and fair and reasonable obligations should be interpreted in such a lax way. Openreach have set a price based on now outdated cost data and are able to take advantage of the failure by Ofcom to impose a price control by extracting an excessive price for MPF line rental for a period of 12 months. When we then realise that the price is set too high based on published Ofcom assumptions, we are now being told that the legal and financial certainty that Ofcom says it afforded to Openreach is seemingly more important than ensuring that the prices consumers pay for their broadband is set on an efficiently incurred basis. The price that customers will pay for Ofcom's ruling in favour of Openreach is about £15 million.¹¹

We consider that lower MPF rental charge should be backdated to 1 April 2012 (or the date in June 2011 when we informed Openreach of the inconsistency). In the alternative:

- If Ofcom consider that only a 'settled' decision is relevant then Ofcom should set the MPF charge (from 20 July 2012) on the basis of the 'settled' cost of capital as decided in the WBA Charge Control decision; or
- If Ofcom consider that certainty is decisive then it should set the MPF rental charge at £88.70 from the determination of this dispute.

Yours sincerely,



Rickard Granberg

Head of Regulation and Compliance

⁹ Waiver of BT's price notification requirements for wholesale analogue exchange line (basic and premium) and LLU metallic path facility services rental charges, Ofcom Statement and Consents, 23 September 2011.

¹⁰ A new pricing framework for Openreach, Ofcom statement, 22 May 2009.

¹¹ 2011/12 average 5.2m MPF lines (LLU charge control March consultation A6.7) and price difference of £91.50 versus £88.70.