



OFCOM'S COST ORIENTATION PROJECT

An opportunity to review Ofcom's overall
approach to price regulation

Initial submission by BT

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Introduction and background:

Ofcom has now started work on a project looking at the cost orientation ("basis of charges") SMP remedy, with a view to producing fresh guidelines for stakeholders. Linked to this, Ofcom is also undertaking a review of regulatory financial reporting requirements.

We think it is essential that the scope of this work is sufficiently broad to include an assessment of when, why and how the overall suite of alternative SMP remedies available in Ofcom's regulatory tool box – which include the cost orientation remedy – should be used to regulate activity in SMP markets. We believe there is a substantial opportunity to streamline the remedies applied and clarify the specific purpose of regulation across different markets. Such clarity will have obvious advantages to all market players by increasing certainty and consistency around the role of regulation. We want to ensure Ofcom's overall future approach reflects key economic principles of good, proportionate regulation.

This paper sets out our initial views on what we see as the underlying concerns with the current shape of regulation and how we think these should be addressed. We will respond separately to Ofcom's "call for inputs" on this project in due course, but are keen to engage on the substance of these issues at the earliest opportunity.

We recognise that many of our concerns touch upon issues raised in recent and ongoing disputes/appeals. We nevertheless believe that constructive progress can be made on the high-level issues of principle and this will assist in moving towards an improved future regulatory framework.

Summary of our position:

- It is understandable that, having found SMP in a defined market, Ofcom may have concerns with the level and structure of pricing in that market. But Ofcom has options about how any regulation should be imposed:
 - it can take prescriptive/interventionist “rules based” approaches to charge setting in SMP markets;
 - it can take more permissive approaches to the level and structure of charges, where the focus of any intervention is more clearly on concerns that pricing may give rise to anti-competitive effects; or
 - it can use other lighter touch regulatory remedies such as non-discrimination obligations that seek to deal with effects, but not prices directly.
- In practice, Ofcom will use a mix of these options to address concerns in any given market – for example, by imposing more restrictive rules-based RPI-X remedies across broad baskets of services alongside theoretically more permissive effects-based remedies to services within the basket. However, we are concerned that the overall balance of regulatory activity in the UK has in effect become more prescriptive/interventionist at far too granular a level and, as a result, less clearly effects-focussed. We are concerned that this is inconsistent with the principle that regulation should be proportionate – i.e. the minimum necessary to address identified concerns with market structures and behaviours.
- Overall, the risks of “over-engineering” regulation applying to the detail of price structures are significant in multi-product, fast moving, dynamic markets such as telecoms with significant fixed and common costs. A broad range of pricing structures within and across regulated markets could be considered consistent with economically efficient market outcomes. Disproportionately prescriptive and granular regulatory intervention clearly risks distorting investment and market entry signals.
- In some respects, Ofcom appears to adopt broadly the correct framework within which to assess the appropriate “primary remedy” to impose in regulating behaviour in different types of markets where SMP has been found. High level commentary within market reviews suggests Ofcom generally imposes more prescriptive and restrictive charge controls where SMP is considered more entrenched; allows greater flexibility by imposing the cost orientation remedy in nascent markets and in markets where demand is falling and/or competition is expected to grow; and uses non-discrimination obligations to ensure a level playing field in other circumstances. However, we have two related headline concerns with how regulation actually seems to then take effect in SMP markets:
 - First, taking too narrow an approach to interpreting the cost orientation obligation works against the very flexibility that this remedy is designed to allow and undermines the reasoning underpinning the choice of “primary remedy” (i.e. whether to use cost orientation instead of a charge control or whether to set a charge control across a broad basket of services). The DLRIC-DSAC test should not be the only reference point for assessing cost orientation, particularly when the test is applied at a granular level of pricing (e.g. at the level of components used to make up services actually purchased). A broader set of evidence needs to be

taken into account and assessed with the primary focus being on the effects of the level and structure of pricing on competition.

- Second, the interaction of different remedies introduced in the same market further unduly limits pricing flexibility. For instance, Ofcom frequently imposes the cost orientation remedy alongside a charge control and a non-discrimination obligation. Where average prices are explicitly constrained by the operation of a charge control – and noting that safeguard sub-caps are also often in place – any further regulation should only be driven by specific concerns about how prices could be structured to disadvantage certain CPs. The DLRIC-DSAC test applied at a granular level does not infer any such effects and applying and interpreting the cost orientation remedy in that way does not seem proportionate.
- We believe that by re-assessing the application of core economic principles of effective regulation which underpin decisions on when to introduce specific SMP remedies in specific markets, there will be scope to streamline the remedies applied and/or to at least take a more proportionate effects-based approach to interpreting remedies such as cost orientation and non-discrimination, when imposed.
- Furthermore, a clearer, more proportionate set of effective regulatory pricing remedies, consistently applied, will present opportunities for simplifying regulatory reporting requirements.
- We recognise that different stakeholders may have different views on what is and what is not proportionate regulation even when assessing the same market structures. However, re-assessing the overall economic rationale and principles underpinning regulation will have broader advantages in this regard. Stakeholders will have a chance to debate and gain clarity on the assessment framework Ofcom will adopt in particular circumstances. This will improve regulatory certainty over time, particularly if this assessment framework is then clearly and consistently applied in market reviews when the overall shape of SMP rules is decided. The aim should be to have a set of remedies in any given market that have been clearly introduced to address a set of identified concerns, such that all stakeholders should have a clear understanding of how/when those remedies will be enforced. Improved certainty around compliance should then result in a reduced level of disputes and complaints moving forwards.

I – Context to this review: we are concerned that overall regulatory activity in the UK exceeds the “minimum necessary” to address the identified structural and behavioural issues in markets

1. At the conclusion of the Telecoms Strategic Review, Ofcom stated:

“[our] overall approach... both in the individual decisions that we have taken over the past year and in the Strategic Review, has been to create a regulatory framework which seeks to encourage and incentivise sustainable, scale, infrastructure competition at the deepest extent possible. “

2. This approach was based on (a) the imposition of specific SMP remedies following market reviews under the Common Regulatory Framework; and (b) the introduction of the Undertakings which introduced a range of organisation and behavioural requirements on BT.
3. We would note the following:
 - The over-riding mindset was clearly that regulatory intervention should be **focussed upstream** on enduring economic bottlenecks and at all times be proportionate and the “**minimum necessary**” intervention. Elsewhere, regulation should seek to “**let the market decide**”. This reflected the view that regulatory judgements would inevitably be “second best” compared to competitive market outcomes.
 - Ofcom had established a clear view – following stakeholder consultation – on “**what good looked like**” in terms of broad market outcomes. This then provided the benchmark for assessing the expected impact and net benefits of different forms of regulatory intervention – i.e. it became the reference point to assess the proportionality of any intervention.
 - By this, Ofcom established that the overall role of regulation was to incentivise behaviour that supported the emergence of scale infrastructure competition and innovation and – as a result – create **choice and value for money** for UK consumers. If regulation would not facilitate this, then it would clearly not be “necessary”. It followed that any **intervention should be effects-driven** – i.e. have the clear aim of preventing behaviour that was likely to have an anti-competitive impact by impeding efficient investment by competitors and result in sub-optimal market outcomes for consumers.
4. We believe that 6 years on from the TSR, there is clear evidence that vibrant and effective competition has continued to emerge in a range of markets downstream of the identified enduring access bottlenecks. Among other things, we see a radically different competitive landscape in the provision of residential services, particularly in the availability, pricing and take-up of broadband where BT is facing strong competition from Virgin Media, TalkTalk and Sky. This clearly reflects the investments those CPs, along with others, have made during that period. Elsewhere, we have seen continued investment by CPs to increase their capabilities in providing business connectivity services in competition to BT.
5. Our concern is that despite this, the regulation overall has not evolved as we would have expected 6 years ago. Rather than seeing a clear focus on the “minimum necessary

regulation" – i.e. focussed intervention to address specific competitive concerns – recent activity suggests that regulation is actually now more intrusive. We would note the following:

- While SMP has been removed in certain markets following the last round of market reviews, we also saw an overall extension in the scope of BT's services subject to charge controls including – in the case of PPC trunk – into services provided over core networks (i.e. outside of enduring access bottlenecks);
 - We still face obligations to provide services to competitors on regulated terms at multiple levels of the value chain and, in fact, a further layer of regulation has now been introduced in relation to, for NGA, the provision of passive infrastructure services in addition to existing regulation of active upstream services; and
 - We continue to see a significant flow of disputes about BT services referred to Ofcom and this has resulted in regulatory intervention to adjust the level and structure of individual prices for services supplied into regulated markets. Moreover, such intervention has been based on the application of rigidly applied pricing rules (e.g. in relation to DSAC) at a highly granular level (e.g. components making up individual services) and has not been clearly effects-driven.
6. We recognise that Ofcom may hold a different view on our high level assessment of regulation. The current set of regulatory remedies reflect the output of detailed consultations on specific market reviews and Ofcom will have considered any dispute raised on its own merits and will have made a regulatory judgement based on the evidence available to it. Furthermore, many of Ofcom's decisions (particularly in last 2-3 years) have been appealed and further scrutinised by the CAT. Where decisions have been overturned, Ofcom will believe that Judgments have been reflected in decision-making processes moving forwards.
7. However, we believe there is value to be gained from taking a step back from the detail of these specific decisions and taking stock of the cumulative impact these have had on the overall regulatory framework and approach. The current level of regulation can then be re-assessed against the core principles of "good regulation" put forward at the time of the TSR and set out above. Our view is that these principles remain valid and should form a set of shared high level objectives with Ofcom and with other stakeholders which, therefore, can be used as an objective basis on which to assess the overall appropriateness of regulation and its application in specific instances, e.g. dispute resolution.
8. Ofcom's project to produce cost orientation guidelines provides a good opportunity to conduct such a re-assessment. Cost orientation – how it should be used and enforced – can only be assessed fully in the context of overall regulation taking account of how Ofcom is using the suite of regulatory remedies in its regulatory tool kit and how the different remedies – charge controls, sub-caps, cost orientation, non-discrimination – interact with each other. The scope of this review should capture both when (and why) the cost orientation remedy should (and should not) be used as well as how it should be used/interpreted in assessing compliance. Furthermore, a full assessment of price regulation will be of significant value to Ofcom's related project reviewing regulatory reporting requirements. There will also be value in clearly restating at a broad, principle

level what regulation is trying to achieve and opening up a debate with stakeholders on this to establish greater clarity and understanding about the regulatory rules.

II - The big picture: Ofcom's overall approach to regulation

9. Ofcom can clearly only regulate activity on an *ex ante* basis where SMP has been established following a market review in a defined economic market. This in itself requires Ofcom to have fully considered the existence of pricing constraints from alternative providers of substitute services and/or from potential market entrants. Once SMP is identified, an understandable set of regulatory concerns with potential market behaviour – including price setting – arise. Wholesale prices set above the economically efficient “competitive” level will lead to sub-optimal levels of consumption and reduced economic welfare overall (a “vertical” issue); prices too low will impede investment in competing infrastructures (a “horizontal” issue). However, the finding of SMP does not in itself mean that any specific form of regulation of prices that is introduced can be considered “necessary”. Ofcom can impose a number of separate *ex ante* remedies once SMP is found – individually or in combination – ranging from intervention to prescribe detailed pricing structures to taking a more ‘permissive’ and flexible approach with any intervention based on *ex post* assessments of specific concerns with market behaviour as they emerge.
10. In identifying the appropriate regulatory approach, we would note that in any multi-service, network-based industry with significant levels of fixed common costs and economies of scale and scope, identifying the economically efficient competitive level of pricing for any individual service or group of services is, outside of simplified theoretical examples, a far from straightforward exercise. It is common ground that:
 - in being **prescriptive** about the structure of charges, and taking a rigid view on how fixed and common costs are recovered from specific services, regulation risks setting economically inefficient charges;
 - in being **more permissive** about pricing in SMP markets, regulation risks allowing prices to be set at levels that might be viewed as exploitative and/or exclusionary in terms of downstream competition and which might allow super-normal returns to persist without triggering market entry.
11. In making its judgement on the appropriate level of intervention and to ensure consistency with the principle of “minimum necessary regulation”, Ofcom therefore takes account of the specific nature of the market in question before deciding the precise form of price regulation that is required.
12. Our view is that, broadly speaking, Ofcom has correctly tended to adopt the following approach in deciding what we would call the “primary remedy”¹ for regulating prices:
 - **Use of specific charge controls:** where entrenched/enduring SMP is found in established markets and is expected to endure throughout the period covered by the market review.

¹ The term “primary remedy” is used to indicate the significance of this choice of whether to set a specific charge control or rely only on cost orientation. We discuss the relevance of other SMP remedies to pricing below.

- **Use of cost orientation remedy and/or the non-discrimination remedy:** where SMP is found in either:
 - nascent markets where the precise nature and level of demand is especially uncertain; or
 - markets where, despite the current finding of SMP, some degree of competition is expected to emerge before the next market review²; or markets containing products at or near the end of their product lifecycle where volumes are expected to fall as customers migrate away to alternative sources of supply over time³.

III - Charge controls impose prescriptive constraints, whilst incentivising efficiency improvements

13. RPI-X charge controls are designed to allow revenues to be earned which provide an opportunity for BT, if efficient, to recover its costs and earn a fair “normal” return on investments – where this return reflects the regulatory estimate of BT’s WACC. In all recent charge controls, Ofcom has taken a view on the appropriate level of fixed and common costs that should be recovered from the regulated basket of services based on Fully Allocated Costs⁴ (“FAC”) – i.e. where all fixed and common costs are distributed across all services following an objective and transparent allocation methodology.
14. By imposing restrictions *ex ante* for – what is now – a 3 year period and on the basis of key assumptions about future volumes, efficiencies and costs, RPI-X controls are also designed to incentivise efficiency improvements – i.e. BT could earn returns above WACC if efficiency targets are exceeded and glide paths will serve to share the benefits with consumers over time rather than clawing them back immediately as under “rate of return” regulation. Nevertheless, charge controls are still broadly set to provide a clear and targeted restriction on BT’s ability to set prices that could earn super-normal levels of profitability within the market in the long run. They are therefore inherently prescriptive and restrictive in nature. That said, Ofcom can allow relatively more or less flexibility (be more or less prescriptive) around the setting of individual service prices by establishing broad or narrow charge control baskets across different combinations of services within the relevant regulated market(s).

IV - The cost orientation remedy is – as a policy choice – imposed as a less restrictive primary remedy for price regulation and must therefore logically be interpreted as such

15. In all the cases above where Ofcom decides to impose the **cost orientation** remedy as an *alternative* remedy to the imposition of a charge control, the common context is a concern that any attempt to impose a prescriptive charge control based on recovery of forecast FAC would present too great a risk to achieving efficient market outcomes when assessed against potential benefits that could be expected to arise by constraining prices in that way. Put simply, any prescriptive regulatory intervention based on forecast future costs would be made against too uncertain a view of how supply and/or demand in the regulated market would dynamically evolve – whether through the emergence of new demand for a suite of services in a developing market, the emergence of new

² Though we would note that the charge control on the PPC trunk market was introduced in 2009.

³ Though we would note the proposed imposition of a charge control on ISDN30.

⁴ Ofcom tends to make certain adjustments to reported FAC data.

competitors providing substitute services or the emergence of new technological solutions replacing existing offerings at lower prices or with improved functionality.

16. Thus, it is implicitly recognised that “over-engineering” price regulation against the backdrop of such uncertainty can skew market outcomes by sending specific price signals to market players based on regulatory constructs and this could result in regulation inadvertently “picking winners” in terms of alternative service offerings, technology choices, etc, that would not have succeeded in an efficiently functioning competitive market environment. For instance, it may be the case that introducing restrictive price regulation too early in a product life-cycle will fail to capture the riskiness associated with launching new services into new markets and could undermine investment incentives.
17. The relative risks of intervening versus not intervening in the variety of ways available to Ofcom once SMP has been found (which tools to use from the regulatory tool kit) will need to be assessed on a case by case basis. The circumstances in which cost orientation tends to be used as the primary remedy for price regulation seem broadly the right ones and the key issue is to ensure that the risks are identified and full considered ahead of making the policy choice about which primary remedy to impose.
18. Once there has been a clear policy choice to adopt cost orientation as the primary remedy as opposed to the imposition of a charge control, it is uncontroversial to note that the cost orientation remedy must by its nature be used as a more flexible remedy than a charge control. It should not, for instance, be interpreted in a way that requires prices to equate to FAC either at the level of individual services or at the overall regulated market level. To do so would clearly amount to “rate of return” regulation and, as such, be even more restrictive than an RPI-X charge control given that, as noted, this provides an opportunity to beat assumed efficiency targets and earn higher returns during the charge control period. This was a concern that arose in Ofcom’s approach to resolving the recent SLU dispute.
19. As currently imposed in the UK, the wording of the cost orientation (basis of charges) remedy clearly reflects the greater flexibility allowed in how common costs are recovered across services and simply requires that prices are reasonably derived from incremental costs of provision plus an “appropriate” mark-up for the recovery of common costs and an “appropriate” return on capital employed.

V – The non-discrimination remedy can be used as an alternative, lighter touch, means of constraining pricing behaviour

20. We would also note that the non-discrimination SMP remedy can also be used as a primary remedy to constrain a CP’s pricing behaviour. While this remedy would not directly address the level of prices charged in the upstream market, it may be a more appropriate remedy to impose in the situations set out above where the level of demand from the SMP operator is considered particularly uncertain given either the nascent nature of the market, the fact that competition is expected to emerge and/or the fact that a high degree of migration onto alternative, newer services is expected. The use of non-discrimination as the primary means of regulating behaviour also seems particularly relevant where Ofcom is imposing SMP remedies at different levels in the value chain, often downstream of charge controlled inputs and EoI requirements. In those circumstances the need to regulate the absolute level of pricing, taking account of the

commercial pressures which will also be present and the scope for market entry, may be less of a consideration than the concern that pricing may be structured in an anti-competitive way in order to adversely impact competition further downstream.

VI - The DLRIC-DSAC test does not provide an absolute ceiling on cost orientation, particularly at granular levels of assessment – Ofcom must assess a broad range of evidence and focus on effects

21. There will be a broad range of pricing structures across services that could be considered consistent with competitive market outcomes and economically efficient. In theory, pricing an individual service beneath its Stand Alone Cost of provision may be entirely consistent with efficient competitive market outcomes if relevant combinatorial tests are passed. While the CAT's Judgment on the PPC dispute highlighted the fact that there are significant practical difficulties in demonstrating that all combinatorial tests are passed, it is still relevant to note that economic principles could support very broad flexibility in how prices are set to recover costs across a range of services. We would also note that Ofcom have used such tests in the past in a pragmatic way to assess pricing.
22. In this context, we are still clearly of the view that "DSAC" should be used with caution in assessing the overall appropriateness of individual charges against cost orientation requirements. We note that Ofcom has continually stated that it does not and would not "rigidly apply" a price versus DSAC test and this has to be right. DSACs may be viewed as providing an established and objective cost benchmark that provide an alternative to conducting theoretically complete combinatorial tests. However, DSAC cannot be the sole criterion for cost orientation and a fuller assessment of the overall structure of prices within a regulated market that focuses on the dynamic effects of that structure on competition is required.
23. This is especially true given concerns that would arise if the DSAC test is to be applied at granular disaggregated levels of individual service prices (or sometimes elements of those services) within a market – for instance to connection charges separately from rental charges or to local ends and main links provided as part of an end-to-end circuit. We would at least expect DSAC assessments to be conducted at different levels of aggregation reflecting the combination of services actually bought so that the sensitivity of analysis to the level the test applied is understood. For instance, if the test is "failed" at the level of connections, but "passed" at the level of connections and rentals combined, we would expect Ofcom to consider in detail why such a pricing structure raised concerns about anti-competitive effects. This will provide a more complete starting point for an overall assessment of the possible effects of the charge structure and appropriateness of the way common costs are recovered across services within the market.
24. More fundamentally, any such DRLIC-DSAC tests need to be considered as one part of a much broader assessment framework that takes due account of, among other things:
 - The assumptions made in actually setting the structure and level of prices. In particular, the overall level of returns that were expected to be made across the portfolio of services in the market at the time prices were set and the reasonableness of these by reference to risk/uncertainty, the stage of product lifecycle (e.g. whether returns are expected to be low in initial years and higher later).

- The expected effect of the structure of prices on customers and competition, reflecting the combination of services they purchase. As above, we would not normally expect significant concerns to arise in the way common costs are recovered from prices for individual services bought in combination by CPs.
 - The level of uncertainty that may have existed at the time prices were set around future demand (total volume and specific mix of different services within a market) and therefore costs expected to be incurred. This will be particularly significant in new, nascent markets – i.e. the sort of markets where Ofcom has tended to use the cost orientation remedy as the primary price regulation remedy.
 - The level of engagement that had taken place with industry and Ofcom over the level and structure of prices ahead of proposing these.
25. Overall, we would expect any assessment by Ofcom of the prices BT has offered to the market to be clearly effects-focussed and consistent with the market assessment conducted when the decision on the primary remedy was adopted. Ofcom should not, for instance, cite uncertainty around future demand in deciding to not impose a forward looking charge control, but then assess BT's pricing structure *ex post* by sole reference to observed volumes and unit costs, ignoring the relevance of such uncertainty.

VII - Where cost orientation is applied alongside a charge control, there is an even stronger need to focus assessment on the potential for anti-competitive effects arising from the structure of prices

26. In the majority of SMP markets where Ofcom has introduced a charge control, Ofcom has also imposed a separate cost orientation remedy – i.e. not as the primary remedy, but as a supplementary remedy⁵. The justification given by Ofcom for this is to control the structure of charges within a basket as well as the average level of charges.
27. This extra layer of regulatory control over charges raises obvious concerns with the overall level of regulation applied in any market and whether this is proportionate and the “minimum necessary” to address specific concerns. Where overall revenues within a market are constrained by the charge control itself, the only concern with the structure of individual prices within the basket must be that the structure could have anti-competitive effects. For example, Ofcom may be concerned that BT skews the recovery of common costs within the basket onto services which are disproportionately purchased by other CPs and away from services disproportionately purchased by downstream BT.
28. Given this, the mechanical application of a DLRIC-DSAC test against individual prices already set by reference to the charge control basket requirements is even less appropriate. There can be no economic basis to infer a negative effect from the fact that an individual price within a charge controlled basket is set above DSAC. The test needs to be whether the structure of pricing within a basket, where average pricing is overall compliant, places any individual customer at an unjustified disadvantage compared to other CPs (in particular, against BT). By its nature, this has to be an “in the round” assessment that looks at where the customer may prosper from the balance of charges

⁵ ISDN30 is a recent example where a charge control was imposed without a cost orientation remedy.

as well as when it does not.

29. We would also note that Ofcom will often identify specific concerns with how BT could move prices within a basket at the point at which the basket itself is defined – i.e. when setting the SMP charge control. Not only is the scope for skewing cost recovery in anti-competitive ways a key factor in defining the scope of services included in the actual basket, but where other concerns are identified, Ofcom will often impose safeguard caps (usually in the form RPI-0% or RPI-RPI) on specific services or combinations of services to deliberately constrain BT's ability to adjust the balance of charges in any significant way. The additional requirement for a remedy requiring charges to be cost oriented looks especially disproportionate in these circumstances. As such, this provides further weight to the need to focus on effects and look in the round at the structure of prices when assessing compliance with the condition when it has been imposed.

VIII - Ofcom should completely reassess whether additional requirements to set cost oriented charges are required alongside charge controls at the next round of market reviews

30. In the longer run, the points raised above strongly suggest that Ofcom should put renewed focus in upcoming market reviews on completely re-evaluating the justification for retaining a cost orientation remedy alongside other remedies as part of the overall policy consideration. We see significant scope for streamlining regulatory remedies. Where charge controls and safeguard caps are in place we would see limited need for further regulatory remedies and pricing constraints which simply add to uncertainty and risk generating unnecessary disputes.

IX - Non-discrimination requirements also need to be assessed by reference to the effects on competition

31. As well as their potential use as “primary remedies” on market behaviour, Ofcom also imposes non-discrimination requirements on BT's activities in SMP markets alongside charge controls and cost orientation remedies. The interaction of these three remedies together therefore needs to be considered. In the recent SLU dispute determination, Ofcom appeared to suggest that the non-discrimination remedy introduced a requirement to cost – and by extension, price – certain “elements” common to the SLU and LLU cost stacks in a consistent way and this seemed to have an impact on the overall approach Ofcom took to resolving the dispute⁶.
32. The apparent approach in the SLU dispute raised a number of practical concerns around whether it is possible to deconstruct prices for services so as to identify prices for costing elements within those services (e.g. to view a connection price as consisting of the sum of prices for individual activities associated with that connection). However, the more fundamental economic concern is the implication that there are some additional constraints on BT's pricing of services in SMP markets which automatically flow from the need for consistency and do not require the need to assess and demonstrate that the pricing will have any material negative effects on competition.

⁶ Although as noted at the time, we do not have a full understanding of the approach Ofcom took in that case.

33. The non-discrimination remedy clearly does not impose a specific prohibition on any inconsistent treatment of costs or the way in which prices are set. Rather, the prohibition is on undue discrimination and requires that BT does not “unfairly favour to a material extent an activity carried on by it so as to place at a competitive disadvantage persons competing with it”. This again clearly signals that any regulatory assessment must be effects-focussed. In the case of SLU, BT was selling services (albeit at limited volumes) to CPs who wish to provide services further downstream in competition with BT and with others. As such, concerns that BT may provide SLU on terms and conditions (including charges) which frustrate the CPs’ ability to compete are understandable. But that implies that the interpretation of the non-discrimination obligation should be wholly focussed on whether efficient SLU providers were, in fact, sufficiently able to compete with BT and others in relevant downstream markets.
34. Given these concerns, we think consideration of how this remedy interacts with other remedies to constrain activity needs to be included within the scope of Ofcom’s work looking at “cost orientation”.

X - Practical considerations in assessing prices against regulatory requirements

35. As well as the above issues of economic principle, there are a number of more practical issues that need to be fully considered in Ofcom’s overall assessment of how to impose and interpret remedies, including cost orientation, relating to price regulation.

Cost allocations and exclusions:

36. It is accepted that BT – in the first instance – has responsibility for setting prices which it believes are compliant with the relevant regulatory obligations. This means BT will need to take a view on cost inclusions and allocations it believes are relevant to assessing any particular price. It is inevitable that Ofcom may take a different view on the inclusion of certain costs and allocations within the relevant cost stacks. As a point of principle, regulation overall must ensure that BT can recover its efficiently incurred costs. However, Ofcom and BT disagree on certain cost treatments in respect of specific services. While some of these disagreements will be known (e.g. pensions costs), others will only become clear after Ofcom has been asked to intervene. BT is therefore setting prices against a backdrop of market uncertainty as well as this uncertainty of “regulatory interpretation”. From a practical perspective, this makes it important that Ofcom does not adopt the approach it seemed to take in the SLU dispute determination and simply remove adjusted/excluded costs from the price set by BT. Putting aside our concerns with those adjustments/exclusions in the SLU case, Ofcom should still assess whether the price set was reasonable when assessed against its revised view of costs. There should not be a simple “ratcheting down”.

Historic disputes

37. Ofcom is aware of our concerns with CPs using the dispute resolution process to reopen prices previously agreed with CPs. While we have challenged Ofcom’s approach to assessing such historic disputes as part of our appeal of the CAT’s PPC Judgment, we recognise that Ofcom will defend its position pending the outcome of that appeal. The practical issue is therefore that even if Ofcom continues to consider such historic disputes, it must in these circumstances have particular regard to the historic context in which prices were set – i.e. among other things, the level of engagement with CPs, the overall returns that were expected to be made at the time prices were set and the reason for the choice of the cost orientation remedy rather than a price control. In other

words, the fact that Ofcom is conducting assessments of historic disputes increases the need to take a more holistic view of evidence and be even less wedded to reliance on DLRIC-DSAC tests as set out above.

38. The current approach to historic prices provides a strong incentive for CPs to complain about current prices on the basis that they can go back many years later and claim the difference is due to them without the need to pass any of the difference on to customers. CPs are in fact likely to be better off today with prices that they later successfully retrospectively dispute down to lower levels, than with having lower prices which they agree in the first place as, in the latter case, retail competition will mean that the lower charges are likely to be passed on to customers, while adjustments to historic charges are not.

XI - Concluding comments

39. In setting out our high level views on issues of principle and practicality, we hope to at least shape the scope of issues Ofcom should consider as part of its cost orientation project. Cost orientation as a remedy has clearly become a significant issue in terms of regulatory resourcing as it drives a number of disputes and appeals. Its recent interpretation has also had a significant financial impact on BT. While we may continue to disagree in the short term on specific disputes, etc, we are nevertheless keen to establish a clearer approach moving forward that is consistently applied. We do not believe that cost orientation can be considered in isolation from broader regulatory principles and the workings of other remedies. We are looking to Ofcom to take an approach to the imposition and interpretation of cost orientation that positions the application of the remedy within a regulatory framework that remains consistent with core principles of good, effective, proportionate regulation focussed on facilitating economically efficient outcomes that drive maximum benefits for UK consumers. Ofcom should therefore ensure there is a broad scope to this project that allows full consideration of the issues raised above.