Charge control review for LLU and WLR services

Non-Confidential version

Statement

Publication date: 7 March 2012

Contents

Section 1

Executive summary

1.1 This Statement contains Ofcom's proposals for new charge controls for Local Loop Unbundling (LLU) and Wholesale Line Rental (WLR) services.

1.2 Charge controls for these services are being set as a consequence of our 2010 reviews of the Wholesale Local Access (WLA)[1] and Wholesale Fixed Analogue Exchange Line (WFAEL)[2] markets. In both markets, we identified that BT (Openreach)[3] has Significant Market Power (SMP) and that charge controls are necessary as a remedy to address Openreach's ability to fix or maintain prices at an excessively high level for LLU and WLR services in the respective markets.

1.3 As part of this charge control review, we undertook a further examination of the WLA and WFAEL markets to satisfy ourselves that there has not been a material change in either market since Ofcom's market power determinations in relation to those markets. As set out in this Statement, we have determined that there has been no material change in either the WLA Market or the WFAEL Market since Ofcom's market power determinations in relation to those markets and that it remains appropriate to set charge controls.

1.4 The previous charge controls expired on 31 March 2011. Since 1 April 2011, Openreach has been setting charges in accordance with a voluntary commitment. This voluntary commitment expires on 31 March 2012.[4]

1.5 In reaching the conclusions set out in this Statement, we have taken account of stakeholder responses to our two consultations in March 2011 and November 2011. We have also considered, where relevant, the 2009 LLU Determination and the 2009 WLR Determination.

1.6 The charge controls will cover two years (2012/13 and 2013/14) after which any extension of the controls will be subject to further market reviews.

Structure of the charge controls

LLU

1.7 We are setting individual charge controls for Metallic Path Facility (MPF) rental, Shared MPF (SMPF) rental, and key migration services (see Figure 1). We are setting separate basket controls for the remaining MPF and SMPF ancillary services. We are also setting a separate Co-Mingling basket for ancillary services used for both MPF and SMPF.

1.8 We have decided that the new charge controls will commence on 1 April 2012.

[1] http://stakeholders.ofcom.org.uk/consultations/wla/statement
[2] http://stakeholders.ofcom.org.uk/consultations/review-wholesale-fixed-exchange/statement
[3] Openreach is the access division of BT established by Undertakings in 2005. Whilst the proposed SMP services conditions in this document formally apply to British Telecommunications plc, Openreach is the division of BT which provides the LLU and WLR services which we are proposing to regulate. Therefore, throughout this document, we refer to Openreach as the supplier of wholesale LLU and WLR services.
[4] http://stakeholders.ofcom.org.uk/binaries/consultations/llcc/statement/charges.

1.9 Based on the policy proposals and financial modelling explained in this Statement, the LLU charge controls are set out in Figure 1.1.

Figure 1.1: LLU charge controls

Basket/service	Charge control for 2012/13	Charge control for 2013/14
MPF rental	£87.41	RPI-5.9
SMPF rental	£11.92	RPI-15.9
MPF Single Migration	£33.54	RPI-11.3
MPF New Provide	£51.16	RPI-14.2
SMPF Single Migration	£33.54	RPI-11.3
SMPF Provide	£33.54	RPI-11.3
MPF ancillary services basket	-3.6%	RPI-9 %
SMPF ancillary services basket	-7.6 %	RPI-13 %
Co-mingling ancillary services basket	1.8 %	RPI-3.6 %

WLR

1.10 For WLR, we are setting charge controls on the same services as in the previous charge controls. That is, the charge controls will apply to the Analogue Core WLR rental service ("WLR rental"), and continue to apply to the charges for WLR New Connection and WLR Transfer.

1.11 Consistent with the charge controls for LLU, the new charge controls for WLR services will commence on 1 April 2012 and will set a specific sterling cap for 2012/13.

1.12 Based on the policy proposals and financial modelling explained in this Statement, the WLR charge controls are set out in Figure 1.2.

Figure 1.2: WLR charge controls

Basket/service	Charge control for 2012/13	Charge control for 2013/14
WLR Rental	£98.81	RPI-7.3 %
WLR Transfer	£3.29	RPI %
WLR New Connection[5]	£50.44	RPI-9.8 %

[5] Since the publication of the Draft Statement we discovered an arithmetic error in the calculation of the charge control for WLR New Connection. We have corrected the error in this statement leading to a change in the X for this charge from -10.2% to -9.8% and the first year charge increased from £50.06 to £50.44.

Valuation of BT's duct network

1.13 The cost of duct is a material input to the LLU and WLR charge controls. While the value of BT's duct assets appeared relatively stable from 2005-2010, we observed that in 2010 BT had undertaken a review of the valuation of its duct network and as a result the RFS for 2009/10 included a significant upward revaluation of its duct network, with the consequence that the proposed value of duct assets, to be used in the setting of the charge controls, was significantly increased.[6]

1.14 As a consequence we have undertaken a review of our treatment of the value of duct to be used as an input to the charge controls. This review includes a re-assessment of the 2005 Cost of Copper Review on the RAV of Openreach access assets.[7] The RAV established a valuation of assets deployed before August 1997 on a HCA basis, and assets deployed since August 1997 on a CCA replacement cost basis.

1.15 As set out in Section 3, and Annex 1, of this Statement we consider that the RAV methodology established in 2005 remains appropriate. Our assessment of BT's revision of the value of post August 1997 duct is that it does not represent a reliable estimate of the CCA value for the purpose of setting regulated charges. Accordingly, we have decided to estimate the value of post August 1997 duct through a RPI indexation of BT duct expenditure since August 1997.

[6] March 2011 Consultation, paragraph 1.10.
[7] http://stakeholders.ofcom.org.uk/binaries/consultations/copper/statement/statement.pdf.

Section 2

Introduction

Introduction

2.1 In this Section we explain the background to the current LLU and WLR charge controls, the developments since the last charge control reviews for each, and our objectives for this review. In particular, we summarise:

- The significance of LLU and WLR for promoting competition in fixed line data and voice services;
- Why we carried out the charge control review and consultation;
- The legal framework and notification to the European Commission; and
- Our Impact Assessment, and our approach to Equality Impact Assessment in this review.

The significance of LLU and WLR in promoting competition in the provision of broadband and narrowband services

LLU

2.2 LLU covers a set of regulated wholesale services sold by Openreach. It allows CPs to physically take over or share the copper access network connection (from end-user to the BT exchange building), and to provide data services (e.g. broadband) and voice to retail customers over that connection.

2.3 CPs can use two types of LLU product - MPF and SMPF. MPF allows a CP to provide the customer with data and voice services; while SMPF only allows direct provision of data by the CP, with narrowband voice services being provided separately.

2.4 There has been considerable investment in networks using LLU to reach customers in the UK in the last few years, and the number of unbundled lines has continued to increase. In November 2011, the number of unbundled lines stood at 7.87 million, up from 7.42 million in November 2010, 6.26 million in November 2009 and 5.36 million in November 2008.[8] This has contributed to an open and competitive retail market, which, in turn, has resulted in greater choice for consumers.

WLR

2.5 WLR is also a regulated wholesale service sold by Openreach. WLR is used by CPs to provide retail customers (both residential and business) with exchange lines and,

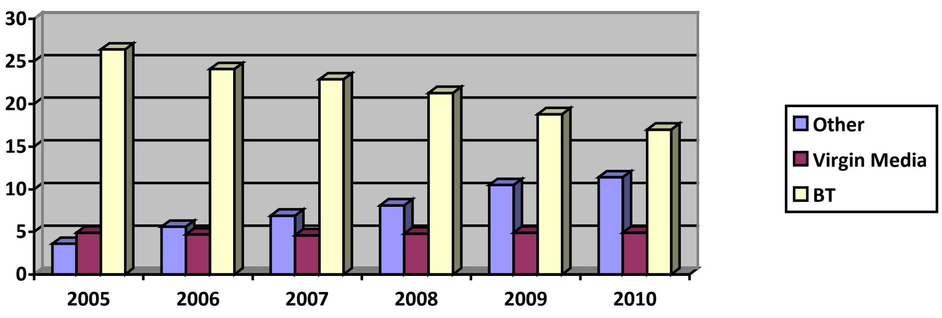
[8] Data from Office of the Telecommunications Adjudicator, http://www.offta.org.uk/updates/otaupdate20111206.htm, http://www.offta.org.uk/updates/otaupdate20101207.htm, http://www.offta.org.uk/updates/otaupdate20091201.htm, http://www.offta.org.uk/updates/otaupdate20081205.htm.

in turn, access to other narrowband telephony services (for example telephone calls, facsimile and dial-up internet access).

2.6 After increasing year on year, the number of WLR lines declined slightly in 2010/11. In November 2011, there were 6.18 million lines, down from 6.24 million in November 2010.[9] There were 6.13 million WLR lines in November 2009 and 5.26 million in November 2008. This reduction is an outcome of increased competition from LLU and, in particular, the use of MPF as the key access product by major CPs. Notwithstanding the recent decrease, WLR has been a major factor in creating a competitive, and now de-regulated, market for exchange lines and calls at the retail level.

2.7 Taken together, LLU and WLR have contributed to a substantial change in the competitive environment for fixed line services in the UK. As shown in Figure 2.1, we have moved from a position of clear BT retail dominance for such services at the beginning of the decade to a situation where consumers are able to, and do, take advantage of choice in suppliers and the range of services available.

Figure 2.1: UK Retail Fixed Line Connections (vertical axis - millions)



Source: Ofcom/Operators[10]

Background to this review and Statement

2.8 This charge control review is concerned with how we should set charges for LLU and WLR services.

2.9 The new controls were required as a result of our conclusions in the WLA 2010 Market Review and WFAEL 2010 Market Review. In both markets, we identified that BT has SMP and that charge controls were necessary to remedy Openreach's[11] ability to set excessive levels of charge for, or operate a margin squeeze in relation to, LLU and WLR services in the respective markets.

[9] Data from Office of the Telecommunications Adjudicator, http://www.offta.org.uk/updates/otaupdate20111206.htm, http://www.offta.org.uk/updates/otaupdate20101207.htm, http://www.offta.org.uk/updates/otaupdate20091201.htm, http://www.offta.org.uk/updates/otaupdate20081205.htm.

[10] Data also presented in the Ofcom CMR 2011 Figure 5.46.

[11] Whilst the proposed SMP services conditions in this document formally apply to BT plc, Openreach is the division of BT which provides the LLU and WLR services which we are proposing to regulate. Therefore, throughout this document, we refer to Openreach as the supplier of wholesale LLU and WLR services. Openreach was created by BT as part of their Undertakings to Ofcom in 2005.

2.10 In the March 2011 Consultation, we set out our proposals and analysis for determining how we would set the level, form and duration of the charge controls for WLR and LLU services. We set out our proposed charge controls for LLU rentals services, WLR rental services and for certain ancillary services that support LLU and WLR products.

2.11 We received twelve responses from stakeholders providing comments on our proposals set out in the March 2011 Consultation. Some of these comments received from stakeholders identified issues relating to the structure of some of the controls, in particular regarding the charge controls for ancillary services. Following the comments received from stakeholders in response to the March 2011 Consultation, we made some amendments to the proposals set out in that consultation and on 23 November published the November 2011 Consultation. We received six responses to our November 2011 Consultation.

Notification to the European Commission in accordance with the Revised Framework.

2.12 Under the revised Article 7 of the Framework Directive[12] NRAs are required to notify their draft Statement to the European Commission, BEREC and other NRAs upon completion of their own domestic consultation and having taken into account all stakeholder responses. The European Commission, BEREC and other NRAs may make comments within a month. The notifying NRA needs to take utmost account of any European Commission and BEREC opinions.

2.13 The revised framework was transposed into UK law by the Electronic Communications and Wireless Telegraphy Regulations 2011[13] which came into force on 26 May 2011 and amended the Act. This new notification requirement is implemented by section 48B.

2.14 We notified our March 2011 Consultation to the European Commission in accordance with the Article 7 procedure in force at that time which provided for notification alongside the domestic consultation. However, as a consequence of our November 2011 Consultation, section 48B of the Act applied. Therefore, having taken account of consultation responses and having made modifications that appear appropriate to us in light of these comments, on 3 February 2012, we notified our intended measures and an explanatory draft Statement setting out the reasons for them to the European Commission, BEREC and the national regulatory authorities in every other Member State under section 48B of the Act.[14]

2.15 We received a comment from the European Commission on our draft Statement. The European Commission summarised the analysis in our draft Statement and noted that given the importance of regulating key wholesale access products in the transition period to NGA networks in an effective and consistent manner across the EU, it is currently working on a recommendation on costing methodologies for key access prices. In light of this, the European Commission invited Ofcom to review its analysis upon publication of any relevant recommendations.

2.16 We are notifying our final decision to the Secretary of State, the European Commission and BEREC in accordance with section 48C of the Act.

[12] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:337:0037:0069:EN:PDF.
[13] http://www.legislation.gov.uk/uksi/2011/1210/pdfs/uksi_20111210_en.pdf.
[14] http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc/statement/LLU_WLR_CC_statement.pdf.

Transitional arrangements for the period between the ending of the previous controls and start of the new controls

2.17 The most recent charge controls, set in May 2009, ceased to have effect from 1 April 2011. In December 2010 Openreach made a voluntary commitment that from 1 April 2011 until 31 March 2012 (or until the next Ofcom charge controls start, whichever is sooner) it would adhere to certain charge ceilings.[15] The charges were calculated using the financial models used to set the previous charge controls, adjusted for the 2009 LLU Determination and 2009 WLR Determination. Ofcom's stated view at the time was that Openreach's approach was "*a reasonable approach to take*".[16] The charge ceilings were as follows:

Figure 2.2: Bridging arrangement prices

Service	**Bridging charge ceiling**	**Previous charge**
MPF Rental	£91.50	£89.10
SMPF Rental	£14.70	£15.04
WLR Rental	£103.68	£103.68
MPF New Provide	£52.79	£62.11
WLR New Connection	£48.22	£55.74
WLR Transfer	£3.09	£3.09
Ancillary services	The charge for individual services to rise by no more than 3%.	

We have set our decision in light of our legal framework

2.18 As part of the 2010 WLA and WFAEL market reviews, on 23 March 2010 and 15 October 2010 respectively, we published the 2010 WLA Consultation and the 2010 WFAEL Consultation,[17] in which, at Annex 5 and Annex 6 respectively, we set out an overview of the market review process, including the imposition of remedies, to provide appropriate context and understanding to the matters discussed in that review.

2.19 This Statement does not seek to duplicate all of the information provided in those Annexes, which remains relevant to understanding the context for the LLU and WLR charge controls.

[15] Letter from M Shurmer (Openreach) to S McIntosh (Ofcom), 24 Nov 2010.
[16] See update on Ofcom's website of 1 December 2010: http://stakeholders.ofcom.org.uk/binaries/consultations/openreachframework/statement/charges.
[17] http://stakeholders.ofcom.org.uk/binaries/consultations/wla/summary/wlacondoc.pdf and http://stakeholders.ofcom.org.uk/binaries/consultations/review-wholesale-fixed-exchange/summary/main.pdf .

2.20 This Statement, in particular Section 8, considers each of the relevant legal tests that apply when imposing a charge control as an SMP condition under section 87(9) of the Act and sets out our reasoning as to why these are met by our charge control conditions. In doing so, we consider each of the following:

- Firstly, section 88 of the Act which prohibits the setting of SMP conditions under section 87(9) of the Act except where it appears, from the market analysis, that there is a relevant risk of adverse effects arising from price distortion; and it appears that the setting of the condition is appropriate for the purposes of promoting efficiency, promoting sustainable competition and conferring the greatest possible benefits on end users. We are also required to take into account the extent of BT's investment in wholesale local access and wholesale fixed analogue exchange lines.

- Secondly, we consider whether the condition meets the test set out at section 47 of the Act. In summary, section 47 requires that any SMP condition must not be imposed unless it is:

  - Objectively justifiable in relation to the services to which it relates;

  - Not such as to discriminate unduly against particular persons;

  - Proportionate to what the condition is intended to achieve;

  - In relation to what it is intended to achieve, transparent.

- Thirdly, we need to ensure that the condition fulfills our general duties under section 3 of the Act and our duties for the purpose of fulfilling our Community obligations as set out under section 4 of the Act.

2.21 In section 3, our principal duty in carrying out functions is to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.

2.22 In so doing, we are required to secure a number of specific objectives and to have regard to a number of matters set out in section 3 of the Act. As to the prescribed specific statutory objectives in section 3(2), we considered in both the 2010 WLA Consultation and the 2010 WFAEL Consultation that the objective of securing the availability throughout the UK of a wide range of electronic communications services was particularly relevant to the market review, and therefore to the regulation in this review.

2.23 In performing our duties, we are also required to have regard to a range of other considerations, as appear to us to be relevant in the circumstances. In the 2010 WLA Consultation and the 2010 WFAEL Consultation, we considered that a number of such considerations were relevant to the market review, namely the desirability of promoting competition in relevant markets, the desirability of encouraging investment and innovation in relevant markets and the desirability of encouraging the availability and use of high speed data transfer services throughout the United Kingdom.

2.24 Section 4 of the Act requires us to act in accordance with six European Community requirements for regulation. In the 2010 WLA Consultation and the 2010 WFAEL Consultation, we considered that the first, third, fourth and fifth of those requirements were of particular relevance to the market review, namely to promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories; to promote the interests of all persons who are citizens of the European Union; to take account of the desirability of Ofcom's carrying out of its functions in a manner which, so far as practicable, does not favour one form of or means of providing electronic communications networks, services or associated facilities over another, i.e. to be technologically neutral; and to encourage, to such extent as Ofcom considers appropriate for certain prescribed purposes, the provision of network access and service interoperability, namely securing efficient and sustainable competition and the maximum benefit for customers of CPs.

2.25 We also considered that no conflict arose in this regard with those specific objectives in section 3 of the Act that we consider are particularly relevant in this context.

We have taken into account our specific policy objectives when developing our proposals

2.26 Our specific policy objectives in proposing the charge controls for LLU and WLR services are:

- to prevent BT from setting excessive charges for LLU and WLR services in the UK, excluding the Hull Area where it has SMP while providing incentives for it to increase its efficiency;
- to ensure that prices are subject to appropriate controls whilst still encouraging BT to maintain service quality and innovation in LLU and WLR services in the UK, excluding the Hull Area;
- to promote efficient and sustainable competition in the delivery of LLU and WLR services;
- to provide regulatory certainty for BT and its customers and to avoid undue disruption;
- to encourage investment and innovation in the relevant markets; and
- to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide BT with the opportunity to recover all of its relevant costs (where efficiently incurred), including its cost of capital.

2.27 We have adopted these policy objectives when developing the charge controls. We believe that these policy objectives flow out of and fulfill our general duties under section 3 of the Act and our duties for the purpose of fulfilling our Community obligations as set out under section 4 of the Act.

Impact assessment

2.28 The analysis presented in this Statement represents an impact assessment, as defined in section 7 of the Act. In Sections 3, 4, 5, 6, 7 and 8 of this Statement we discuss all of the relevant considerations and options that we have considered, including their impact.

2.29 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which requires Ofcom to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy, Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see the guidelines, "*Better policy-making: Ofcom's approach to impact assessment*", which are on the Ofcom website.[18]

2.30 Specifically, pursuant to section 7 of the Act, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.

Equality Impact Assessment

2.31 Ofcom is separately required by statute to assess the potential impact of all our functions, policies, projects and practices on race, disability and gender equality. Equality Impact Assessments (EIAs) also assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity. Unless we otherwise state in this Statement, it is not apparent to us that the outcome of our review is likely to have any particular impact on race, disability or gender equality. Specifically, we do not envisage the impact of any outcome to be to the detriment of any group of society.

2.32 Nor are we envisaging any need to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This is because we anticipate that our regulatory intervention will affect all industry stakeholders equally and will not have a differential impact in relation to people of different gender or ethnicity, on consumers in Northern Ireland or on disabled consumers compared to consumers in general. Similarly, we are not envisaging making a distinction between consumers in different parts of the UK or between consumers on low incomes. Again, we believe that our intervention will not have a particular effect on one group of consumers over another.

Structure of this Statement

2.33 The rest of this Statement is structured as follows:

- Section 3 sets out our approach to setting charge controls;
- Sections 4 and 5 set out the structure of LLU and WLR charge controls;
- Section 6 sets out our calculation of the charge controls;
- Section 7 sets out our approach to setting WLR and LLU differentials for core and ancillary services;
- Section 8 sets out the implementation of the charge controls and legal tests;
- Annex 1 discusses our valuation of BT's duct assets;
- Annex 2 sets out our revised LLU and WLR volume forecasts;
- Annex 3 sets out our detailed analysis of scope for efficiency gains;

[18] http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf.

- Annex 4 sets out our detailed analysis of cost allocation;
- Annex 5 sets out our detailed review of unit costs by activity;
- Annex 6 sets out our detailed review of assets;
- Annex 7 sets out our detailed analysis on the RAV adjustment;
- Annex 8 sets out our detailed analysis of the cost of capital;
- Annex 9 sets out our detailed analysis of single jumpering;
- Annex 10 sets out our detailed analysis of the modelling reconciliation;
- Annex 11 sets out our detailed analysis of the “no material change” assessment;
- Annex 12 sets out the formal legal instruments of our decision;
- Annex 13 sets out the glossary; and
- Annex 14 sets out a list of the main evidence we have relied upon in reaching our decision.

Section 3

Approach to setting charge controls

Introduction

3.1 In this Section, we set out our conclusions on the following issues, which relate to both LLU and WLR charge controls:

- the appropriate cost basis for the setting of the controls;
- our approach to technology change in the setting of the controls;
- the valuation of duct for the purpose of setting the controls;
- alignment of costs and charges using glide paths;
- compliance arrangements;
- use of RPI;
- the duration of the controls;
- implementation of the controls; and
- our approach to transparency and disclosure of charge control models.

3.2 For each of the above issues under consideration we set out below:

- a summary our proposals as set out in the March 2011 Consultation and the November 2011 Consultation (where relevant);
- a summary of the comments received from stakeholders on our proposals set out in the March 2011 Consultation and the November 2011 Consultation (where relevant); and
- our response to those comments and in light of this response, our decision, together with arguments in support of our conclusions.

Summary of our decisions

3.3 Our conclusions on the approach to setting charge controls are summarised below.

- **Cost basis:** We have decided to continue to use a CCA FAC methodology to establish the cost basis for the LLU and WLR charge controls.
- **Technology change:** We consider that the anchor pricing test proposed for these charge controls is appropriate as it encourages efficient levels of investment and provides protection for consumers through a period of transition.
- **Duct valuation:** We have concluded that the RAV adjustment of pre-1997 duct assets is still required. We have also concluded that CCA FAC remains

the appropriate approach for valuing post-1997 duct assets. We consider that the appropriate method for estimating CCA FAC value in this case is indexing annual spend on the network by RPI.

- **Glide path:** We have decided to derive the charge for 2012/13 and 2013/14 on the basis of a fixed percentage control (the X in a RPI-X formulation) applied over three years starting from the charges in force at the end of 2010/11. This will lead to smooth nominal charge reductions for the two largest rental services (MPF and WLR) and closer alignment of SMPF and the ancillary services to cost.

  We considered the alternative of a glide path starting from the interim prices but considered that the effect of this was to embed inappropriately high returns. We also considered a two year glide path but considered that the higher charges derived were not appropriate given the scale of over-recovery.

- **Compliance:** We have decided to continue with the existing compliance monitoring arrangements but note that we are undertaking a review of Cost Orientation and Regulatory Reporting[19] in which we are looking at issues around compliance monitoring.

  We have decided that we will retain provisions for "carry over" of charge control obligations in the new set of LLU and WLR charge controls. These obligations allow correcting adjustments to be made to the controls in the subsequent year if the regulated firm sets charges above or below the level allowed by the cap in any year of the charge controls. We will also continue to review annually BT's use of any carry-over provision in our review of BT's annual compliance report.

- **RPI:** We have decided to continue to use RPI rather than an alternative national index (e.g. CPI) for the LLU and WLR charge controls.

- **Duration:** We have decided to synchronise charge controls for LLU and WLR and both sets of charge controls will expire on 31 March 2014.

- **Implementation:** In accordance with our proposals in the November 2011 Consultation, we have decided that the new charge controls will commence on 1 April 2012.

- **Transparency of models:** In developing our proposals relating to the LLU and WLR charge controls set out in this Statement, we have considered the need to ensure appropriate transparency (including in relation to financial modelling underlying our proposals) balanced against the confidential nature of certain information and data which informed our proposals. We consider that we have provided stakeholders with an appropriate level of transparency and disclosure within the legal framework (including the test under section 47 of the Act) and this has allowed those consulted to give intelligent consideration and an intelligent response.

[19] http://stakeholders.ofcom.org.uk/consultations/cost-orientation-telecoms/.

Cost basis for new charge controls

March 2011 Consultation proposals

3.4 In the March 2011 Consultation, we proposed to continue to use CCA FAC as the cost basis for setting the LLU and WLR charge controls.[20] We also proposed to continue to apply an adjustment to reflect the RAV which abstracts away from a 'pure CCA'[21] approach to prevent over-recovery of the costs of older assets (see separate further discussion on RAV paragraphs in Annex 1, A1.6-A1.113).

3.5 The CCA FAC approach was used to set the previous LLU and WLR charge controls and has been used by Ofcom to set other charge controls imposed on BT. Furthermore, the use of CCA FAC to set the previous LLU and WLR charge controls was considered by the CC in the 2009 LLU and WLR Appeals. The CC found that Ofcom had not erred by reason of Ofcom setting the price differentials on a CCA FAC basis rather than on a LRIC basis.[22] The CC also found it did not consider that in setting prices, Ofcom erred by adopting an approach that took greater account of productive efficiency considerations than allocative or dynamic efficiency considerations.[23]

3.6 CCA FAC provides a robust and transparent basis for the regulation of wholesale access charges. It is a well understood concept and has been the cost basis for many previous charge control obligations imposed by Ofcom. Furthermore, CCA FAC uses data which can be reconciled to the RFS, which are published by BT and independently audited.

3.7 CCA FAC is a suitable cost basis to prevent excessive levels of charges being levied by Openreach. It also ensures that the delivery of regulated services is sustainable by enabling Openreach to recover all relevant and efficiently incurred costs.

3.8 We were mindful that, whilst CCA FAC has the advantages explained in this section, it will not, in all circumstances, necessarily result in the most efficient outcome. In the March 2011 Consultation we therefore considered carefully whether there are any strong objections to CCA FAC as the basis for the rental charge controls on efficiency grounds.

3.9 In addition, as we did when the previous LLU and WLR charge controls were set,[24] we carried out an analysis to check whether efficiency could be distorted through the setting of charges for separate regulated services, which are inputs to the same downstream markets. LLU and WLR services, and in particular MPF and SMPF+WLR, provide a wholesale platform for retail voice and broadband bundles. Our analysis in Section 8 of the March 2011 Consultation considered whether the differentials between the charges for MPF and WLR rental, and MPF and SMPF+WLR rental, were sufficient to cover the difference in costs between the services on a LRIC basis. Our analysis indicated that the differentials on the basis of CCA FAC are likely to be at least as great as the differentials on the basis of LRIC (see Section 7 of this Statement for an update of this analysis with respect to this charge controls).

[20] March 2011 Consultation, paragraphs 3.14 to 3.20.
[21] As the RAV adjustment includes HCA cost elements for pre-1997 assets, its inclusion in our cost model means that the costs used are not 'pure' CCA.
[22] See paragraph 3.163 of the 2009 WLR Determination.
[23] See paragraph 3.176 of the 2009 WLR Determination.
[24] Set out in Section 5 of the 2009 WLR Statement, paragraph 5.14 to 5.97.

3.10 On the basis of this analysis of the efficiency characteristics of CCA FAC in Section 8 of the March 2011 Consultation, we considered that there were no reasons to depart from the use of CCA FAC as a cost basis on efficiency grounds.

3.11 In the March 2011 Consultation, we asked stakeholders the following question:

> ***Question 3.3****: Do you agree with Ofcom's proposal to use a CCA FAC methodology to establish the cost base for the next LLU and WLR charge controls? Please give reasons for your answer.*

March 2011 Consultation responses

3.12 C&WW,[25] GC,[26] TTG,[27] and Openreach[28] agreed with our proposal to use a CCA FAC methodology to establish the cost base for the next LLU / WLR charge controls. EE told us that: "*EE considers that Ofcom should regulate consistently across different segments of the telecommunications industry and therefore considers that the default* approach *to price regulation should be based on some form of long run incremental cost standard.* [...] *EE is not expressing a strong view on the use of a CCA FAC standard (as opposed to LRIC) and understands the benefits of continuing to base these charge controls on a broadly CCA FAC basis. However, EE notes that this in itself introduces an inconsistency in Ofcom regulation (as between different segments of the telecoms industry)*".[29]

3.13 VM said that an EPMU accounting standard "*would better meet the transparency objectives*" and "*deliver tangible benefits in transparency and monitorabiliy* [...] *to more easily ascertain whether accounting treatment accords with cost orientation obligations*" as a "*LRIC + EPMU* [standard] *effectively removes the ability for BT to allocate common costs in its own interests*".[30]

Our response and conclusions

3.14 We acknowledge the comments received from EE and note that the LRIC cost standard has been used in other regulatory charge controls (for example, MCT rates). In relation to the choice between the CCA FAC or LRIC cost standards, we consider that the relevant distinguishing factor is the degree to which LRIC information can be relied upon, which may vary greatly depending upon whether it is derived from, for example, industry constructed cost models (such as in the case of MCT rates) or actual company cost models (i.e. the LLU / WLR charge control review).

3.15 If CCA FAC is applied consistently over time to Openreach's regulated services, charges based on the underlying efficient CCA FAC should prevent excessive charging and also ensure that the delivery of the regulated services is sustainable by allowing Openreach an opportunity to recover all of its relevant efficiently incurred costs.

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[25] C&WW response to the March 2011 Consultation, page 9.
[26] GC response to the March 2011 Consultation, page 2.
[27] TTG response (July 2011) to the March 2011 Consultation, paragraph 346.
[28] Openreach response to the March 2011 Consultation, paragraphs 305 to 306.
[29] EE response to the March 2011 Consultation, page 6, response to question 3.3.
[30] VM response to the March 2011 Consultation, page 3.

3.16 As a basis for modifying charge controls (i.e. setting a charge control on a previously regulated service), the use of CCA FAC also offers some important practical advantages:

- It is a widely understood concept and has been the anchor point for many previous price controls (for example all previous LLU and WLR charge controls, the Network Charge Controls and previous Leased Lines charge controls); and
- It uses data that can be reconciled to the RFS, which are audited.

3.17 In general, therefore, CCA FAC represents a predictable way of setting charges, which builds stakeholder confidence in the regulatory regime and encourages efficient investment.

3.18 The use of LRIC + EPMU as an alternative to CCA FAC for the LLU and WLR charge controls has been considered and rejected in both the 2005 LLU Statement[31] and 2009 Openreach Financial Framework Consultation.[32]

3.19 In relation to these LLU and WLR charge controls, we have noted in the above previous reviews that, on efficiency grounds, there is little to differentiate between CCA FAC and LRIC + EPMU. Both CCA FAC and LRIC + EPMU involve accounting rules and assumptions for the recovery of common costs from different products without regard to the implications for efficiency. Unlike HCA, CCA FAC and LRIC + EPMU reflect forward looking costs rather than the actual prices at the time the relevant assets were purchased, giving a better signal for efficient investment and entry.

3.20 However, in the 2005 LLU Statement, we stated that we preferred CCA FAC to LRIC + EPMU, as a more practical and transparent approach to establishing service costs. We considered that LRIC + EPMU, "*has the disadvantage of involving a time consuming operation which BT carries out on an irregular basis*".[33] Ofcom has limited visibility of how BT generates costs in its LRIC model and the further analysis required by BT to create LRIC outcomes, neither elements of which are subject to an external audit (unlike the RFS). Furthermore, performance monitoring on a LRIC + EPMU basis against BT's actual financial performance is not straightforward, as the wholesale service profitability information routinely prepared by BT is prepared on a CCA FAC basis. By contrast, CCA FAC uses data that can be reconciled to the RFS. Given that LRIC+EPMU is not conceptually superior to CCA FAC as a cost standard for setting charges and CCA FAC is more transparent we remain of the view that CCA FAC remains preferable to LRIC + EPMU.

3.21 Having considered the comments received from stakeholders in relation to our proposal in the March 2011 Consultation, we have decided to continue to use CCA FAC methodology to establish the cost basis for the charge controls. In reaching this view we have also had regard to the fact that in the WLR appeal the CC determined that the choice of CCA FAC as the basis for cost modelling that underpinned the previous LLU and WLR charge controls was not an error.[34]

[31] 2005 LLU Statement, paragraphs 3.9 to 3.10.
[32] 2009 Openreach Financial Framework Consultation, paragraphs 6.8 to 6.9.
[33] 2005 LLU Statement, paragraph 3.9.
[34] 2009 WLR Determination, paragraphs 3.161 to 3.162.

Treatment of technology change in modelling for the LLU and WLR charge controls

March 2011 Consultation proposals

3.22 In the March 2011 Consultation, we noted that our preferred approach to setting charges is to base costs on what is believed to be the most efficient available technology, which is sometimes described as the MEA approach to pricing.[35] We noted however, that there are circumstances where we do not set charges on the basis of MEA costs. During a period of major technological change, we generally adopt an approach to charge control setting which we refer to as the "anchor product pricing" approach. Following the anchor product pricing approach, we do not allow prices to rise above the level implied by the hypothetical continuation of the existing technology, which prevents the introduction of new technology increasing the prices for the same services provided on the basis of the legacy technology.[36]

3.23 In the March 2011 Consultation, we considered that Openreach's provision of LLU and WLR would be affected over the period of the charge control by the development of its NGA network, alongside the current generation copper access network.[37] However, we also noted in the March 2011 Consultation that some of the costs of providing LLU and WLR services were already affected by NGA development. As such, in the March 2011 Consultation, we set out our proposal to employ anchor product pricing principles as a test at each stage of setting the LLU / WLR charge controls to ensure that NGA investments would not result in increases in charges for existing services.

3.24 In the March 2011 Consultation,[38] we noted that the adoption of a new platform – in this case, NGA – had the potential to offer significant cost savings. We considered it important that the LLU / WLR charge controls afford the right incentives for Openreach to undertake NGA investment where it would be of benefit to consumers in the long run. We acknowledged that, at the same time, the migration of services to a new platform poses significant challenges, as the costs and volume of that migration are uncertain, as is the full extent of the take-up of NGA. For the LLU / WLR charge controls, the relevance of anchor pricing is to ensure that charges for regulated products and services do not rise as a result of NGA deployment.

3.25 We also noted in the March 2011 Consultation, that in previous charge controls (for example in the Network Charge Control), we had implemented the anchor product pricing approach by using a hypothetical ongoing model of the current technology network, which establishes the price ceiling for service charges with reference to existing technology by assuming no investment or migration to the new technology network.[39] The anchor product pricing approach, therefore, mimics current technology in an ongoing rather than end-of-life phase.

3.26 In the March 2011 Consultation, we noted that we had not created a hypothetical ongoing model for the proposed LLU / WLR charge controls.[40] We explained that the

[35] Treatment of NGA costs is covered at paragraphs 3.21 to 3.30 of the March 2011 Consultation.
[36] If a new technology changes cost structures, then once a new technology has been established, prices structures can gradually be moved to reflect the new technology.
[37] March 2011 Consultation, paragraph 3.25.
[38] March 2011 Consultation, paragraph 3.27.
[39] See for example, the approach Ofcom took in its 2009 review of Network Charge Controls http://stakeholders.ofcom.org.uk/consultations/review_bt_ncc/statement/.
[40] March 2011 Consultation, paragraph 3.29.

modelling approach we had used for these charge controls was based on a detailed view of cost allocation and abstracting from this to create a hypothetical view would not be straightforward. Therefore, we proposed to use off-model calculations to ensure that our modelling outcomes would be consistent with the anchor product pricing approach.

3.27 In the March 2011 Consultation, we considered that the most appropriate application of the anchor product pricing principle in setting the LLU / WLR charge controls would be to set an upper bound for prices under charge control. As explained in Section 7 of the March 2011 Consultation, since the complex allocations in our model resulted in marginally lower levels of cost than the anchor product pricing cross-check, we believed that it was reasonable to set the charge controls with reference to costs derived from the Cost Allocation Model. As this was based on the actual allocation of costs in Openreach, it was likely to reflect the early stages of NGA roll-out i.e. with the inclusion of some preliminary cost attribution to NGA. In the November 2011 Consultation, we noted that we did not expect NGA to substantially impact on access services within the period up to 2013/14.[41]

3.28 This approach had the advantage of including economies of scope which were already realised in the allocation of costs to NGA assets. The setting of charges with reference to this model could therefore be regarded as including a "technology dividend" in the form of these economies of scope and is also consistent with the over-arching objective of anchor product pricing in that it ensures that prices would not rise as a result of technology change.

3.29 In the March 2011 Consultation, we asked stakeholders the following question:

Question 3.4*: Do respondents agree with our proposal to apply anchor product pricing as a guiding principle in setting the charge controls, whilst including economies of scope which result from the allocation of costs in our financial modelling? Please give reasons for your answer.*

March 2011 Consultation responses

3.30 Openreach, C&WW, FCS and GC broadly agreed with our proposal.[42]

3.31 GC said that the: "…*new technology will be inherently more economical to supply and maintain, hence we anticipate that future charges will fall below this mark. We would not expect the charge model to create any disincentives for switching to suitable modern equivalents and would expect that migration costs from current technology to the NGA equivalent should be borne by BT in order to increase the incentive for switching*".[43]

3.32 EE considered that "*it will not always be appropriate to apply this principle rigidly*".[44]

3.33 C&WW told us that "*the primary assets that go into the provision of LLU and WLR services are duct and copper/fibre. Ofcom follows the* [anchor product pricing] *approach adopted for previous charge controls of LLU and WLR services. This charge control is a little different however as now BT's NGA services can take a*

[41] November 2011 Consultation, paragraph 4.31.
[42] March 2011 Consultation responses to question 3.4: Openreach, paragraph 307; C&WW, page 10; FCS, page 4 and GC, page 2.
[43] GC response to the March 2011 Consultation, page 2, response to question 3.4.
[44] EE response to the March 2011 Consultation, page 7, response to question 3.4.

share of the common costs associated with the duct facilities. We agree that it is appropriate to reflect this economy of scope. The share of common costs attributed to NGA services can be further increased to account for CP usage of the new PIA product. Consistency between the allocation of costs to BT's NGA and PIA is required. It is not clear whether Ofcom has included an allocation of costs to account for PIA".[45]

3.34 In relation to NGA and PIA, Fujitsu said that "[t]*he viability of any next generation access (NGA) network using PIA depends on the terms on which these wholesale access services are supplied... Fujitsu believes that* [current draft PIA] *prices are well in excess of efficiently incurred costs, and since Openreach also competes in downstream markets through GEA, it faces strong commercial incentives to maintain PIA prices at this high level*".[46]

3.35 TTG argued that Ofcom has misapplied its own anchor pricing principles by failing to remove all costs that should be more appropriately allocated in full or in part to NGA services.[47] The correct approach, in TTG's view "…*is to derive the fully allocated LLU / WLR cost based on expected NGA deployment and the hypothetical cost under the no NGA deployment scenario and set LLU/WLR prices to equal the minimum of the two* costs *under the scenarios".*[48] TTG argued that Ofcom was instead setting the price within the two scenarios. TTG said that deviating from the FAC/anchor pricing approach will set costs / prices above FAC and will have a number of harmful consequences. TTG identified a number of errors which it considered had been made including, for example, no cost being allocated to NGA for its use of duct.

3.36 TTG pointed to a number of examples of areas where it was concerned Openreach costs included in the LLU / WLR charge model should be reduced to remove NGA associated costs, in particular duct and engineering effort.

3.37 Sky considered that there is no need to adopt an anchor pricing approach – even as a cross check – because in its view "*there is no risk under a robust FAC approach that BT's FTTC deployment will result in rising LLU and WLR costs*".[49] Sky also pointed out a number of examples (including corporate overheads, duct, NGA provisioning costs) where it considered costs more appropriate attributed to NGA have been allowed to remain in this LLU / WLR charge control model.

Our response and conclusions

3.38 We consider that TTG and Sky may have misunderstood the approach we have adopted in relation to anchor product pricing. We have used anchor pricing as a test to ensure that costs attributed to LLU / WLR are not inflated as a result of NGA. However, we have also sought to identify and remove costs which we consider are specifically NGA related.

3.39 The charges for LLU / WLR are not those that would have existed if NGA had not been developed, as we have taken advantage of cost reductions arising out of the NGA development (e.g. the greater use of the duct assets) in setting the charge controls.

[45] C&WW response to the March 2011 Consultation, page 10, response to question 3.4.
[46] Fujitsu response to the March 2011 Consultation, page 5.
[47] The points raised by TTG on NGA allocation are set out at paragraphs 68 to 81, pages 20 to 23, of its response.
[48] TTG response (July 2011) to the March 2011 Consultation, paragraph 74.
[49] Sky response to the March 2011 Consultation, paragraph 75.

3.40 However, we have, for the reasons set out at paragraphs 3.45 to 3.47 below, been cautious in our allocation of costs to NGA where these are projected on the basis of retail take-up of NGA services.

3.41 We have developed the anchor product pricing approach in response to the problems associated with setting charges at a time of rapid and major technological change.

3.42 Fortunately in the UK, we are beyond the point of initial incentives to encourage investment in new technology. BT and VM have both embarked on the roll-out of NGA services and we have seen the beginning of consumer take up. Accordingly, our main focus is to protect consumers at a time of technological change while ensuring that we do not undermine the existing incentives for investment.

3.43 We have adopted the anchor product pricing test in response to these concerns. The underlying principle is that consumers should benefit from new investment or at least the new investment should not lead to consumer paying a higher price that they would have faced absent that investment.

3.44 We disagree with Sky's view that there is no risk that a robust CCA FAC approach could lead to higher prices if NGA is taken into account. There are fixed costs in the provision of legacy copper services which would not be borne by NGA services[50] even with FTTC.[51] As NGA volumes increase such fixed costs would be redistributed over the remaining legacy services, thereby increasing costs for the legacy services. Accordingly, we consider that the use of the anchor pricing test to ensure consumers are not overcharged is appropriate in this case (i.e. at a time of technological change).

3.45 Equally, given the risk that low charges may undermine the retail prices for those new services, it is important that we do not over attribute costs to NGA which, in turn, would reduce legacy charges below an efficient equilibrium level (i.e. a level that ensures a demand for investment and take-up of new services is equivalent to the true additional consumer value of those services).

3.46 In their response to the March 2011 Consultation, TTG and Sky both note the risk of under allocation of costs to NGA.[52] We consider that in an environment of low initial take up of NGA, the risk (where it exists) is more likely to be an over allocation of costs to NGA. We have included NGA costs identified in Openreach modelling (provided under formal powers) as costs for the first year of the charge control period but not sought to inflate these costs against predicted volumes over the term of the LLU / WLR controls. Our reasoning is that these costs represented an initial view of the costs that it was appropriate to allocate to NGA at this nascent stage in its roll-out. Furthermore, Openreach had allocated costs without reference to retail take up of the service. This meant that costs were not associated with specific expectation of returns against the assets deployed. While we anticipate there will be some increase in deployment over the period, we do not expect that it will be matched by revenue and consequently there is a significant risk of over-allocation of costs to NGA compared to return on assets deployed (compared to the return to LLU / WLR) if we were to seek to increase the allocation of costs to NGA over the charge control

[50] For example, the SMC costs currently attributed to SMPF may not be attributed in the same proportion to GEA services.
[51] The proposed use of existing copper line (i.e. WLR or MPF) for voice provision in the FTTC NGA model means that most many of the copper costs are still imbedded in the provision of FTTC NGA.
[52] TTG response to the March 2011 Consultation paragraph 79 and Sky respone to the March 2011 Consultation page 2.

period such that prices for existing services were significant lower than they would otherwise have been as a result.

3.47 Our caution with respect to NGA volumes is bolstered by current retail competition (as set out in Annex 2 of this Statement). We note that up to now only BT Retail has actively promoted a GEA service. TTG began offering such a service on a small scale in 2011[53] but is yet to undertake a full launch.[54] Sky in its September 2011 results presentation said that customer bandwidth demand remains low and it is not seeing its customers complaining that there is no fibre provision. Sky suggested that it will only begin to offer such services when this demand becomes clear.[55] This suggests that retail supply may remain low during the charge control period.

3.48 Our detailed treatment of estimate of NGA costs is set out in Section 6 and Annex 4 of this Statement.

3.49 Stakeholders have noted also the development of PIA and potential charges for those services. As we noted in the November 2011 Consultation, we consider that PIA is still at a very early stage in development and do not anticipate that the significant provision of services via PIA will occur during the period of these charge controls. As such cost attribution is not affected by PIA.

3.50 In summary, we consider that the anchor pricing test is appropriate for these charge controls as it promotes efficiency (by encouraging efficient levels of investment), promotes sustainable competition and confers the greatest possible benefits on end-users of public electronic communications services.

3.51 Furthermore, we consider that, in setting charges for LLU / WLR services, we should be conservative in the allocation of costs associated with the nascent NGA product. As the level of NGA take-up inversely impacts on the retail cost of legacy services and given our determination in the 2010 WLA Consultation the legacy services are in the same market as NGA products,[56] over-estimates of NGA volumes might lead to legacy prices which undermine NGA take-up.

MEA, efficiency and review of BT system

3.52 At paragraphs 3.38 to 3.51, we discuss our approach to the costing of the legacy copper systems in the context of NGA.

3.53 There is a further issue with respect to the establishment of the appropriate costs for the copper product, namely whether the existing systems and network for the delivery of the copper products is the appropriate basis for establishing the costs upon which to set charges.

3.54 We set prices to recover efficiently incurred costs and in general we value assets based on the MEA, as we set out in the March 2011 Consultation.[57] We noted in the

[53] http://www.ispreview.co.uk/story/2011/01/14/uk-isp-talktalk-taking-40mbps-fttc-fibre-optic-broadband-boost-registrations.html.
[54] See the section on fibre access at page 4 of TTG's Interim Management Statement, dated 8 February 2011: http://www.talktalkgroup.com/investors/~/media/Files/T/TalkTalk/pdfs/results/Interim%20Management%20Statement%20-08th%20feb.pdf.
[55] September 2011 Results Conference call, Questions and Answers session, http://corporate.sky.com/page.aspx?pointerid=a0ec307496274142a410e823f905b751.
[56] 2010 WLA Consultation, paragraph 1.21.
[57] March 2011 Consultation, paragraphs 3.21 to 3,22.

March 2011 Consultation that Ofcom may not set charges on the basis of an MEA approach during a period of major technological change, when we generally adopt an anchor product pricing approach.

3.55 While this anchor pricing approach is appropriate when we compare the copper and NGA alternatives to the provision of access services, we still need to consider whether there are clearly more efficient alternative approaches to the provision of existing services.

3.56 While in principle it is possible to consider the efficiency of individual sub-processes in the provision of services, in practice it is difficult to do this. The provision of access services involves a number of interrelated processes and systems at different stages of modernisation and investment. The service supplier has to decide which component of its service to focus on at any given time to improve efficiency. We consider this in Annex 3 of this Statement.

3.57 Given the complexity of these systems, we have adopted the principle that it is appropriate to focus on total network efficiency rather than seek to analyse every component of service delivery. In this way the incumbent is incentivised to optimise its system overall rather than respond to the regulator's focus.

3.58 That being said, we would be open to basing costs on an alternative process / system where it is clear that the process/system is demonstrably more efficient and moving to this process / system would not negatively impact on other components of service delivery.

Valuation of duct for the purpose of setting charge controls

Cost valuation approach for Openreach duct assets

March 2011 Consultation proposals [58]

3.59 The cost of duct is a material input to the LLU and WLR charge controls. In the March 2011 Consultation, we consulted on Ofcom's treatment of the value of duct as an input to the charge controls.[59]

3.60 As we explained in the March 2011 Consultation, the 2005 Cost of Copper Review established a valuation of assets deployed before August 1997 on a HCA basis and assets deployed since August 1997 on a CCA replacement cost basis.[60]

3.61 In the March 2011 Consultation, we noted that BT had undertaken a review of the valuation of its duct network and as a result the RFS for 2009/10 included a re-valuation of BT's duct network and BT further provided an estimate of post-1997 duct value to be used in the LLU and WLR charge controls based on this re-valuation.[61]

Pre-1997 assets

3.62 In the March 2011 Consultation, we proposed to continue valuing pre-1997 duct assets according to the RAV. We said that such a valuation allows BT shareholders to achieve a reasonable return on their assets without creating windfall gains and the

[58] We have considered our March 2011 Consultation proposals in more detail in Annex 1.
[59] March 2011 Consultation, paragraphs 3.33 to 3.89.
[60] March 2011 Consultation, paragraph 3.36.
[61] March 2011 Consultation, paragraph 1.10.

continuation of the methodology adopted in the 2005 Cost of Copper Review is consistent with maintaining a stable regulatory environment.[62] We also explained, in the March 2011 Consultation that this would, in turn, promote sustainable competition and confer the greatest possible benefits on the end-users.

PIA

3.63 In the March 2011 Consultation, we said that we would expect that the difference between the charges for MPF (and also WLR+SMPF) and PIA should be at least as great as the difference in their respective incremental costs.[63] In the March 2011 Consultation, we explained that the main efficiency concern raised by the possibility of NGA investment using PIA is related to the efficiency of the relative prices of PIA and downstream services such as MPF and/or WLR+SMPF. Efficient relative prices can be achieved by setting the charges for PIA, MPF and other access products in a consistent way, reflecting a consistent asset valuation including the RAV adjustment in all cases.

Post-1997 assets

3.64 In the March 2011 Consultation we explained that in the 2005 Cost of Copper Review, the rationale for allowing a CCA replacement cost valuation of post-1997 assets had been twofold [64]:

- the post-1997 assets had been consistently valued on a CCA replacement cost basis throughout, so there was no concern, at the time, about windfall gains on these assets; and
- it was felt that, in the longer term "*while concerns over incentives to invest in access infrastructure have merit, they must be balanced by measures to protect consumers. The approach* [we are] *taking will, in the longer term, restore the asset base to its CCA value in line with Ofcom's previously stated view on the appropriateness of CCA as a basis for encouraging infrastructure investment*".[65]

3.65 In the March 2011 Consultation, we explained that in relation to future competitive entry, there are two key considerations:

- whether it is necessary to price services using the existing assets on the basis of full costs (i.e. including sunk costs), in order to give the right signals for competitive entry; and
- whether such entry is likely.[66]

3.66 As we explained in the March 2011 Consultation, for competitive entry to be statically efficient, it is necessary for the costs of the entrant to be lower than the forward-looking opportunity costs of the incumbent. Where there is spare capacity and the duct network is unlikely to require replacement, full replacement valuation would overstate this forward-looking cost. However, as we argued in the 2005 Cost of Copper Review, competitive entry in duct investment is not considered likely in the

[62] March 2011 Consultation, paragraphs 3.43 to 3.47.
[63] March 2011 Consultation, paragraphs 3.44 to 3.47.
[64] March 2011 Consultation, paragraph 3.48.
[65] 2005 Cost of Copper Review, paragraph 4.28.
[66] March 2011 Consultation, paragraph 3.50.

medium term, although it may become so in the longer-term future.[67] Allowing post-1997 assets to be valued on a CCA basis now allows the total duct valuation to move towards an appropriate valuation for promoting competitive investment without the need for step changes in value or charges.[68]

3.67 In the March 2011 Consultation, we also noted that if future competition was never to emerge, embedding full CCA valuations into the charge control valuations may lead to more volatility in charges than would be necessary simply to ensure a reasonable return to investors.[69]

3.68 In the light of the above, in the March 2011 Consultation, we proposed to conclude that CCA remains the appropriate approach for post-1997 asset valuation for these LLU/WLR charge controls.[70]

3.69 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 3.5*: Do you agree with our assessment that the decision on the treatment of pre-1997 duct assets set out in the 2005 Valuing BT's Copper Network remains appropriate for this set of charge controls? If not, why do you consider that the basis of valuing pre-1997 assets should change and what valuation basis should be used?*

Question 3.6*: We note that we would expect that the difference between the charges for MPF and PIA should be at least as great as the difference in their respective incremental costs. Thus, if we maintain the RAV adjustment in copper based access services, we would expect that any assessment that we make of duct access charges would reflect a consistent approach to asset valuation, recognising the RAV adjustment. In reaching this view we have taken utmost account of the European Commission's recommendation on NGA. Do you agree with this assessment of the need to recognise the RAV adjustment in the setting of duct access charges? If not, please give your reasoning.*

Question 3.7*: Do you agree that it remains appropriate to value post-1997 assets on a replacement/CCA basis? If not, please give your reasoning.*

Consultation responses[71]

3.70 In Annex 1 of this Statement, in paragraphs A1.12 to A1.20, A1.62 to A1.64, A1.111 to A1.112 and A1.116 to A1.120, we summarise in greater detail the responses to the March 2011 Consultation on the cost valuation approach for Openreach duct assets.

Pre-1997 duct valuation

3.71 In the light of the comments received from stakeholders in response to the March 2011 Consultation and, in particular, our assessment of the arguments made by Openreach, we have reached the conclusion that our decision on the treatment of pre-1997 duct assets set out in the 2005 Cost of Copper Review remains appropriate

[67] 2005 Cost of Copper Review, paragraph 3.3.
[68] March 2011 Consultation, paragraph 3.51.
[69] March 2011 Consultation, paragraph 3.52.
[70] March 2011 Consultation, paragraph 3.53.
[71] In Annex 1, we summarise in greater detail the responses to the March 2011 Consultation on the cost valuation approach for Openreach duct assets.

for these LLU / WLR charge controls. Our assessment and conclusion is set out more fully in Annex 1.

3.72 In particular, for the reasons explained more fully in Annex 1, we do not consider that any of the economic arguments put forward by Openreach give us grounds to depart from our view that Ofcom's decision on the treatment of pre-1997 duct assets set out in the 2005 Cost of Copper Review remains appropriate for these LLU / WLR charge controls.

3.73 We do not agree with Openreach that there was no possibility of a windfall gain in 1997, or that a return to CCA is now required in order to reward shareholders adequately.

3.74 We have also considered whether BT's absolute valuation is a potential alternative to the RAV adjustment. In our view, it would produce unexpected values that move up and down over the years, while the RAV adjustment provides greater predictability to stakeholders.

3.75 Accordingly, we have decided that the RAV adjustment is still required. It is important to understand that our principal duty is to further the interests of citizens and consumers and it is on this basis that the RAV adjustment is made – not on the basis of the cost recovery of private shareholders.

Physical Infrastructure Access

3.76 We acknowledge the comments from Openreach that PIA is outside the scope of the March 2011 Consultation and the November 2011 Consultation. We are not reaching any decision in this Statement on this issue as any future decision will need to be based on the information available at the time. However, our current view remains that the principles we have applied to setting the relative prices for MPF and WLR are likely to be relevant to setting the relative charges for MPF and physical infrastructure access.

Post-1997 duct assets – basis of valuation

3.77 It is clear from the comments received from stakeholders that consensus as to whether or not a CCA valuation should be used largely depends on how that valuation should be undertaken.

3.78 As discussed in Annex 1 (see paragraphs A1.90 to A1.103), the absolute valuation methodology used by BT has serious flaws in the context of setting a charge control. As noted by TTG is opaque and inconsistent, with the potential incentives on BT to 'game' the process.

3.79 However, we consider that it is appropriate to determine a value of post-1997 assets that does encourage the right incentives for both BT and other potential telecommunications asset investors. Our view on these incentives is derived from our wider view on market conditions and we agree with stakeholders that it is may be appropriate to reconsider the basis of valuation of BT's post-1997 duct assets which we would do as part of our next WLA market review. This would allow us to consider the role of duct in the context of the range of access remedies.

3.80 While we share some of the concerns of stakeholders on the risks in a CCA valuation we consider that these can be modified through the approach taken to deriving the valuation.

3.81 As we explain in paragraphs A1.121 to 1.126 of Annex 1, a CCA valuation based on an appropriate index, rather than the existing absolute valuation approach, can avoid many of the risks identified and in effect satisfies the need to set a value that provides the risk investment incentives while ensuring that the value is not out of line with movements in costs and efficiency.

3.82 Accordingly, we have decided that it is appropriate for BT's duct assets deployed post-1997 to be valued on a CCA though one derived from indexation rather than absolute valuation.

Valuation of post-1997 assets

March 2011 Consultation proposals[72]

3.83 In the March 2011 Consultation, we said that we did not consider that BT's valuation of post-1997 assets represented a robust basis for estimating a CCA valuation of post-1997 duct assets.[73]

3.84 In particular, we identified significant discrepancies between BT's valuation of post-1997 duct and our analysis using BT's capital expenditure over the same period, including a valuation "gap" of approximately £1 billion between BT's post-1997 valuation and alternative valuations based on actual capital expenditure inflated by RPI or industry indices over the same period.

3.85 In the March 2011 Consultation, we noted that we would not expect duct capital expenditure in recent years to diverge to such an extent from a valuation using inventory data. BT's estimate of the NRC of the post-1997 duct assets appeared to be significantly more than would be expected based on historical spend, even before adjusting the historical spend to reflect the national discount.

3.86 Openreach had offered a range of reasons why duct costs may have increased in real terms, including that duct construction is likely to incur relatively higher costs in more recent years compared to older duct and the costs associated with ensuring compliance with relevant legislation (e.g. health and safety, streetworks and traffic management regulations).

3.87 In the March 2011 Consultation we explained that we did not consider that BT's explanations provided sufficient evidence to demonstrate that BT's proposed value for post-1997 duct assets was reasonable.

Alternative approaches to CCA valuations

3.88 As noted above (paragraphs 3.77 to 3.82) we did not accept BT's basis for valuing post-1997 duct assets. Given there was no clear approach to "correcting" BT's methodology it was necessary to consider alternative approaches to independently derive the value of the post-1997 duct assets.

3.89 In the March 2011 Consultation, we consulted on a range of bases for the CCA valuation for post-1997 duct assets, derived directly from capital expenditure on duct since 1997.

[72] We have considered our March 2011 Consultation proposals in more detail in Annex 1.
[73] We addressed the valuation of post-1997 duct assets at paragraphs 3.54 to 3.81 of the March 2011 Consultation. We summarise our proposals in the March 2011 Consultation regarding the valuation of BT's post-1997 duct assets in greater detail in paragraphs A5.66 to A5.185.

3.90 We considered that any approach should, as far as possible, remain consistent with the principles of valuation used in the past, so that we would not solely draw on indexation, but also take account of how a true ‘replacement’ network would be provided. Accordingly, our approach included the use of an economy of scale national roll out discount, as has historically been used by BT in its estimate. For the purposes of the March 2011 Consultation, in the absence of a clearly defined alternative for this discount, we used BT’s estimate of 14.5%.[74]

3.91 As set out in Annex 5 of the March 2011 Consultation, we drew on the work of Analysys Mason[75] in selecting an appropriate index for use in our estimation.

3.92 In the March 2011 Consultation, we asked stakeholders the following questions in respect of our proposals for the valuation of duct:

***Question 3.8**: Do you agree with our assessment that as BT’s recent valuation of post-1997 assets is not consistent with alternative estimates of replacement values it does not form a appropriate basis for setting charges? If not, please give your reasoning.*

***Question 3.9**: Do you agree with our proposal to include a valuation of duct in the charge controls based on indexation of post 1997 expenditure? If so, should this indexation be based on RPI;* [GBCI] *or* [GBCI] *adjusted for either productivity, scale economies or both (the detailed examination of these indices is set out in Annex 4? Please give reasons for your answer.*

***Question 3.10**: Do you agree with our proposal to discount the indexed valued by an estimate of a national roll out of duct? If so, do you consider BT’s estimate of 14.5% to be appropriate? If you disagree with our approach please give your reasons.*

***Question 3.11**: Our range for the duct value is defined by the degree to which BT is able to establish contracts with cost below the national average? Do you consider that it is reasonable to expect BT to achieve below national costs on average?*

3.93 While we consulted on a range of possible approaches (including RPI and GCBI alone) we suggested a possible range for CCA values in the March 2011 Consultation Duct valuation (see Annex 5 of the March 2011 Consultation) which we used for illustration:[76]

- at the high end, actual expenditure indexed by GBCI each year, less 14.5%.
- at the low end, actual expenditure, indexed by GBCI – 1% each year, less 14.5%.

[74] March 2011 Consultation, paragraph 3.84.
[75] Analysys Mason is a management consultancy.
[76] Historic duct expenditure is available as part of the RAV model which will be available published in the near future.

March 2011 Consultation responses[77]

3.94 In Annex 1 of this Statement, in paragraphs A1.144 to A1.172, we summarise in greater detail the responses to the March 2011 Consultation on the cost valuation approach for Openreach duct assets.

Our response and conclusions

3.95 We note Openreach's concerns about the application of an additional efficiency factor in the indexation of expenditure. We consider that it may be reasonable to assume that BT benefits from economies of scale in its purchases, but it is not clear that these economies of scale will progressively increase year on year as would be implied by an efficiency factor applied to a national index which will already include national efficiency gains. Accordingly, we do not consider that we should seek to apply an efficiency factor to the index chosen.

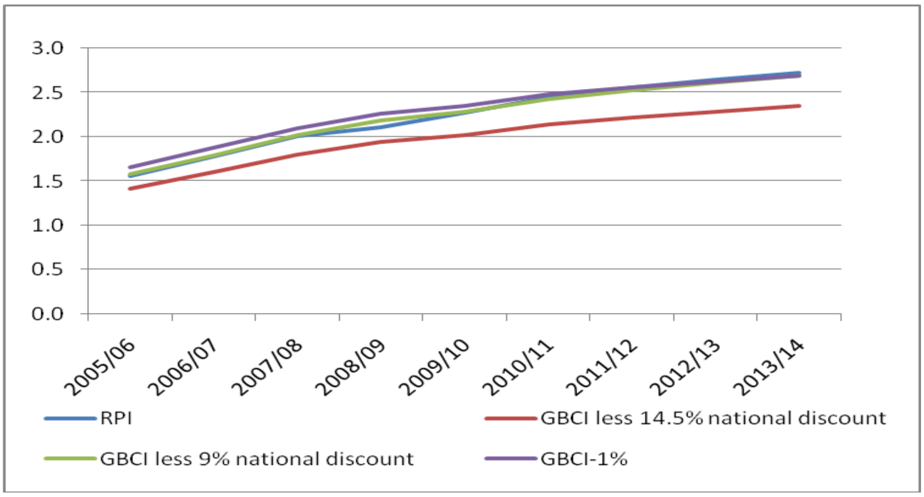
3.96 We accept Openreach's argument that it is difficult to be confident in the level of discount BT could obtain in rebuilding their duct network.

3.97 We have taken account of the evidence provided by BT that a lower discount may be appropriate, noting also that Openreach's disagreement to the application of such a discount in setting the index.

3.98 Nevertheless, we consider that there clearly is scope for a cost discount in a single large scale rebuilding project while recognising that it is difficult to determine a robust figure for what might be possible in a theoretical scenario (of an overnight rebuild of the full network) in an environment of limited scope for economies of scale for a dispersed infrastructure project. We consider that the discount used in BT's last accounts (14.5%) and its latest estimate (9%) set a plausible range. However, there is not sufficient information to determine a single "correct" figure.

3.99 There are a number of plausible indices within the range defined by GBCI-14.5% to GBCI-9% including RPI, which was one of the indices we proposed in the March 2011 Consultation. See Figure 3.1 below.

Figure 3.1 Post 97 Duct RAV NRC illustration using different indices (£bn)



[77] In Annex 1, we summarise in greater detail the responses to the March 2011 Consultation on the cost valuation approach for Openreach duct assets.

3.100 In the light of the above we conclude that RPI is the most appropriate index to use as the basis for duct valuation for the following reasons:

- Its value sits within the range determined by GBCI-14.5%-GBCI-9%.
- RPI is a well recognised index that is used by other regulators for indexed valuations and price regulation calculations.
- The use of RPI will enable a more transparent calculation without the need to estimate the exact figure for the national discount. This is advantageous as even if the 'correct' discount could theoretically be determined, the figure may change year on year leading to unpredictable movements in duct valuation. The use of RPI index removes the need for the re-evaluating the national discount estimate annually.

3.101 We have updated the calculation to reflect BT's actual capex for 2009/10 and the relevant RPI. The resulting figures for 2009/10 duct valuation which we will use in our CA model, along with the current 2010/11 capex figure, are in Figure 3.2 below:

Figure 3.2: 2009/10 duct valuation figures

	£ bn
Gross Replacement Cost	2.9
Less depreciation	(0.6)
Net Replacement Cost	2.3

3.102 We have concluded that CCA remains the appropriate approach for valuing post-1997 duct assets. We consider that the appropriate method for estimating CCA value in this case is indexing annual spend on the network by RPI.

Use of glide paths to align charges with costs

March 2011 Consultation proposals

3.103 In the March 2011 Consultation we explained why, in setting charge controls, particularly where the controls replace similar existing controls (as is the case for the LLU / WLR charge controls), we have a strong preference for glide paths, rather than one-off adjustments, to align charges to costs.[78]

3.104 In the March 2011 Consultation, we explained that the benefit of the glide path approach is that it more closely approximates the workings of a competitive market in which excess profits tend to be gradually eroded as rivals improve their own efficiency (compared to one-off reductions). The glide path approach also avoids discontinuities in prices over time and leads to a more stable and predictable background against which investment and other decisions may be taken, by both suppliers and customers, in the telecoms market. We noted that this approach also has greater incentives for efficiency improvement compared to immediate adjustment of charges to CCA FAC levels as it allows the firm to retain the benefits of cost reductions made under a previous charge control for longer.

[78] March 2011 Consultation, paragraphs 3.91 to 3.95.

3.105 We explained in the March 2011 Consultation that, notwithstanding our preference for glide paths, we would not rule out one-off reductions where there were good reasons to introduce them. In the context of the LLU / WLR charge controls, we explained in the March 2011 Consultation that the scenarios under which we may consider making one-off reductions may include where:

- there are strong allocative efficiency arguments for bringing prices into line with cost sooner (such as where BT's prices of particular services are out of line with cost-orientation requirements);
- the previous charges were unregulated or are not subject to charge control and where Openreach's charges are high relative to costs; and/or
- there is a need to align the charges for corresponding ancillary services provided alongside MPF and SMPF where the charges for MPF and SMPF variants are materially out of line and this may have a distorting effect on the market.

3.106 In the March 2011 Consultation, we said that if the prices of individual services were materially out of line with costs we may need to address this through one-off reductions. However, in assessing possible one-off reductions, we would need to balance a one-off reduction against alternative (and potentially more proportionate) regulatory approaches.

3.107 As such, in the March 2011 Consultation, we asked stakeholders the following questions (note that the Question 7.12 from Section 7 of the March 2011 Consultation sets out how the glidepath was derived, whereas Question 3.12 from Section 3 of the March 2011 Consultation sets out our general approach to how we set the glidepath in this LLU/WLR charge control review):

Question 3.12*: Do respondents agree with our preferred approach to use glide paths to align charges with costs except in the circumstances discussed above where one-off adjustments may be preferable? Please give reasons for your response.*

Question 7.12*: Do you agree with our approach for deriving the glide path?*

March 2011 Consultation responses

3.108 C&WW[79] and GC[80] agreed with our proposed approach of using glide paths to align charges with costs. Openreach acknowledged the reasons we gave for potentially departing from such an approach and added that: "*Ofcom should also recognise that it can get its forecasts of unit costs wrong (for example, if volumes decline faster than it* forecasts *in the presence of economies of scale). Openreach considers that in such circumstances it should be recognised that some one-off adjustments (increases) might be appropriate to avoid continuing, and inadvertently amplifying, the effect of a mis-forecast into the subsequent control".*[81]

[79] C&WW response to the March 2011 Consultation, page 19.
[80] GC response to the March 2011 Consultation, page 3.
[81] Openreach response to the March 2011 Consultation, paragraphs 352 and 353.

3.109 GC[82] and Openreach[83] agreed with the approach for deriving the glide path linked to the charges in 2010/11 rather than the interim prices.

3.110 TTG said it agreed with the general approach although it said that "*certain one-off changes (up and/or down) may be required to meet alignment obligations".*[84] TTG said that its preferred approach to overcome this unwanted effect would be to "[d]*erive the 2011/12 price as an amount of £ based on a smooth nominal cost change between the starting price (in 30 March 2011) and the cost in 2013/14* [and] [s]*et the X for 2012/13 and 2013/14 based on that required to achieve the target price in 2013/14 and using the likely lagged RPI figures (currently 3%)*".[85]

November 2011 Consultation proposals

3.111 In the November 2011 Consultation we noted that the new controls are now expected to apply from the start of the 2012/13 year and will therefore apply for only two years, rather than the slightly longer period envisaged in the March 2011 Consultation.

3.112 In the November 2011 Consultation we noted that we may decide to define the 2012/13 charges by reference to an absolute amount (i.e. expressed as an amount in pounds) rather than based on an RPI-X calculation (as the 2013/14 control is likely to remain in an RPI-X format). This would have two potential advantages: it allows us the flexibility to set prices in 2012/13 that recognise the current volatility in RPI and is relatively easy to understand. This approach was similar to that adopted in the controls that were set in 2009 and this approach was anticipated in the draft SMP Conditions in Annex 5 of the November 2011 Consultation.

3.113 In the November 2011 Consultation, we explained that we would set prices in 2012/13 with reference to the price-controlled prices in 2010/11 and not the more recent bridging arrangement prices, recognising, particularly with respect to RPI, that we are two years into the three year charge control period.

3.114 On this basis, we said that we expected that the effect of the new controls would be prices that are similar to those that would have been set in the second and third years of a three year glide path starting in 2010/11.[86]

November 2011 Consultation responses

3.115 Openreach and TTG provided comments in relation to the glide path.

3.116 Openreach noted that:

> *"... the control will now only be for two years rather than the three years originally envisaged ... Openreach contends that Ofcom's proposed approach gives rise to start price adjustments that are inappropriate and disproportionate, and instead proposes an alternative approach based on a two year glide that avoids any distortion* [which otherwise] *will result in large price reductions on 1 April 2012, in effect amounting to a start price adjustment.*
>
> *Ofcom has previously noted that the reason it generally prefers glide paths rather than one-off price adjustments is partly because they lead to greater stability and*

[82] GC response response to the March 2011 Consultation, page 10.
[83] Openreach response to the March 2011 Consultation, paragraph 511.
[84] TTG response (July 2011) to the March 2011 Consultation, paragraph 533.
[85] TTG response (July 2011) to the March 2011 Consultation, paragraph 538.
[86] November 2011 Consultation, paragraph 2.10.

predictability...and also because they improve cost reduction incentives, particularly towards the end of a control period. ... It is clear that the conditions which Ofcom has previously set out that might warrant start price adjustments are not satisfied in the case of LLU/WLR... We note that this approach is consistent to that adopted by Ofcom in other charge controls e.g. Wholesale Broadband Access

Ofcom's proposals also adopt an inconsistent approach to products subject to individual charge controls and products controlled within baskets. For individual charge controls, Ofcom proposes a price ceiling from 1 April 2012 that reflects the second year of the three year glide path, but ancillary basket prices will be subject to a straight two year glide path. These approaches are inconsistent and instead, Ofcom should adopt a two-year glide path for all products." [87]

3.117 Alternatively, TTG noted that there was a risk of a '*bumpy*' and irregular glide path that was "*not justified by the direction of cost."*[88] Instead TTG suggested that:

"The simple way to address this anomaly and set a price trend that is consistent with the cost trend would be as follows [footnote omitted] *(using example of MPF rental):*

- *Derive the 2012/13 and 2013/14 'target' prices (£87.85 and £87.23 respectively) as an amount of £ based on a smooth nominal cost change between the starting price (in 2010/11) and the cost in 2013/14. This smooth price path will reflect the smooth cost trend*

- *The price for 2012/13 can be set in specific £ terms since the relevant RPI figure (from October 2011) will be known (as suggested by Ofcom in §2.10*[footnote omitted]*). In this case the price can be set at £87.85*

- *The price for 2013/14 can be set by means of an RPI-X formula (as suggested in §2.10) and in this case the X would be –3.7%*

  ...

We see there being a number of reasons to adopt this approach [including]*:*

- *The standard approach delivers BT a windfall since the prices are above those that the cost trends would justify....*

- *If Ofcom were to gift BT this windfall it would be on top of the unjustified windfall BT have enjoyed by virtue of the interim charges in 2011/12 being set significantly above the appropriate prices.".* [89]

Our response

3.118 In both the March 2011 Consultation and the November 2011 Consultation we proposed that we would set prices in 2012/13 with reference to the price-controlled prices in 2010/11 and not the more recent bridging arrangement prices, recognising, particularly with respect to RPI, that we are two years into the three year charge control period.

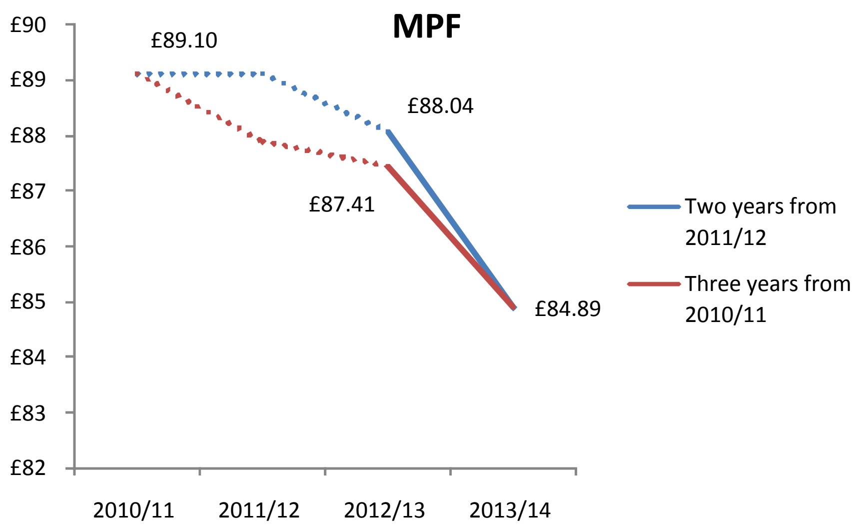
[87] Openreach response to the November 2011 Consultation, paragraphs 8 to 11.
[88] TTG response to the November 2011 Consultation, paragraphs 8 to 13.
[89] TTG response to November 2011 Consultation, paragraphs 14 to 15.

3.119 As noted at paragraphs 3.108 to 3.110, stakeholders including Openreach agreed that the 2010/11 charges are an appropriate basis for the glide path. Openreach has had the benefit of charges, some of which have been, in excess of CCA FAC costs over 2011/12. We consider that that it would not be appropriate to embed possible over-recovery, which would have been the case if charges remained flat from 2010/11 with the glide-path for the charge control period.

3.120 Openreach expressed its concern that we should not construct the 2012/13 controls to reflect a level of charges we would expect in a second year of a charge control rather than the first year, as this would require a larger one year adjustment than would otherwise be appropriate[90]. TTG focussed on us ensuring a "smooth *nominal cost change"* over the two years of the control.[91] These positions are not inconsistent.

3.121 In Figure 3.3, Figure 3.4 and Figure 3.5 below we compare the glide paths we may structure with a constant controlling percentage to 2013/14 starting from 2010/11 prices with the glide starting in 2011/12 and 2012/13, for each of the rental services.

Figure 3.3: Comparison of 2 and 3 year glidepaths for MPF rental charge



[90] Openreach response to November 2011 Consultation paragraphs 8-11.
[91] TTG response to the March 2011 Consultation, paragraph 538.

Figure 3.4: Comparison of 2 and 3 year glidepaths for WLR rental charge

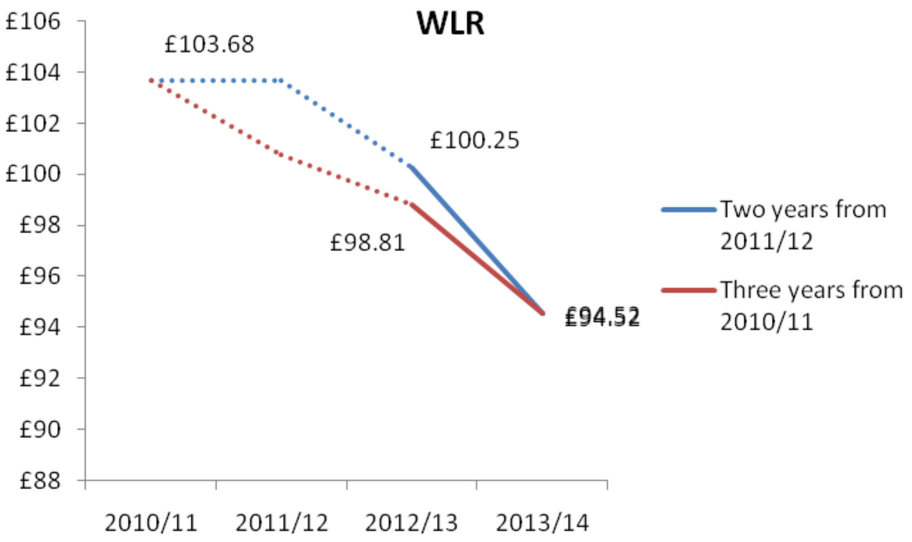
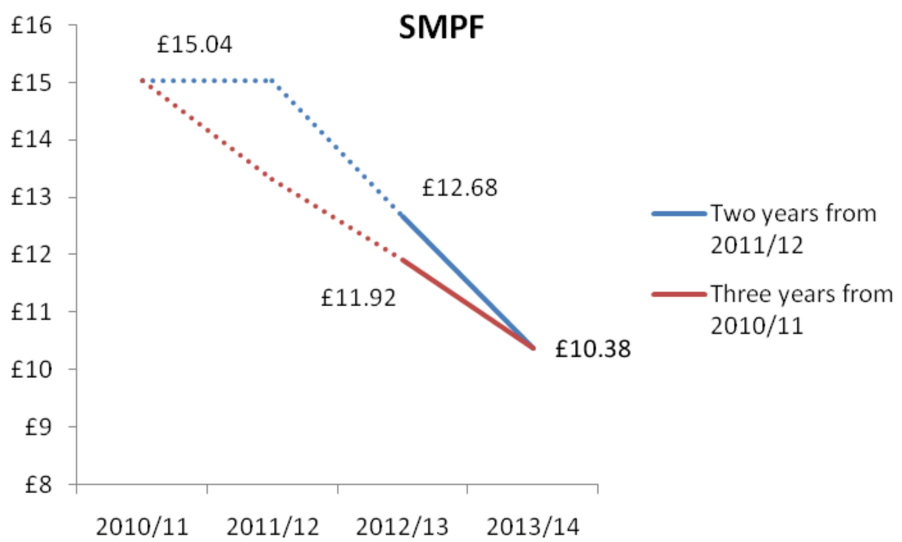


Figure 3.5: Comparison of 2 and 3 year glidepaths for SMPF rental charge



3.122 As can be seen, as the 2011/12 controlling percentage for MPF and WLR are close to RPI in that year, and the three year glide paths for those two services have a near nominally constant control in 2011/12, there is very little difference in the effect of a three year and two year glide paths for MPF and WLR rental services.

3.123 SMPF is different. The far higher controlling percentage means that the two and three year glide paths are quite distinct. However, the absolute differential in the charge for 2012/13 remains very small.

Our conclusions

3.124 We consider that it is reasonable to set a smooth two year control for the LLU and WLR charges.

3.125 We consider that it remains appropriate for the control to align the charges to CCA FAC with a glide path, but given the direction of cost change, it would not be appropriate to allow Openreach to benefit from a glide path that was linked to the current voluntary charges as this would embed an over-recovery in the charge controls (over and above that which revised charges from the last agreed cost level).

3.126 We have considered the alternatives to a two or three year glide path and consider that, on balance, a three year path is preferable. While we accept that Openreach has reasonable concerns with respect to rapid changes in charges, there is limited effective difference in the approaches for the two primary rental charges and a three year glide path will ensure that the SMPF charge which is substantially out of alignment with its underlying CCA FAC costs is more quickly moved closer to alignment. We note that the effect of the three year control on the core rental charges will be a smooth nominal reduction in charge, as proposed by TTG.

3.127 We have not directly considered the basket controls and other individual ancillary services in the above analysis, but we consider that, in relation to the basket controls and other ancillary services, there is no reason to depart from a three year glide path. Openreach will continue to benefit from the above cost charges for the first year of the controls and, within the baskets, has the flexibility with respect to individual service charges to ensure a smooth transition path.

3.128 We set out the specific controls in Section 6 of this Statement.

Charge control compliance

Compliance monitoring

March 2011 Consultation proposals

3.129 In the March 2011 Consultation, we said that compliance with the current LLU/WLR charge controls is monitored by Ofcom on the basis of data submitted by Openreach within three months of the ending of each relevant year. We proposed to maintain the same arrangements for compliance and requirements for provision of data in the new charge controls.

3.130 In the March 2011 Consultation, we asked stakeholders the following question:

> ***Question 3.13****: Do you agree with Ofcom's proposal to impose the arrangements for charge control compliance and requirements for provision of data set out in Annex 13* [of the March 2011 Consultation]*? Please give reasons for your answer.*

March 2011 Consultation responses

3.131 Openreach told us that it supports our proposal to maintain the same arrangements for demonstrating compliance, but that we should "*remove the formal reporting requirements for low volume products*" and requested that Ofcom "*formally verify whether or not Openreach has complied with its charge control requirements following each charge control year*".[92]

3.132 GC said it "*believed that it is important to maintain an obligation on the SMP party (a) to accept the burden of proof and (b) to ensure to Ofcom's satisfaction that each and every service that is subject to the control is cost-oriented*".[93]

[92] Openreach response to the March 2011 Consultation, paragraphs 3.54 to 3.57.
[93] GC response to the March 2011 Consultation, page 3, response to question 3.13.

3.133 C&WW considered it to be good practice for us to transparently monitor charge controls, but considered that BT should also provide information as to the general effect of price changes in relation to both internal and external sales.[94]

Our response and conclusions

3.134 We agree with stakeholders that it is important to maintain adequate arrangements for compliance. Accordingly, we do not consider that it is appropriate to reduce the extent of the compliance obligations proposed in the charge control condition.

3.135 We also accept that there is an interest from both Openreach and others for more transparency from Ofcom in relation to compliance but we consider that this is not an issue that it appropriate to consider purely in terms of the LLU / WLR charge controls. We consider that it is more appropriate to consider any changes to monitoring charge control compliance and requirements for provision of data within Ofcom's review of Cost Orientation and Regulatory Reporting.

3.136 In the light of the comments received in response to the March 2011 Consultation, we have decided to impose arrangements for charge control compliance and requirements for provision of data as in the same form as that proposed in our March 2011 Consultation and November 2011 Consultation. Given our position on the points raised by Openreach and Ofcom's review of Cost Orientation and Regulatory Reporting, we have also decided that it is not appropriate at this stage to remove the formal reporting requirements for low volume products or develop arrangements within the LLU/WLR charge controls which would provide public verification of whether or not Openreach has complied with its charge control requirements.

Provision for "Carry Over"

March 2011 Consultation proposals

3.137 In the March 2011 Consultation, we said that the current controls (and other controls applied to wholesale services) enable correcting adjustments to be made to the controls in the subsequent year if the regulated firm sets charges above or below the level allowed by the cap in any year of the charge control (referred to as "carry over").[95] As well as being a safeguard mechanism, this ensures that the regulated firm has the ability to recover its relevant and efficiently incurred costs across the life of the charge controls. We proposed to retain these provisions in these charge controls to provide reasonable flexibility in the compliance targets for any given year while ensuring adjustments can be made to avoid the under or over-recovery of costs across the period of the charge controls.

3.138 In the March 2011 Consultation, we asked stakeholders the following question:

> ***Question 3.15:*** *Do you agree with Ofcom's proposal to retain provisions for "Carry Over" in the new controls? Please give reasons for your answer.*

March 2011 Consultation responses

3.139 Openreach said that it "*agrees with Ofcom's proposal to retain the 'carry over' provision within the new controls which require Openreach to make adjustments to the Controlling Percentage in each Relevant Year to account for any under/over*

[94] C&WW response to the March 2011 Consultation, page 19, response to question 3.13.
[95] March 2011 Consultation, paragraphs 3.105 and 3.106.

provision in prior Relevant Years" [and noted that] "*The carry-over and carry-under provisions are required in the event that Ofcom places overly restrictive controls on the baskets*".[96]

3.140 C&WW said that "[c]*arry over appears a fair provision, however it requires transparency. Ofcom should collect data regarding BT's use of carry over so that its use can be better understood. Within subsequent charge controls we would like to understand the materiality of the use of the carry over provision*".[97]

3.141 GC said that "[w]*hile we generally support Ofcom's proposed 'carry over' approach, we propose that Ofcom should give a clear indication that if any service is found to have significantly breached cost-orientation obligations then a strong approach to remedial measures will be considered*".[98]

Our response and conclusions

3.142 In light of comments received from stakeholders, we have decided that to retain the provisions for "carry over" in the new LLU / WLR charge control conditions. We will also continue annually to review BT's use of any carryover provision in our review of BT's annual compliance report.

3.143 We would also note that the use of the carryover provision is distinct from the cost orientation obligation. Services in a basket remain subject to cost orientation obligations and affected parties are always able to raise (via the dispute resolution process under section 185 of the Act or otherwise) concerns that specific charges are not compliant with the applicable cost orientation obligations.

RPI as the appropriate index for charge control

March 2011 Consultation proposals

3.144 We explained in the March 2011 Consultation that our approach to indexation in both retail and wholesale price caps had been to use the RPI measure of inflation. We recognised that there are alternatives measures of inflation, for example, CPI, which focuses to a greater extent on household consumption of goods than RPI, and RPIX.[99]

3.145 In the March 2011 Consultation, we said that in our view RPI remained an appropriate means by which to index-link of the LLU/WLR charge controls. We said that RPI was a widely used measure of general inflation and is the index typically used to set price caps in other sectors subject to economic regulation. With regard to the LLU/WLR charge controls, we proposed that the RPI indexation applied should be the change in RPI for the year ending on 31 October before the start of each year of the charge controls, expressed as a percentage rounded to two decimal places.

3.146 In the March 2011 Consultation, we asked stakeholders the following question:

Question 3.14: *Do you agree with Ofcom's proposal to use the RPI as the appropriate measure of inflation for indexation? Do you agree that change in RPI for*

[96] Openreach response to the March 2011 Consultation, paragraphs 361 to 363.
[97] C&WW response to the March 2011 Consultation, page 20, response to question 3.15.
[98] GC response to the March 2011 Consultation, page 4, response to question 3.15.
[99] March 2011 Consultation, paragraphs 3.101 to 3.103.

the year to 31 October preceding the start of each Relevant Year should be used? Please give reasons for your answers.

March 2011 Consultation responses

3.147 Openreach agreed that there are no reasons why Ofcom should depart from regulatory precedent and move away from the use of RPI as a measure of inflation indexation.[100] Openreach also agreed with our proposal that the change in RPI for the year to 31 October preceding the start of each year of the charge controls should be used.[101]

3.148 FCS also agreed with our proposal, as did EE, which noted the use of RPI for setting the RPI-X price control formulae is consistent with long held UK regulatory precedent in telecoms and other industries.[102]

3.149 C&WW said that "*Ofcom and before that Oftel have used RPI as the measure of inflation since the first charge control in the communications market was established. Since the introduction of CPI in the mid-1990s many organisations have adopted it as their preferred measure of inflation and the popularity of CPI in recent years has accelerated. We now believe this is the right point in time for Ofcom to consider this issue in far greater detail than has been presented within the context of this consultation. While we don't believe further debate on the measure of inflation should delay Ofcom's work on this charge control, we feel it is important for Ofcom to commence a comprehensive review of the two measures of inflation in the near future, so that stakeholders can help make an informed judgement over which to advocate in future Ofcom charge controls. We simply have insufficient detail on this issue on which to base a decision and we would therefore urge Ofcom to embark upon a new policy project to review this issue. With HM Government now using CPI for an increasing number of purposes, a review to determine the most appropriate measure of inflation is now overdue*".[103]

3.150 GC also disagreed with our intended continued use of RPI and proposed that Ofcom should conduct a thorough analysis of this issue, especially to consider whether CPI would be a more suitable inflation index than RPI in relation to this and other charge controls.[104]

3.151 TTG said the appropriate measure (CPI or RPI) should depend on which is best correlated with the cost item, but that CPI is more appropriate.[105]

Our response and conclusions

3.152 We use inflation indexes in a number of instances in setting the LLU / WLR charge controls to forecast costs and to set the charge controls. We discuss each of these below and consider whether there is a justification for changing the inflation index from that proposed (i.e. RPI) in the March 2011 Consultation.

[100] Openreach response to the March 2011 Consultation, paragraph 358.
[101] Openreach response to the March 2011 Consultation, paragraph 359.
[102] FCS response to the March 2011 Consultation, page 6, response to question 3.14 and EE response to the March 2011 Consultation, page 13, response to question 3.14.
[103] C&WW response to the March 2011 Consultation, page 19, response to question 3.14.
[104] GC response to the March 2011 Consultation, page 4, response to question 3.14.
[105] TTG response (July 2011) to the March 2011 Consultation, paragraph 338.

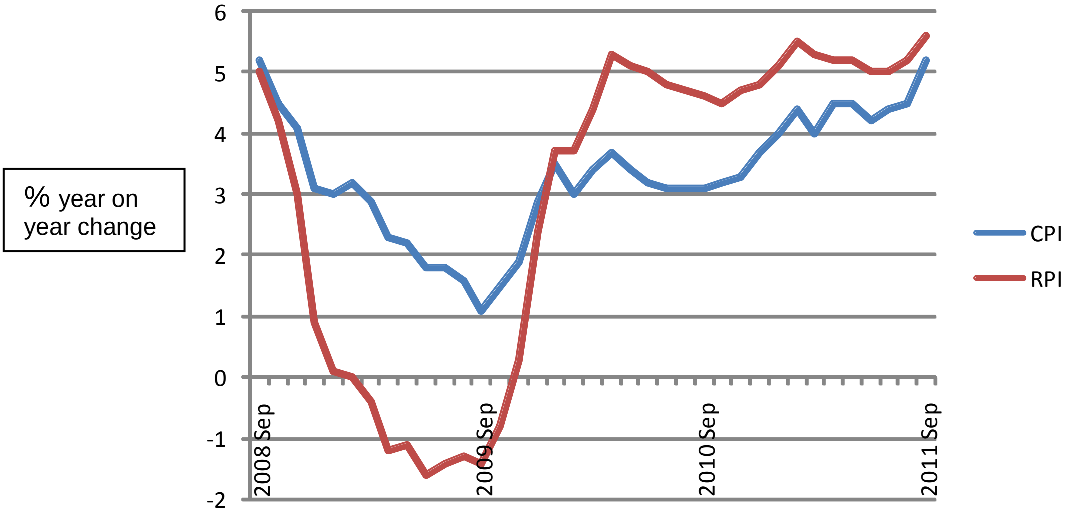
3.153 With respect to cost forecasts, we will adopt the appropriate index for the particular cost, for example, for labour costs we use a national labour index. However, RPI is used to forecast a number of costs.

3.154 We have used RPI for the purposes of estimating future asset values. However, as we noted in the November 2011 Consultation changes in inflation assumptions also affect the underlying cost estimates, increasing operating costs, but this impact is reduced by higher in-year holding gains, which reduce depreciation costs.[106] We only use RPI where as RPI is a reasonable index estimate and the moderating impact of holding gains reduces the risk of serious error. Given this effect (i.e. RPI increases being offset in the charges by the holding gain adjustment) the use of an alternative index, e.g. CPI, is unlikely to lead to a material difference in charges.

3.155 RPI is also used to set the charge control itself. As we noted in the November 2011 Consultation we adjusted our X in the RPI-X control to reflect our estimation of RPI in order to ensure that the final value of the control is in line with our expectation of CCA FAC.[107]

3.156 The purpose of the inflation index is to capture the variation in costs. While RPI will not match our prediction precisely, as can be seen from Figure 3.5 below, both RPI and CPI are subject to substantial volatility. There is no reason to consider that the variation in CPI is any more predictable or reliable or reflective of Openreach costs nor would its use as a cost estimator lead to consistently lower charges.

Figure 3.5: RPI and CPI since September 2008 to September 2011



Source: Office for National Statistics[108]

3.157 In conclusion, we have decided to continue to use the RPI measure of inflation for the LLU / WLR charge controls.

[106] November 2011 Consultation, paragraph 2.9.
[107] November 2011 Consultation, paragraph 2.9.
[108] http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-223814.

Duration of the LLU and WLR charge controls

March 2011 Consultation proposals

3.158 In the March 2011 Consultation, we proposed that the new charge controls for LLU / WLR should run concurrently to end on 31 March 2014.[109]

3.159 In developing our proposal in relation to the duration of the LLU / WLR charge controls we took account of the four year forward look period (2010 - 2014) covered by the WLA and WFAEL Market Reviews. Therefore, a four year charge control for LLU and WLR would outlast the duration of our forward look contained in the market reviews and would require a further review of the market (or finding of no material change) to cover the final months of the controls. In addition, as set out in the March 2011 Consultation, we preferred to take a three year approach to achieve synchronisation of charge control remedies and market review periods.[110]

3.160 We also took account of the new harmonised framework for the regulation of electronic communications networks and services (known as the "Common Regulatory Framework") implemented by the 'Better Regulation' Directive.[111] The Common Regulatory Framework sets the requirements for harmonisation of communications regulation across European Member States through a series of Directives establishing rules to be enshrined in the national law of each Member State.

3.161 The new Common Regulatory Framework requires that the analysis of the relevant market and notification of the corresponding draft measure must take place within three years of the adoption of a previous measure relating to that market (although, exceptionally that period may be extended).[112] In the March 2011 Consultation we noted that our proposal to set the LLU and WLR charge controls for a period ending in March 2014 is consistent with this obligation.[113]

3.162 In addition, as part of our assessment of the potential options for the duration of the current LLU and WLR charge control reviews, we considered the balance between incentives for dynamic efficiency for the regulated firm, and the benefits of allocative efficiency.

3.163 Dynamic efficiency concerns the ability of firms to innovate and make efficient investments, including activities designed to reduce costs over time. Price caps generally provide strong incentives for dynamic efficiency because they allow regulated firms to earn profits in excess of the cost of capital if they are able to manage costs below the level established by the RPI +/- X formula which sets the regulated prices. These incentives can drive innovation and investment. Other things being equal, incentives for dynamic efficiency will be stronger in a longer price cap than in a shorter one because a longer period gives the firm more opportunity to enhance its profitability through innovation and cost reduction.

[109] March 2011 Consultation, paragraphs 3.4 to 3.13.
[110] March 2011 Consultation, paragraphs 3.11 to 3.13.
[111] Directive 2009/140/EC of the European Parliament and of the Council of 25 November 2009 amending Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services, 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities, and 2002/20/EC on the authorisation of electronic communications networks and services.
[112] Article 16(6) of the revised Framework Directive.
[113] March 2011 Consultation, paragraphs 3.4 to 3.10.

3.164 In designing a price cap, incentives for dynamic efficiency must be considered alongside the benefits of allocative efficiency. Allocative efficiency is achieved when prices are aligned with underlying resource costs. Prices can diverge from costs over the life of a price cap if the costs of price-capped services deviate from the trajectory of prices or charges established by the RPI +/- X formula. However, in establishing price caps, regulatory authorities are able to ensure that allocative efficiency objectives are also met through the market review mechanism and periodic setting of new controls. Hence price caps, if set correctly, have built-in safeguards for both dynamic and allocative efficiency.

3.165 Whilst a four year duration has proved effective in providing a good balance between dynamic and allocative efficiency for other charge controls set by Ofcom, we considered that expiry in March 2014 is more appropriate for these controls for the reasons explained above.

3.166 In the November 2011 Consultation, we noted that we would, in effect, only be setting charges for the final two years of the three year control period,[114] with the charges in the first year covered by the voluntary commitment offered by BT. This shorter period will undoubtedly provide less scope for dynamic efficiency promotion as Openreach will have less time to adjust its behaviour in response to the charges set in this review. However, as discussed above (paragraphs 3.159-3.160) we do not consider it would be appropriate to extend the controls beyond the forward look period of the market reviews.

3.167 In the March 2011 Consultation, we also proposed that the new controls for LLU and WLR should start on the same date and both end on 31 March 2014.

3.168 In the 2009 WLR Statement, we explained that consistency in the setting of charge controls for LLU and WLR was important because these services share a high proportion of common costs, and both are inputs to common downstream markets.[115] We said that, whilst exact synchronisation was not a necessity, it could be an advantage going forward and, for this reason, we set the previous WLR charge control to end in March 2011 (in the 2009 WLR Statement) to enable synchronisation in the setting of the new charge controls.

3.169 In the March 2011 Consultation, we considered an alternative approach regarding the duration of the LLU and WLR charge controls, that is, to de-link the end point for the charge controls. We considered that this may be appropriate if the forward look for the WFAEL market were longer than that for WLA and there were advantages to setting a longer control for WLR than for LLU (e.g. if there were reasons to strengthen dynamic efficiency incentives in the WLR charge control relative to the LLU control). In the March 2011 Consultation, we explained that we did not consider there to be any such advantages and we believed that there were strong advantages to synchronising both the start and end points of the LLU and WLR charge controls to facilitate consistency.

3.170 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 3.1*: Do you agree with Ofcom's proposal to set synchronised charge controls for LLU and WLR?*

[114] November 2011 Consultation, paragraph 2.10.
[115] 2009 WLR charge control Statement and Consultation, paragraph 3.63.

***Question 3.2**: Do you agree with Ofcom's proposal to set charge controls for LLU and WLR to expire on 31 March 2014?*

March 2011 Consultation responses

3.171 Of the five stakeholders which responded to the March 2011 Consultation on the issue of the duration of the LLU / WLR charge controls, C&WW, EE, FCS, GC and Openreach broadly agreed with our proposals, both in terms of duration and consistency in the setting of WLR and LLU controls.[116]

3.172 EE told us that "[w]*e strongly agree that consistency in the setting of WLR and LLU charges is vital to create a level playing field between MPF and WLR+SMPF / SMPF based broadband providers (i.e. to comply with Ofcom's legal obligations not to favour one means of providing broadband services over another)*".[117]

3.173 Openreach said that it "*prefers market reviews, and the period covering charge controls, to be set for a longer period than three years to encourage stability and investment. This is because the well-known incentive effects of a ‗RPI-X' control are best realised by a longer charge control period.* [...] *Openreach accepts, however, that Ofcom's proposals for a three year duration is consistent with the EU Electronic Communications Framework. We therefore, somewhat reluctantly, agree that this control should expire on 31 March 2014. It is important that in future Ofcom's timeline should allow subsequent controls to run for at least three years"*. [118]

3.174 VM said that "[i]*n setting any control on the level of BT's charges, we consider that Ofcom should, as a principal objective, ensure an appropriate level of certainty and stability. This is important not just for BT as the regulated entity, but for its customers and competitors alike. The controls should therefore be unambiguous, absent of scope for alternative interpretation and their period of applicability should be definitive from the outset"*.[119]

3.175 C&WW noted that: "[it was] *very unfortunate that by the time that the charge controls are put in place that they will only run for a 2 ½ year period. Serious consideration needs to be given to finding a mechanism for managing market reviews and charge controls reviews to avoid the existence of time periods over which charge controls are not in place. We suggest that Ofcom investigates the ability for it to roll on the charge controls that it puts in place as an alternative to the controls ending and voluntary commitments from BT taking their place. Such an approach would incentivise BT in providing essential data at sufficient levels of detail and disincentivise BT against making late in the day accounting adjustments which delay the consultation process*".[120]

Our response and conclusions

3.176 We note the concerns expressed by stakeholders regarding certainty and stability in setting the duration of the LLU / WLR charge controls.

[116] Responses to questions 3.1 and 3.2 in the March 2011 Consultation: C&WW response, page 9; EE response, page 6; FCS response, pages 3 to 4; GC response, page 1; and Openreach response, paragraphs 299 to 304.
[117] EE response to the March 2011 Consultation, page 6, response to question 3.1.
[118] Openreach response to the March 2011 Consultation, paragraph 302 to 305.
[119] VM response to the March 2011 Consultation, page 3.
[120] C&WW response to the March 2011 Consultation, page 9, response to question 3.2.

3.177 In setting the LLU / WLR charge controls, we have adopted a number of principles which were aimed at addressing these concerns. We have sought to set out clear principles of asset valuation (the RAV calculation) and principles of charging consistency given technological change (the anchor product pricing approach). More broadly, we have demonstrated that we have a preference for consistency in approach, such as the use of CCA FAC, although we would note that any charge control decision has to be reviewed in context. Aside from these general comments on consistency, there is limited scope within these charge controls to offer stakeholders certainty beyond the expiration of the LLU / WLR charge controls in 2013/14. Our future approach will depend on the outcome of future market and charge controls reviews.

3.178 We are also satisfied that the SMP conditions setting charges for the final two years of the three year control period meets the requirements under Section 88 of the Act (see Section 8).

3.179 In the light of the comments received from stakeholders on the issue of duration and synchronisation of the charge controls our response to those comments and, in line with our proposals set out in the March 2011 Consultation, we have decided to synchronise charge controls for LLU and WLR and both the charge controls will expire on 31 March 2014.

Implementation of the controls at the start of the charge control period

March 2011 Consultation proposals[121]

3.180 In the March 2011 Consultation we explained that Condition FAA.6, established in the WLA 2010 Market Review, required that changes to charges for existing Network Access (including LLU services) must be notified with at least 90 days notice.[122] Likewise Condition AAAA6(a), established in the WFAEL 2010 Market Review, requires that changes to charges for the WLR rental service should be notified with at least 90 days notice (other WLR services are subject to a 28 day notification requirement).[123]

3.181 We explained in the March 2011 Consultation that because the new charge controls will not be in place until summer 2011 at the earliest, the first period of the controls will be considerably shorter than a full year and that as a 90 day notice period would eat further into this period, we had considered whether a shorter minimum notice period is appropriate for any charge changes made under the new controls before April 2012. We explained that our preference was to allow any charge changes made under the new controls prior to April 2012 to be made with a minimum 28 days notice.

3.182 We decided in the 2009 Openreach Financial Framework Statement, that in relation to LLU ancillary services, a period of 90 days notice was appropriate. In coming to this conclusion we recognised that the nature of the basket structure adopted for these services may not allow a CP to predict what an individual charge within the basket may be with any confidence. However, in this LLU charge control, we proposed to remove five of the largest volume services from the baskets and charge control these individually. Consequently, the services that we proposed should

[121] March 2011 Consultation, paragraphs 3.107 to 3.113.
[122] 2010 WLA Statement, paragraph 5.124.
[123] 2010 WFAEL Statement, paragraph 5.94.

remain in the basket are not used as frequently. We therefore considered that a 28 day notice period is proportionate for these services.

3.183 We also considered whether the controls for rental and other services proposed to be individually controlled should be set with reference to explicit charge ceilings rather than a controlling percentage in the first period of the new controls. Whilst this would be a departure from usual price cap compliance arrangements, we said it has the benefit of providing certainty, both for Openreach and its wholesale customers about the charges for key services in the first period of the controls.

3.184 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 3.16*: Do you agree with Ofcom's proposal that charge changes made under the new controls prior to April 2012 should be made with a minimum 28 days notice? Please give reasons for your answer.*

Question 3.17*: Do you agree with Ofcom's proposal that charge ceilings for key services should be set for the 1st period of the new controls – i.e. the period between the first day of the new controls and 31 March 2012? Please give reasons for your answer.*

March 2011 Consultation responses

3.185 In response to the March 2011 Consultation, Openreach agreed with our proposal to reduce the notification period for controls prior to April 2012 to 28 days. However, Openreach requested that the charge controls should only become *"effective 8 weeks after publication of Ofcom's final Statement to allow for internal governance to implement 100+ price changes*" (i.e. in the baskets) and that we should consider whether a 28 day price notification period would be appropriate for the Second Relevant Year of controls.[124]

3.186 Openreach also said that it was unclear as to the meaning of the wording in the draft legal instrument, "*amendments to charges made prior to 1 April 2012*". It did not know whether this referred to amendments announced prior to 1 April 2012 or amendments which become effective prior to 1 April 2012.[125]

3.187 C&WW, EE and GC broadly agreed with our proposal to reduce the notification period for controls prior to April 2012 to 28 days.[126]

3.188 Openreach, C&WW and EE were broadly supportive of our proposal to impose charge ceilings for key services for the First Relevant Year of the new controls.[127]

3.189 GC noted that:

> "*the charge changes for WLR and, particularly, LLU services are relatively quickly flowed through into retail offerings so we propose*

[124] Openreach response to the March 2011 Consultation, paragraph 364.
[125] Openreach response to the March 2011 Consultation, paragraph 364.
[126] Responses to question 3.16 in the March 2011 Consultation: C&WW response, page 20; EE response, page 14; and GC response, page 4.
[127] Responses to question 3.17 in the March 2011 Consultation: Openreach response, paragraph 365; C&WW response, page 21 and EE response, page 14.

that the solution is guided by analysis of what outcome will be better for the consumer". [128]

November 2011 Consultation

3.190 In the November 2011 Consultation, we noted that the new charge controls were now expected to apply for only two years (from the start of the 2012/13 year) rather than the slightly longer period envisaged in the March 2011 Consultation.

November 2011 Consultation responses

3.191 There were no specific comments about the implementation dates in response to the November 2011 Consultation.

Our response and conclusions

3.192 The unexpected delay in implementation means that there is a strong priority for prompt implementation of the charge controls. All stakeholders that responded on this issue appear to accept that 28 days was sufficient to implement the specific charge changes for the non basket services.

3.193 We have considered Openreach's concerns about the basket services but consider that they will have sufficient notice to implement changes quickly and, due to the structure of the baskets, also have the flexibility to ensure compliance even if Openreach does not introduce new charges, on the first day of the charge controls.

3.194 We also note that under the revised consultation framework with the European Commission, the revised charges have now been in the public domain since 6 February.

3.195 We further note the extended delay in setting revised charge controls and consider it is in the interest of all Stakeholders that there is a clear set of regulatory controls in place from the beginning of the financial year. We consider that given the effect pre-nofication of charges there is little risk of major distruption to business of a slight modification of the notification period to instituting the changes from the beginning of the financial year. Accordingly, we consider that it is appropriate to implement a slightly shorter notification period than the 28 days discussed in the consultation. We have decided, therefore that the new LLU/WLR controls should commence on 1 April 2012, with 23 days prior notification.

Transparency

3.196 In relation to the disclosure of the LLU / WLR charge control modelling[129] (undertaken as part of the development of our proposals) we provided stakeholders with an extensive description and explanation of the models[130] as well as disclosure[131] of the models themselves as part of the March 2011 Consultation. In

[128] GC response to the March 2011 Consultation, page 4, response to question 3.17.

[129] We undertook modelling to establish the capital base for the calculation of the charge controls (the "RAV Model"), forecast Openreach's operational costs over the period of the control (the "Cost Forecast model") and allocate these costs to products provided by Openreach (the "Cost Allocation model").

[130] See Section 7 (and supporting Annexes) of the March 2011 Consultation.

[131] In relation to the Cost Forecast and Cost Allocation models, we provided non-confidential versions which took account of confidentiality of the underlying data while enabling us to consult effectively.

providing this information, we engaged closely with Openreach on model disclosure, including testing Openreach's concerns on confidentiality.

3.197 Our approach to the disclosure of the models is outlined more fully in the March 2011 Consultation.[132]

3.198 It is our view that the non-confidential models made available, taken together with the description in the March 2011 Consultation, provided the level of transparency necessary to allow those consulted to give intelligent consideration and an intelligent response. It is our view that we have provided sufficient information to enable stakeholders to respond effectively to the consultation.

3.199 In addition to the disclosure provided in the March 2011 Consultation, we engaged with stakeholders. This included responding to stakeholder questions, providing further explanation and disclosure where possible (having regard to confidentiality).[133] Our responses to individual stakeholder queries were published on our website, in order to provide transparency and to ensure that all stakeholders were provided with the information and data. During this process we also held bi-lateral meetings with stakeholders when they were requested.

March 2011 Consultation responses

3.200 We received comments from stakeholders regarding the level of disclosure during the consultation process. In response to the March 2011 Consultation, TTG noted that while they considered that transparency had improved (compared to the [2009 LLU Determination]), the models provided were "*either highly redacted and non-functioning or populated with 'dummy' data*" and that "[s]*ome of the information that has been provided in the* [March 2011 Consultation] *and model is insufficiently granular and/or unclear/inconsistent and/or is not adequately explained*".[134] TTG also said that it had "*presented further questions to Ofcom and Ofcom has responded to many of these,* [but] *the answers provided are often not complete or clear and many questions remain unanswered*".[135] TTG also made further comments on the level of transparency in their further submission in October 2011 in which they noted the imbalance in information between BT and other Stakeholders and said "[t]*he question is what level of transparency is necessary for Ofcom to best meet its statutory obligations both procedurally and in terms of ensuring a high quality decision"*[136]*.*

3.201 Openreach, however, considered that "*that disclosure has been carried out in this consultation in a way which balances those interests*"[137] between the rights of a consultee, the regulated undertaking and the public interest in the protection of commercially sensitive and confidential information and went on to note that "*Openreach firmly believes that any application from stakeholders for further disclosure of information* [beyond that already provided in the March 2011 Consultation] *would be disproportionate, unnecessary and inappropriate*".[138]

3.202 We did not receive any stakeholder comments regarding transparency in response to the November 2011 Consultation.

[132] See Section 6 of the March 2011 Consultation.
[133] We received 246 questions from stakeholders during the consultation process.
[134] TTG response (July 2011) to the March 2011 Consultation, paragraph 41.
[135] TTG response (July 2011) to the March 2011 Consultation, paragraph 42.
[136] TTG response (October 2011) to the March 2011 Consultation, paragraphs 81 to 84.
[137] Openreach's response to the March 2011 Consultation, paragraphs 55 and 59.
[138] Openreach's response to the March 2011 Consultation, paragraph 60.

Our response and conclusions

3.203 In response to TTG's general comments, we consider that, having regard to the need to ensure appropriate transparency when set against the confidentiality of the underlying data, we provided stakeholders with sufficient information and data to allow those consulted to give intelligent comment and intelligent response. We also provided stakeholders with sufficient time to respond.

3.204 In response to TTG's specific concerns relating to the answers to the questions it raised, we would note that this process was naturally an iterative process, which often required further engagement with Openreach in order to respond to the questions. In answering such questions, where we considered that stakeholders had already been provided with sufficient information for the purposes of consultation, we considered that it would be disproportionate to expend significant time and resource on further investigation to fully answer each and every question. Overall, we consider that we provided sufficient responses to the questions necessary for stakeholders, including TTG, to provide meaningful consideration and responses to the consultation.

3.205 Overall, therefore, we consider that the LLU / WLR charge control and its aims and effects are transparent. We discussed our proposals in detail in both the March 2011 Consultation and the November 2011 Consultation, as well as in this Statement. We also published non-confidential versions of the financial models that we used to calculate the charge controls and provided further disclosure where possible (having regard to confidentiality) in order to respond to stakeholder queries. In addition, we held bi-lateral meetings with stakeholders where they were requested. Accordingly, we consider that we have provided stakeholders with an appropriate level of transparency and disclosure within the legal framework, including the test under section 47 of the Act, and this has allowed those consulted to give intelligent consideration and an intelligent response.

Section 4

LLU charge control structure

4.1 In this Section we set out our conclusions on the structure of the LLU charge controls and related ancillary services. In particular, we set out our conclusions with respect to:

- the nature of the charge control of LLU rentals;
- the treatment of ancillary services, including key migration services;
- the measures to prevent gaming of prices within baskets;
- the treatment of services on which issues have been raised by stakeholders during the LLU/WLR charge control review – low volume services, TRCs, SFIs, Electricity charges, LLU Expedite connections, and LLU Enhanced Care Services;
- the treatment of low volume services in the Co-Mingling basket; and
- the treatment of new services (which partially or fully replace regulation).

4.2 In this Section, we also discuss an issue raised by Openreach, in its response to the March 2011 Consultation, in relation to overlapping regulation of Co-Mingling services in the Leased Lines and LLU and WLR charge control reviews.[139]

4.3 For each of the above issues under consideration we set out below:

- a summary of our proposals as set out in the March 2011 Consultation and, where applicable, the November 2011 Consultation;
- a summary of the comments received from stakeholders on our proposals set out in the March 2011 Consultation and, where applicable, the November 2011 Consultation; and
- our response to those comments and our decision, in light of stakeholder comments, together with arguments in support of our conclusions.

Summary of our decisions

4.4 We have decided, in summary, to:

LLU rentals

- set separate charge controls for MPF rental and SMPF rental services, so that the charge for each will equal its respective CCA FAC by the end of the charge control (see paragraphs 4.5 to 4.15);

[139] See Appendix A of Openreach response to the November 2011 Consultation for complete list of services.

LLU ancillary key migration service design and structure

- set a charge control for MPF New Provide to bring the charge into line with its CCA FAC by the end of the charge control period (see paragraphs 4.16 to 4.24);

- align (i.e. set charges at the same level) MPF Single Migration[140] and SMPF Single Migration/Provide[141] services (see paragraphs 4.25 to 4.87);

- set MPF Cease and SMPF Cease charges at zero and to recover the service costs from their respective line rental charges. We have also decided to recover MPF Cease CCA FAC and SMPF Cease CCA FAC in equal proportions from the respective MPF and SMPF rentals (see paragraphs 4.88 to 4.119);

LLU ancillary baskets design and structure

- set a three basket structure for LLU ancillary services (i.e. MPF, SMPF and Co-Mingling) (see paragraphs 4.120 to 4.131);

- set basket specific controls (i.e. separate charge controls for each basket) (see paragraphs 4.132 to 4.137);

- set an inertia clause of 7.5% on each of the three LLU ancillary services baskets (MPF, SMPF and Co-Mingling) and use prior year weights as a basis for setting prices. We have also decided not to implement the exception to the basket inertia clause (as was proposed in the November 2011 Consultation)[142] (see paragraphs 4.138 to 4.184);

- set a sub-cap on MPF Stopped Line Provide at the level of the overall MPF basket control (see paragraphs 4.185 to 4.206);

- not set starting charges for the LLU Bulk Migration services[143] (see paragraphs (4.206 to 4.229);

- include the MPF and SMPF Expedite connection services in the MPF ancillary services basket in the SMPF ancillary services baskets, respectively (see paragraphs 4.230 to 4.239);

- keep MPF Expedite connection services and SMPF Expedite connection services unaligned (i.e. not to set the charges at the same level) and not to intervene to narrow the differential in charges for MPF and SMPF Expedite connection services (see paragraphs 4.240 to 4.260);

- make a one-off adjustment to reduce the starting charge for SMPF Singleton Jumper removal to its respective CCA FAC (2011/2012), and to reduce the SMPF Bulk Jumper Removal charge; and make a one-off adjustment to increase the starting charge for MPF Single Jumper Removal to its respective CCA FAC (2011/2012) and to increase the starting charge for MPF Bulk Jumper Removal (see paragraphs 4.261 to 4.291);

[140] We referred to this service as ‘MPF Transfer/Connection’ in the March 2011 Consultation.
[141] We referred to this service as ‘SMPF connection’ in the March 2011 Consultation.
[142] November 2011 Consultation, Section 2, paragraphs 2.121 to 2.129.
[143] SMPF Same Mass migration and MPF Bulk migration.

- not to align (i.e. not to set charges to the same level) the remaining services[144] within the MPF and SMPF ancillary services baskets (see paragraphs 4.292 to 4.317);

Other LLU issues

- determine that, where TRCs are reasonably necessary for the use of LLU services, TRCs should be subject to existing general remedies set out in the WLA 2010 Market Review (see paragraphs 4.322 to 4.342);

- determine that, where SFI2[145] services are reasonably necessary for the use of LLU services, SFI2 services should be subject to general remedies set out in the WLA 2010 Market Review. We will also maintain the current alignment of MPF and SMPF SFI2 service charges (i.e. to keep service charges equal) (see paragraphs 4.343 to 4.369);

- determine that electricity should remain outside the scope of the LLU charge control, but remain subject to general remedies set in the WLA 2010 Market Review, where reasonably necessary for the use of LLU services (see paragraphs 4.370 to 4.385);

- align LLU Enhanced Care services charges with WLR Enhanced Care services charges over the duration of the charge control period. In light of this we are removing the requirement under the general remedies imposed by the WLA 2010 Market Review for LLU Enhanced Care services to be cost orientated (see paragraphs 4.386 to 4.403);

- keep low volume products in the Co-Mingling ancillary services basket (see paragraphs 4.404 to 4.409 and

- provide guidance to industry regarding new services (i.e. a product or service wholly or substantially in substitution for that existing product or service that is included within the scope of the LLU / WLR charge control) introduced by Openreach during the period of the LLU / WLR charge control (see paragraphs 4.18 to 4.130).

LLU rentals

4.5 MPF rental and SMPF rental are regulated wholesale services sold by Openreach. MPF rental or SMPF rental allows CPs to physically take-over or share the copper access network connection (from end-user to the BT exchange building) and to provide data services (e.g. broadband) and voice services to retail customers. MPF rental allows a competing CP to provide the customer with data and voice services. SMPF rental only allows direct provision of data, with voice services being provided separately.

[144] Tie Pair Modification (3 working day lead time Re-termination); Tie Pair Modification (Multiple Re-termination); Bulk Jumper removal order charge; Order rejected at initial validation and Order rejected at detailed validation; Order returned for Amendment; Cancellation of orders for Migration, Modification or Amend; Amend Orders; Standard line test; and Network RWT.
[145] We note that the SFI services which were replaced by SFI2 no longer exist and are therefore not subject to any regulation.

4.6 In the 2010/11 RFS, Openreach reported revenues of £188 million for MPF rental and £62 million for SMPF rental. MPF rental and SMPF rentals are charge controlled separately.

March 2011 Consultation proposals

4.7 In the March 2011 Consultation,[146] we proposed to separately charge control each of MPF rental and SMPF rental, so that each charge will equal its CCA FAC by the end of the charge control period.

4.8 In particular, in the March 2011 Consultation, we proposed that the charges for MPF rental and SMPF rental should each be separately controlled to protect downstream markets and consumers from pricing distortions. This is consistent with the approach taken in the previous LLU charge control, and we considered that it would ensure that CPs and Openreach have maximum clarity of the prices of the rentals.[147]

4.9 In the March 2011 Consultation we asked Stakeholders the following question:

> ***Question 4.1****: Do you agree that we should set separate line rental charge controls for (i) MPF rental and (ii) SMPF rental?*

March 2011 Consultation responses

4.10 The vast majority of stakeholders supported our proposals set out in the March 2011 Consultation, to set separate charge controls for MPF rental and SMPF rental services.

4.11 GC, however, noted that "*until the cost stack information has been fully analysed, we are unable to give definitive views*".[148]

4.12 Openreach said that it's "*preference is to have broad baskets to give greater flexibility in setting prices to reflect market demand and so as to align prices with costs over the control period. However, if, as Ofcom propose, the MPF and SMPF line rental have separate charge controls then we believe that the corresponding Xs need to be set in such a way such that prices align with underlying costs over the period of the charge control".*[149]

Our response and conclusions

4.13 With respect to GC's comments, we note that the cost stacks were fully analysed in section 7 of the March 2011 Consultation. We set out our final modelling approach in Section 6 of this Statement.

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[146] March 2011 Consultation, Section 4, paragraphs 4.12 to 4.14.

[147] We have also decided to continue the current framework in which the basis of charges obligation (cost orientation) is dis-applied from the MPF rental charge as the charge ceiling imposed on MPF rental is not based on a forward looking long-run incremental cost approach, allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed, and therefore is not consistent with the relevant obligation (SMP Condition (FAA4.1)). A Direction to ensure continuation of this is included in Annex 9. Note that this Direction is included for completeness and avoidance of doubt as cost orientation is already dis-applied from MPF rental by virtue of Condition FAA4(A).2.

[148] GC response to the March 2011 Consultation, page 4.

[149] Openreach response to the March 2011 Consultation, Section 7, paragraphs 366 to 367.

4.14 In line with the March 2011 Consultation proposals, and taking into account stakeholder comments, we have decided that it is appropriate to set separate charge controls for MPF rental and SMPF rental, so that each charge will equal its CCA FAC by the end of the charge control period.

4.15 We set out our final RPI-X for LLU rentals in Section 6 of this Statement (Figure 6.21).

LLU key migration ancillary service design and structure

MPF New Provide

4.16 MPF New Provide is requested by a CP from Openreach when a CP's customer requires a new copper line to be installed into their home. MPF New Provide is currently subject to a separate charge control.

March 2011 Consultation proposals

4.17 In the March 2011 Consultation we proposed to set a set charge control for MPF New Provide. Specifically, we decided to set the charge on a glidepath and bring it into line with its CCA FAC by the end of the charge control period.[150]

4.18 We noted that the price of MPF New Provide is only slightly above the price of WLR New Provide, and that given there are "*slightly different underlying activities involved in delivering the services a small misalignment of prices may be justified*".[151]

4.19 In the March 2011 Consultation, we asked Stakeholders the following question:

> ***Question 4.10****: Do you agree that a charge control in the range RPI-9.9% - RPI-12.9% (base case RPI-11.4%) should be imposed on MPF new provide to bring the charge into line with CCA FAC by the end of the charge control period?*

March 2011 Consultation responses

4.20 The majority of stakeholders supported our proposals as set out in the March 2011 Consultation. However, GC asked that we make a one-off starting charge adjustment to MPF New Provide.[152] TTG also argued that we should align MPF New Provide and WLR New Provide, given the costs and activities are similar, and in order to prevent competitive distortions.[153]

Our response and conclusions

4.21 We have considered the arguments raised by TTG and agree that service charges should be aligned (i.e. set charges at the same level) where the services have similar underlying costs. However, we do not consider that the underlying costs or activities for WLR New Provide and MPF New Provide services are sufficiently similar to align charges. In particular, jumpering activity costs (i.e. the cost of adding jumpers to the MDF) are higher for MPF, as MPF involves more jumpering activity on the main distribution frame than WLR. Nor do we consider that TTG has identified a competitive distortion that would justify departing from this approach.

[150] March 2011 Consultation, paragraph 4.105.
[151] March 2011 Consultation, paragraph 4.104.
[152] GC response to the March 2011 Consultation, page 6.
[153] TTG response (July 2011) to the March 2011 Consultation, paragraphs 445 to 446.

4.22 With respect to the comments received from GC, we would note that since the March 2011 Consultation, the charge for MPF New Provide has reduced to £52.79.[154] The differential between this charge and MPF New Provide's CCA FAC is not significant and as such we do not consider that a one-off adjustment to the starting charge is necessary.

4.23 In line with the proposal set out in our March 2011 Consultation and taking into account stakeholder comments, we have decided that MPF New Provide should be charge controlled and set on a glide path to bring the charge into line with CCA FAC by the end of the charge control period.

4.24 Specifically, we have decided to set MPF New Provide on indexation of RPI-14.2 to enable charges to glide to 2013/14 CCA FAC (£45.43) by the end of the charge control period. The charge control for MPF New Provide for 2012/13 is £51.16.

MPF Single Migration, SMPF Single Migration/Provide

4.25 CPs can buy the MPF Single Migration[155] or the SMPF Single Migration/Provide[156] product where an end user, with an existing Openreach copper line, wants to switch its broadband service to that CP or start a broadband service with that CP.

4.26 More specifically, a CP can use MPF Single Migration to switch to MPF (which supports voice and broadband):[157]

- o from WLR (which supports telephone only); or
- o from MPF, (which supports voice and broadband); or
- o from WLR and SMPF (which supports voice and broadband).

4.27 A CP can use SMPF Single Migration to switch to, or use SMPF Provide to start, an SMPF product (which supports broadband only):

- o with WLR (which supports telephone only); or
- o from MPF (which supports broadband and telephone) or from SMPF (which supports broadband only).[158]

4.28 MPF Single Migration and SMPF Single Migration/Provide are currently subject to separate charge controls.

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[154] http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=totid5BwFmkf9vLcBITRyZF9loRxWIbIKK6V7YWmlYAlMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AIlSgtIFAKw%3D%3D as at 30/01/12.

[155] We referred to this service as 'MPF transfer/connection' in the March 2011 Consultation. In the November 2011 Consultation we described this same service as MPF Single Migration to provide clarity.

[156] We referred to this service as 'SMPF connection' in the March 2011 Consultation. In the November 2011 Consultation we described this same service as MPF Single Migration to provide clarity.

[157] The product name in Openreach's pricing list for MPF Single Migration is 'MPF Connection charge - Singleton migrations ('Transfer from WLR/SMPF' (i.e. from WLR or SMPF) or 'Change of CP migrations' (i.e. from MPF)).

[158] The product names in Openreach's pricing list for SMPF Single Migration/Provide in Openreach's pricing list are Basic Provide on existing WLR, Simultaneous Provide of SMPF with WLR, Singleton Migration (Transfer or change of CP migrations) from WLR, MPF and SMPF.

4.29 These migration services have a direct impact on the cost of acquiring a customer for a CP, and their relative charge size affects the level of competition between CPs using MPF and those using WLR+SMPF.

4.30 The impact of any difference in the migration charge on competition between CPs using different access products is complex, because of the different switching costs and processes with respect to switching from MPF provision to SMPF+WLR provision as compared to switching from SMPF+WLR provision to MPF provision.

4.31 More specifically, while a CP who provides telephone and broadband services using MPF Single Migration product will only pay one migration charge (April 2011 charges are £39.79 under MPF Single Migration), a CP who provides telephone and broadband services using *both* SMPF Single Migration/Provide product and MPF to WLR Transfer product, migrating a customer from an MPF provider, will pay two charges (at roughly twice the MPF cost, i.e. April 2011 charges are £39.79 under SMPF Single Migration/Provide + £34.86 under MPF to WLR Transfer[159]). This situation may change in the future as we understand Openreach is considering a recent SoR for a combined migration product (we discuss this further in paragraph 4.62 below).

4.32 Given the different effects of the MPF Single Migration and SMPF Single Migration/Provide charges on competition for MPF to SMPF+WLR and vice versa, it does not follow that we must necessarily align these charges for competitive neutrality. However, given that there is the risk of a distortion of competition if the charges are not appropriate we need to consider the economic basis for any charge differential.

March 2011 Consultation proposals

4.33 In the March 2011 Consultation[160] we considered whether the charges for MPF Single Migration and SMPF Single Migration/Provide should be aligned (i.e. set at the same level) on the basis that they have similar underlying costs. Specifically, we proposed to maintain alignment of the charges for MPF Single Migration and SMPF Single Migration/Provide during the period of the charge control and to bring the charges for these services to a weighted average of the forecast CCA FAC 2013/14 cost for MPF Single Migrations and SMPF Single Migration/Provide.

4.34 In the March 2011 Consultation, we set out the following information, Figure 4.1, (reproduced from figure 4.8 in the March 2011 Consultation):

Figure 4.1: Charges and FAC costs of connection charges

Service	Current charge	2010/11 FAC costs	2013/14 FAC costs
MPF transfer/connection	£38.64	£37.14	£37.03
SMPF Connection (New Provide and Single Migration)	£38.64	£30.58	£30.24
Weighted average			£32.35

4.35 In the March 2011 Consultation, we asked stakeholders the following question:

[159] We discuss our approach to this service in Section 5 of this Statement.
[160] March 2011 Consultation, paragraphs 4.103 to 4.107.

***Question 4.11**: Do you agree that charge controls in the range RPI-7.7% - RPI-10.7% (base case RPI-9.2%) should be imposed on MPF transfer and SMPF connection to bring the charges into line with CCA FAC by the end of the charge control period?*

March 2011 Consultation responses

4.36 There was a mixed response to the March 2011 Consultation proposals.

4.37 C&WW[161] agreed with our proposals.

4.38 TTG agreed that MPF Single Migration and SMPF Single Migration should be aligned.[162] TTG said that the "*the activities for each are broadly similar* [….and] *though the activities / costs are slightly different these differences are either unexplained (and so are not credible) or inefficient (and so are not relevant)*".[163]

4.39 TTG also argued that "*the* [MPF Single Migration and SMPF Single Migration/Provide] *charges are currently aligned (and have been for several years) and so currently charges and costs are inconsistent* […and] [a]*lignment will create better efficiency incentives for BT and reduce the advantage it games from its abusive behaviour".*[164]

4.40 GC noted "*that significant changes are required either at the outset or during the charge control period to bring the prices into line with costs*".[165]

4.41 Both Openreach and EE disagreed with the proposal to align MPF Single Migration and SMPF Single Migration/Provide during the charge control period.

4.42 Openreach noted "*that while the underlying activities are similar the proposals would result in MPF Single Migration and SMPF Single Migration (but not SMPF Provide)* [being priced below their individual 2013/14 CCA FACs]*".*[166] Openreach also noted that the proposals would negatively affect its pricing hierarchy for other LLU ancillary services, thereby distorting its ability to make efficient use of its resources and preventing it from recovering efficiently incurred costs for certain other basket services.[167]

4.43 EE was concerned that our proposals could distort CPs incentives to invest in MPF Single Migrations in a way which is not justified by the underlying costs; and "*that this competitive distortion would be exacerbated by the gross asymmetry in much higher non-price controlled MPF to WLR and SMPF conversion charges as compared to the regulated Openreach WLR and SMPF conversion charges*".[168] EE argued that our

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[161] C&WW response to the March 2011 Consultation, page 24.
[162] TTG response (July 2011) to the March 2011 Consultation, paragraph 441.
[163] TTG response (July 2011) to the March 2011 Consultation, paragraph 438.
[164] TTG response (October 2011) to the March 2011 Consultation, paragraph 49.
[165] GC response to the March 2011 Consultation, page 6.
[166] Openreach response to the March 2011, paragraphs 2.45 to 2.48.
[167] Specifically, MPF and SMPF same CP Mass migration, MPF and SMPF Tie Pair Modification (3 day re-termination), MPF and SMPF Tie Pair Modification (Multiple re-termination), MPF WLTO and MPF Stopped Line Provide.

[168] EE response to the March 2011 Consultation, page 19.

analysis set out in the March 2011 Consultation contradicted one of our key reasons for alignment i.e. that the underlying costs of the services are similar.[169]

November 2011 Consultation proposals

4.44 We reviewed the arguments presented by stakeholders to the March 2011 Consultation and felt that it was appropriate to give stakeholders the opportunity to comment again on our proposals in light of additional information on the underlying costs of providing these services that had become available.

4.45 In the November 2011 Consultation[170] we proposed to retain our March 2011 Consultation proposal to align MPF Single Migration[171] and SMPF Single Migration/Provide[172] services (Option 1 in the November 2011 Consultation), and set out why we still considered it appropriate to do so.

4.46 In particular, we explained that *"that competition benefits are more likely to be realised where services reflect their underlying costs of provision (i.e. their LRICs). Where there is a differential in the charges, this should be broadly reflective of the LRIC differentials, as this ensures that the price differential does not lead to a distortion of consumer choice between services".*[173]

4.47 We explained that while we did not have precise LRICs, it would be useful to assess what activities are required to provide the services and then check the CCA FACs against these activities.

4.48 Accordingly, we explained that Jumpering activity and SMC activities are the main underlying cost drivers for MPF Single Migration and SMPF Single Migration Provide variants. We went on to say that we consider the underlying costs associated with Jumpering activity and SMC activity should be broadly similar across the variants, based on the activity required to provide the variants.

4.49 However, we noted that the CCA FAC cost information indicated a very small differential in incremental costs between MPF Single Migration and SMPF Single Migration/Provide.

4.50 With respect to Jumpering activity costs (by far the main incremental cost driver), we noted that the differences in average incremental costs (from the CCA FAC costs) are likely to reflect differences in the existing configuration of how copper lines are connected before migration (i.e. whether it is MPF, WLR and/or SMPF that is being migrated from). We also explained that "*the different average starting configurations in the future will depend on the extent to which there is a level playing field in competition between SMPF and MPF – i.e. are they competing for the same set of customers. This is turn will be influenced by the charges set for migration. This would suggest that we need to be cautious in setting charges as this has the potential to influence such differences*".[174]

[169] EE response to the March 2011 Consultation, pages 17,18 and 19.
[170] November 2011 Consultation, paragraphs 2.42 to 2.56.
[171] We referred to this service as 'MPF Transfer' in the March 2011 Consultation.
[172] We referred to this service as 'SMPF connection' in the March 2011 Consultation.
[173] November 2011 Consultation, paragraph 2.43.
[174] November 2011 Consultation, paragraph 2.49.

4.51 We went on to say that it is not clear that we would be confident that these incremental cost differences represent an "*enduring* LRIC *differential*" and these may be "*subject to variation over time*".[175]

4.52 On the basis that the incremental cost differential is very small and variable (according to CCA FAC information) we preferred to maintain our March 2011 Consultation proposal to align the charges for these services during the charge control period ('Option 1' in the November 2011 Consultation). We noted that any negative impact on competition from this approach would be negligible.

4.53 However, we accepted that that there was some evidence for a very marginal difference in LRICs between MPF and SMPF variants (based on the CCA FAC information), and so considered an alternative option of not aligning these charges, but instead allow these charges to move to their respective CCA FACs levels by 2013/14 ('Option 2' in the November 2011 Consultation).

4.54 We also considered the risk of wider unintended consequences to Openreach's pricing structure as a result of our alignment proposals ('Option 1' in the November 2011 Consultation) is likely to be extremely low.

4.55 In the November 2011 Consultation, we set out the following information, Figure 4.2 and 4.3 for Option 1 and Option 2:

Figure 4.2: November 2011 Consultation Option 1 (reproduced from Figure 2.7 in the November 2011 Consultation)

Service	Starting Charge 1 April 2012	2013/14 FAC costs
MPF Single Migration	£36.40	£35.24
SMPF Single Migration/provide	£36.40	£28.97
Volume weighted average 2013/14 CCA FAC of MPF Single Migration and SMPF Single Migration/provide		**£30.92**

Figure 4.3: November Consultation 2011 Option 2 (reproduced from Figure 2.8 in the November 2011 Consultation)

Service	Starting Charge 1 April 2012	2013/14 FAC costs
MPF Single Migration	£37.80	£35.24
SMPF Single Migration/provide	£35.60	£28.97

4.56 We asked stakeholders the following question in the November 2011 Consultation:

***Question 2.3**: Do you agree that Option 1 is a more effective remedy than Option 2 - if not please explain why - in particular, we welcome evidence on why you alignment would significantly negatively impact on competitive conditions.*

[175] We also noted SMC incremental costs are likely to be variable over time.

November 2011 Consultation responses

4.57 C&WW supported our preferred Option 1.[176]

4.58 Sky agreed with our preferred Option 1, on the basis that "*the costs of these activities are similar; the incremental costs relating to the SMC function (where some cost differentials arise) are very low; there is a lack of clear explanation as to the drivers to the outstanding cost differentials"*.[177]

4.59 Sky also argued that "*it is possible that the efficient costs for the provision of the MPF Single Migration service would be lower (both on the basis of Single Jumpering and a more appropriate allocation of some costs)"*.[178]

4.60 Like Sky, TTG also broadly supported Option 1, arguing there may be a case for the MPF Single Migration charge to be lower than the SMPF Single Migration charge.[179] In doing so, TTG argued that *"to the degree to which the jumpering cost difference results from different starting configurations* today*, as Ofcom points out, these are likely to diminish over time;* [that the MPF and SMPF Migration] *cost difference should be based on the use of single jumpering for MPF since this is the efficient approach to jumpering and so represents the efficient forward looking cost*".[180] TTG also noted that the SMC costs for MPF Single Migration and SMPF Single Migration/Provide should be same in the long run, but the difference today is likely to reflect the *"youth of MPF"* and BT gaming of cost allocations.[181]

4.61 Openreach "*disagree*[d] *that Option 1 is a more effective remedy than Option 2*" arguing (as in its response to the March 2011 Consultation) that it would have a negative impact on Openreach's MPF and SMPF product portfolio and would "*unfairly distort competition in favour of MPF providers relative to WLR and/or SMPF providers*".[182]

4.62 More specifically, Openreach argued that Option 1 is *"counter to industry requirements and anti-competitive"* because stakeholders want (on the basis of the recent SoR submitted to Openreach, see paragraph 4.31 above) further alignment of migration charges to and from MPF and WLR+SMPF, and that Option 1 would not reduce the differential between what a CP pays when migrating customers from WLR + SMPF to MPF versus that of MPF to WLR+SMPF (whereas Option 2 would reduce the differential by £6.27).[183]

4.63 Openreach also argued that setting MPF Single Migration below its CCA FAC, under Option 1, would force it to reduce the prices of the following products in its portfolio:

- MPF Tie Pair Modification and MPF Tie Pair Modification (Multiple Re-termination) as these have activities which are similar to MPF Single Migration and CPs may view "*these* [MPF Tie pair modifications and MPF Single Migrations] *as substitutional*";[184] and

[176] C&WW response to November 2011 Consultation, page 7.
[177] Sky response to the November 2011 Consultation, paragraph 24.
[178] Sky response to the November 2011 Consultation, paragraph 24.
[179] TTG response to the November 2011 Consultation, paragraph 24.
[180] TTG response to the November 2011 Consultation, paragraph 23.
[181] TTG response to the November 2011 Consultation, paragraph 23.
[182] Openreach response to the November 2011 Consultation, Section 4.12, paragraphs 34.
[183] Openreach response to the November 2011 Consultation, Section 4.12, paragraphs 34 to 36.
[184] Openreach response to the November 2011 Consultation, Section 4.11, paragraph 32.

- MPF Stopped Line Provide and WLTO - to ensure "that CPs are not incentivised to instead purchase a WLR Transfer/WLR Start of Stopped line (£3.09) plus the MPF Transfer in a homemover scenario, which leads to end-users experiencing more inconvenience than if the more efficient products were chosen".[185]

4.64 Openreach also noted that MPF WLTO and MPF Single Migration are substitutes "under a home-mover scenario" and argued that reducing the price "of MPF Transfer [i.e. MPF Single Migration] below FAC will therefore incentivise CPs to avoid WLTO, causing consumer harm".[186]

4.65 Finally, Openreach argued that Option 1 could "*stimulate extra and inefficient demand resulting in an under-recovery of costs by Openreach*" given that volume forecasts may be inaccurate.[187]

4.66 Similarly, EE was concerned that Option 1 would further distort competition between MPF and WLR+SMPF migrations (in favour of MPF users). Of the two options we proposed in the November 2011 Consultation, EE preferred Option 2, but noted that Option 2 would still not create a level playing field between MPF and SMPF users. Instead EE suggested that we set the MPF Single Migration and SMPF Single Migration/Provide charges "*to reflect Ofcom's best estimate of the relevant LRIC differential in SMC and Jumpering activity costs*".[188]

4.67 With respect to jumpering activity costs EE said "*we note Ofcom's concerns regarding the fact that these costs may change over time as a result of the changing mix of services in the market (§§2.48-2.49). However, it is a fallacy for Ofcom to think that it can avoid creating competitive distortions by not taking account of these differences in its regulated charge controls. Prima facie, it has an equally distortive effect on investment incentives and competition for Ofcom to ignore these LRIC differentials where they are present than for Ofcom to take them into account in a situation where they may not otherwise endure over time*".[189]

Our response

4.68 We set out our response to stakeholder concerns below.

Impact on competition between MPF and SMPF+WLR

4.69 We note Openreach's and EE's concern that our preferred Option 1 would further distort competition in favour of MPF users as compared to WLR+SMPF users. We understand that this is related to a broader concern with respect to the relative competitive position of providers of voice and broadband who use WLR+SMPF as compared to those who use MPF. More specifically, EE and Openreach have suggested changes that would lead to a closer alignment of the costs of migration of from WLR+SMPF with those of migration from MPF to WLR+SMPF.

4.70 As set out in Section 5 of this Statement,[190] we recognise this broader concern. We consider that there is scope to simplify the charge and processes for the MPF to

[185] Openreach response to the November 2011 Consultation, Section 4.11, paragraph 32.
[186] Openreach response to the November 2011 Consultation, Section 4.11, paragraph 32.
[187] Openreach response to the November 2011 Consultation, Section 4.11, paragraphs 30 to 33.
[188] EE response to the November 2011 Consultation, Section 4.1, response to question 2.3.
[189] EE response to the November 2011 Consultation, Section 4.1, response to question 2.3.
[190] See Section 5, paragraphs 5.77 to 5.81.

WLR (+SMPF) conversion, and note that BT Retail has presented an SoR to Openreach that will help address the concern.

4.71 However, with respect to our approach to MPF Single Migration and SMPF Single/Migration in this LLU charge control, we maintain our position that consumer interests will be better served by implementing Option 1 (i.e. maintaining an alignment of MPF Single Migration charges), and do not consider that our preferred option will materially exacerbate the competitive position between MPF and WLR+SMPF users. We discuss our reasons why further in paragraphs 4.72 to 4.76 below.

4.72 We note Openreach's comment that Option 2 (i.e. setting separate charges for MPF and SMPF Single Migration/Provide) would reduce the cost differential between MPF and WLR + SMPF migrations (whereas Option 1 would not reduce it). While this may be the case, we do not consider this would be in the interests of consumers, as this cost differential under Option 2 would not be broadly reflective of the LRIC differences between MPF and SMPF Single Migration/Provide. As discussed in the November 2011 Consultation, we consider that where there is a differential in the charges, this should be broadly reflective of the LRIC differentials, as this ensures that the price differential does not lead to a distortion of consumer choice between services.[191]

4.73 We also note EE's arguments that we should set the MPF Single Migration and SMPF Single Migration/Provide charges "*to reflect* Ofcom's *best estimate of the relevant LRIC differential in* [SMC and Jumpering activity] *costs*".[192] However, we do not consider that this approach is necessary.

4.74 We feel that the benefits of EE's suggested approach are unlikely to be realised, and also that the costs to competition could be greater under this approach, than under our preferred approach. We discuss our reasons why further in paragraphs 4.75 to 4.76 below.

4.75 As discussed in the November 2011 Consultation,[193] the LRIC differential between the MPF Single Migration and SMPF Migration/provide is likely to be very marginal in any case, and so any potential cost to competition from our preferred approach is likely to be minor.

4.76 Further, as noted in the November 2011 Consultation, the LRIC differential is likely be subject to variability throughout the charge control period, given that the differences in LRIC are mostly sensitive to changes in the average starting conditions before jumpering activity occurs (the jumpering activity is in turn affected by the type and level of competition between MPF and SMPF users).[194]

Risk of unintended consequences

4.77 We note Openreach's comments that our preferred Option 1 may have a negative impact on the pricing and cost-recovery of its broader portfolio of products. However, as discussed in the November 2011 Consultation,[195] we consider that these risks are negligible. We take each point in turn.

[191] November 2011 Consultation, Section 4, paragraph 2.43.
[192] EE response to the November 2011 Consultation, page 9.
[193] November 2011 Consultation, Section 4, paragraphs 2.47 to 2.51.
[194] November 2011 Consultation, Section 4, paragraphs 2.48 to 2.50.
[195] November 2011 Consultation, Section 4, paragraphs 2.52 to 2.53.

LLU Tie Pair Modifications

4.78 With respect to SMPF and MPF Tie Pair Modifications (single and multiple), we recognise that that these services may share broadly similar activities to MPF Single Migration (given they require similar jumpering etc.), and so the LRICs may be broadly similar as such. However, we disagree that MPF Tie Pair Modifications are substitutes for MPF Single Migration and SMPF Single Migrations. This is because MPF Tie Pair Modifications are used to re-jumper lines at the exchange to new equipment (e.g. 20CN to 21CN equipment). We have received no evidence that suggests otherwise.

MPF Stopped Line Provide/ MPF WLTO

4.79 We also do not accept that the charge for MPF Stopped Line Provide and MPF WLTO would have to be reduced, as a result of our preferred option (i.e. which lowers the price of MPF Single Migration), in order to incentivise CPs to not use inefficient processes and/or incentivise CPs to use these products, where a consumer moves home and sets up a broadband and voice service (i.e. a "home mover scenario").

4.80 This is because MPF Single Migration has different features which are designed to achieve different objectives, compared to MPF Stopped Line Provide and MPF WLTO. We also note that we have not received evidence of any material switching between MPF Single Migration and MPF Stopped Line Provide/WLTO products, over the last two years where the price of MPF Single Migration charge has been 15% to 17% lower than MPF Stopped Line Provide/WLTO.[196] We discuss our reasoning further in paragraphs 4.81 to 4.83 below.

4.81 CPs are not incentivised to use MPF Single Migrations for a home-move. This is because MPF Single Migration orders cater for customers switching CPs where there is no change of address and also incorporates a 10-day cooling-off period for consumer protection purposes.

4.82 By way of contrast, MPF WLTO and MPF Stopped Line Provide processes are appropriate for a home move. For instance, these services do not incorporate this 'cooling off period' (for example, the WLTO process is designed such that the incumbent CP at the target address may take control of the cease date to line up with the date that their consumer is moving out).

4.83 We also note that MPF Single Migration has always been priced below MPF WLTO and MPF Stopped Line Provide. However, since the inception of MPF Stopped Line Provide (in 2007) and MPF WLTO (In 2010) we have not received evidence that MPF Single Migration has been used as a substitute for MPF WLTO and/or MPF Stopped Line Provide, under a consumer home move scenario, despite a lower price.

Volumes

4.84 With respect to Openreach's comment regarding volatile volume forecasts, we accept that while volume forecasts can volatile and be subject to uncertainty, we

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[196] Openreach pricing list http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=totid5BwFmkf9vLcBITRyZF9loRxWIbIKK6V7YWmlYAlMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AIlSgtIFAKw%3D%3D as at 30 January 2011.

consider our volume forecasts are robust and that the risk of over- or under-recovery is low.

4.85 On the basis of the analysis set out above, we therefore see little reasoning or evidence to suggest that the unintended consequences noted by Openreach would occur as a result of implementing Option 1.

Our conclusions

4.86 Having considered stakeholder comments in response to the March 2011 Consultation and November 2011 Consultation, and for the reasons set out above, we have decided to implement Option 1, that is, to set aligned starting prices to glide to a volume weighted average of the 2013/14 CCA FAC for each of the MPF Single Migration and SMPF Single Migration/Provide.

4.87 We have decided that the aligned charge control should be set at an indexation of RPI-11.3. On this basis our first year aligned charges for 2012/13 are £33.54. We expect prices to glide to £30.67 by the end of the charge control.

Figure 4.4: MPF Single Migration/SMPF Single Migration/Provide charges

	Ofcom charges	
Service	**2012/13**	**2013/14 FAC costs**
MPF Single Migration	£33.54	£30.67
SMPF Single Migration/Provide	£33.54	£30.67

MPF Cease and SMPF Cease charges

4.88 MPF Cease and SMPF Cease charges[197] are charges for record keeping services which may[198] be incurred when a CP terminates an LLU service. In the March 2011 Consultation we noted that the vast majority (approximately 80%) of LLU termination services are MPF Cease or SMPF Cease, while the remainder are Jumper Removal (which involve both a record change and engineering activity).[199]

4.89 MPF Cease and SMPF Cease services are currently subject to separate charge controls.

4.90 Similar to LLU Migration charges (i.e. MPF Single Migration and SMPF Single Migration/Provide) LLU Cease (i.e. MPF Cease or SMPF Cease) charges can have a direct impact on competition for customers. The imposition of an LLU Cease charge at the retail level can influence consumers' appetite to switch providers. While such Cease charges are rare, more commonly, retail CPs impose ETCs which can include any costs incurred by the CP in terminating the service (i.e. including the corresponding LLU Cease charge).

[197] These can also be known as 'Flexi Cease' services.
[198] These may be incurred where an end user terminates its service early (i.e. before the expiry of the contract period during which early termination charges may apply) and are often charged when a consumer takes an LLU New Provide.
[199] March 2011 Consultation, paragraph 4.108.

4.91 We are concerned that high ETCs have an impact on competition and consumer switching. Accordingly, unless it is economically inefficient to do so, we have a preference for LLU retail charges that do not include LLU Cease costs.

March 2011 Consultation proposals

4.92 In the March 2011 Consultation we explained our proposal to set both MPF Cease and SMPF Cease charges to zero, recovering the respective MPF and SMPF Cease CCA FACs proportionately from the respective MPF and SMPF rental services.[200]

4.93 We considered that the marginal or incremental costs involved in ceasing an LLU service were likely to be very low and close to zero, and not substantially different between services. In particular we noted that there were doubts about the CCA FAC data available as it forecast substantially different costs for the MPF and SMPF variants of the same service. This seems unlikely to reflect the true underlying costs of the service because, as explained above, it is essentially the same activity for MPF and SMPF and that the LLU Cease services are provided using a data only change, and so we consider it likely that the incremental cost of the activity is likely to be close to zero.

4.94 We also considered that MPF and SMPF Cease CCA FACs should be set to zero, and recovered from the MPF and SMPF rental services, respectively, given our policy preference to minimise termination charges (such as LLU Cease services) to mitigate the risk that CPs will levy them in retail markets to raise barriers to switching.

4.95 In the March 2011 Consultation, we presented the following information regarding LLU Cease services.

Figure 4.5: March 2011 Consultation LLU Cease information (reproduced from Figure 4.9 in the March 2011 Consultation)

Service	Current charge	2013/14 forecast volumes	2013/14 CCA FAC costs
MPF Cease	£5.22	810,000	£4.22
SMPF Cease	£5.22	1,120,000	£2.28
Weighted average			**£3.09**

4.96 In the March 2011 Consultation, we asked stakeholders the following question:

***Question 4.12**: Do you agree that the charge for MPF and SMPF cease should be zero and costs recovered from rental charges?*

March 2011 Consultation responses

4.97 C&WW,[201] GC,[202] and Openreach[203] agreed with our proposal to set LLU Cease charges (i.e. MPF Cease and SMPF Cease) to zero and to recover the CCA FACs proportionately from MPF rental and SMPF rental services respectively. C&WW also

[200] March 2011 Consultation, paragraphs 4.11 to 4.14.
[201] C&WW response to the March 2011 Consultation, page 24.
[202] GC response to the March 2011 Consultation, page 6.
[203] Openreach response to the March 2011 Consultation, paragraph 398.

queried the amount of the CCA FAC differential between MPF Cease and SMPF Cease services that should be recovered from the MPF rental and SMPF rental services, "*in light of the difference in action being only the removal of an additional tie cable*".[204]

4.98 TTG agreed that we should set MPF and SMPF Cease charges to zero and recover the CCA FACs from MPF rental and SMPF rental services respectively, but only in circumstances where DLRIC is very low. TTG said that MPF Cease and SMPF Cease CCA FAC costs should be recovered in equal proportions from the MPF rental and SMPF rental services, respectively.[205]

4.99 EE argued that until we have *"reliable cost information*" from BT, our proposed approach is not justifiable, and asked that we re-consult once we have such information.[206]

November 2011 Consultation proposals

4.100 In the November 2011 Consultation, we made reference to stakeholder comments about the underlying costs and cost information and, in light of those comments, we explained that, having undertaken a detailed review[207] we nevertheless proposed to retain our March 2011 Consultation proposal to set the MPF Cease and SMPF Cease charges to zero and recover the CCA FACs proportionately from the respective MPF and SMPF rentals.

4.101 In doing so, we demonstrated that the marginal costs for MPF Cease and SMPF Cease services (which relate to SMCs) are likely to be very small per se, and that the marginal cost differential between MPF Cease and SMPF Cease services is also likely to be very small.[208] We also argued again that there were important competition reasons underpinning our proposal.[209]

4.102 However, in undertaking the further review, we revised the March 2011 Consultation proposal in relation to the recovery of the MPF Cease and SMPF Cease CCA FACs from MPF and SMPF rentals, respectively.

4.103 In the November 2011 Consultation, we said that we preferred to recover the respective CCA FACs associated with each of the MPF Cease and SMPF Cease services equally from their respective MPF and SMPF rental services, during the period of the charge control. This is because we considered that the marginal cost differential between MPF Cease and SMPF Cease is likely to be very low. We also explained that the remainder of the CCA FAC for MPF Cease and SMPF Cease services largely comprise of fixed and common costs and these are large relative to the marginal costs.[210]

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[204] C&WW response to the March 2011 Consultation, page 24.
[205] TTG response (July 2011) to the March 2011 Consultation, paragraphs 458 to 465.
[206] EE response to the March 2011 Consultation, page 19.
[207] November 2011 Consultation, paragraphs 270 to 283.
[208] We noted in the November 2011 Consultation that only a minority (below a third) of the SMC CCA FAC costs for LLU Cease services are likely to be true marginal cost related directly to provision of the services. The CCA FAC differential is much larger than the marginal cost differential (which is approximately under £1), between the MPF and SMPF Cease variants, because the MPF and SMPF Cease CCA FAC cost stacks largely comprise of fixed and common costs, and these are large relative to the marginal costs (see paragraph 2.72).
[209] November 2011 Consultation, paragraphs 274 to 277.
[210] November 2011 Consultation, paragraphs 2.72 to 2.78.

4.104 However, we also consulted on our original proposal in the March 2011 Consultation to recover the respective MPF Cease and SMPF Cease CCA FACs proportionately from the respective MPF and SMPF rentals over the charge control period.

4.105 In the November 2011 Consultation, we asked stakeholders the following questions:

Question 2.4*: Do you agree that the charge for MPF and SMPF Cease should be set to zero and CCA FAC costs recovered from rental charges? If not please, please set out your reasoning.*

Question 2.5: *Do you agree that we should recover the CCA FAC Cease costs equally from the MPF and WLR rentals, or do you consider that we should retain the March 2011 Consultation proposal to recover LLU Cease CCA FAC proportionately from the line rentals. Please set out your reasons for your preference.*

November 2011 Consultation responses

4.106 TTG agreed with our proposals to set the MPF Cease and SMPF Cease CCA FAC costs to zero and recover these from the MPF and SMPF rentals respectively, given that we had estimated that LRIC costs differential between the MPF and SMPF Cease services to be for "*low – about £1 according to Ofcom*".[211] TTG also said that "[r]*egarding the amount of the cost to be recovered we believe that the cost for each of MPF cease and SMPF cease should be the same*".[212] Separately, TTG expressed a concern that there is no WLR Cease service.[213]

4.107 Sky noted that "[s]*hould cease costs be recovered from rental prices then it would be appropriate to adopt Ofcom's latest proposal and recover the CCA FAC costs of ceases equally from SMPF and MPF rentals* [because] *the apparent cease cost differential between MPF and SMPF is unlikely to be justified given the similar activities involved; and most of the CCA FAC costs are common and fixed as opposed to incremental"*.[214]

4.108 C&WW "*question*[ed] *the level of the administrative only flexi cease charge"*.[215] C&WW also thought that we should implement a *"a cost equalised recovery of the cease costs across MPF, SMPF and WLR services",* as advocated by TTG[216] in its response to the March 2011 Consultation.[217]

4.109 EE noted that MPF Cease and SMPF Cease are only used when a CP decides to migrate a customer using an MPF New Provide service and SMPF New Provide service, and not between CPs like other Migration services (e.g. MPF and SMPF Single Migration). EE was concerned that our *"proposals* [to set MPF and SMPF Ceases to zero and recover from LLU rentals] *are likely to encourage communications providers to use (potentially to an even greater extent than currently) inefficient (as well as customer unfriendly) cease and re-provide switching processes, when there are in fact lower cost and more efficient migration processes*

[211] TTG response to the November 2011 Consultation, paragraph 40.
[212] TTG response to the November 2011 Consultation, paragraph 41.
[213] There is no equivalent Cease service for WLR services in our cost modelling. These WLR Cease costs are recovered from MDF Hardware jumpering.
[214] Sky response to the November 2011 Consultation, paragraph 26.
[215] C&WW response to the November 2011 Consultation, page 7.
[216] TTG response (July 2011) to the March 2011 Consultation, paragraphs 109 to 110.
[217] C&WW response to the November 2011 Consultation, page 7.

available (or, where these are not suitable, where regulatory effort should better be spent in improving these processes)".[218]

4.110 EE also argued that MPF Cease and SMPF Cease charges should not be equal, and that the amount of cost recovered from LLU rentals (or cost allocated to MPF and SMPF Cease services if we do not recover costs from the LLU rentals) should reflect the LRIC differential (of around £1) between the respective MPF and SMPF Cease services to prevent competitive distortions at the expense of SMPF users.[219]

4.111 Openreach agreed with our proposal to set the MPF Cease and SMPF Cease charges to zero and recover CCA FAC from LLU rentals, but not that we should recover these costs equally from the LLU rentals.[220]

4.112 Telefonica UK "*remain supportive of Ofcom's original proposal* [i.e. in the March 2011 Consultation] *to recover costs on a proportionate basis rather than an equal basis*".[221]

Our response and conclusions

MPF and SMPF Cease charge structure

4.113 We note EE's comments that our proposal may incentivise CPs to use more inefficient products (e.g. MPF New Provide) than migration products (e.g. MPF Single Migrations). However, we consider that the risk of this unintended consequence is negligible, given that these are different products with different user needs. We also note that MPF New Provide would still be priced sufficiently above MPF Single Migrations (where MPF Ceases are set to zero, as under our proposal), to deter CPs from using MPF New Provide at the expense of MPF Single Migrations.

4.114 As discussed in the November 2011 Consultation, we consider that LLU Cease services can have an impact on competition for customers, and can be levied as ETCs to retail consumers. We therefore prefer for charge structures which do not include Cease charges, as long as it is economically efficient to do so.[222]

4.115 Having considered stakeholder comments, we retain that preference and therefore, we have decided to set MPF Cease and SMPF Cease service charges to zero and to recover the respective CCA FACs from the respective MPF rental and SMPF rental services, to allow appropriate recovery of incurred costs.

Recovery of MPF and SMPF Cease CCA FACs

4.116 Given that we have decided that it is appropriate to recover CCA FACs from the respective MPF rental and SMPF rental services, we now consider what proportion of the total annual CCA FACs for both MPF Cease and SMPF Cease should be recovered from the respective rental services, for each year of the control.

4.117 We note the comments received from those stakeholders that argue that we should recover MPF Cease and SMPF Cease CCA FACs proportionately, rather than equally, from LLU rental service, and EE's comments that the difference in costs

[218] EE response to the November 2011 Consultation, Section 4.1, response to question 2.4.
[219] EE response to the November 2011 Consultation, Section 4.1, response to question 2.5.
[220] Openreach response to the November 2011 Consultation, Section 5, paragraphs 60 to 61.
[221] Telefonica UK response to the November 2011 Consultation, paragraph 32.
[222] November 2011 Consultation, Section 4, paragraphs 2.58 to 2.59.

recovered should reflect an estimate of marginal cost differentials between MPF Cease and SMPF Cease.

4.118 While we recognise that there is likely to be some marginal cost differential between MPF and SMPF Cease, we consider that this is likely to be very small. While we cannot specify the marginal cost differential exactly, we consider that it is likely to be significantly below £1, and so any risk of competitive distortion is low. We also consider that fixed common costs are the same across MPF and SMPF Cease variants and so should be recovered equally across the MPF and SMPF rentals.

4.119 In the light of the consultation responses received, and our response above, we have decided to recover MPF Cease and SMPF Cease CCA FACs equally from their respective MPF rental and SMPF rental, for the charge control period. More specifically, we have decided to use a volume weighted average of the MPF Cease and SMPF Cease annual CCA FACs to allocate costs equally to the respective MPF and SMPF rentals for each year of the charge control.

LLU ancillary baskets design and structure

Three basket structure

March 2011 Consultation proposals

4.120 In the March 2011 Consultation, we proposed to maintain the current structure of three separate baskets for MPF ancillary services, SMPF ancillary services and Co-Mingling ancillary services. We considered that this three basket structure would prevent Openreach from potentially distorting competition in BT's favour (by trading off price decreases in services that BT predominantly uses (i.e. SMPF), against increases in prices in services predominantly used by other CPs (i.e. MPF), but also allow Openreach sufficient flexibility to efficiently adjust prices.[223]

4.121 In the March 2011 Consultation, we asked stakeholders the following question:

***Question 4.2**: Do you agree that separate baskets for MPF ancillary services, SMPF ancillary services and Co-Mingling ancillary services is appropriate to mitigate the opportunity for gaming while providing Openreach some flexibility to efficiently adjust prices?*

March 2011 Consultation responses

4.122 The majority of respondents broadly agreed with the proposed three basket structure, with the exception of Sky and TTG who argued that we should create additional dedicated baskets for certain services.

4.123 Openreach agreed with our proposals, but argued that, in practice, its ability to game is limited given the existence of "*Further obligations found in the 2010 WLA Market Review* [and] *general UK and EC Competition law*".[224]

4.124 EE also agreed, but said that we should ensure non-BT SMPF providers can compete with each other and BT (as well as MPF based competitors).[225]

[223] March 2011 Consultation, page 44, paragraphs 4.24 to 4.27.
[224] Openreach response to the March 2011 Consultation, paragraphs 370 to 371.
[225] EE response to the March 2011 Consultation, page 10.

4.125 Sky[226] and TTG[227] both argued that Tie cables and accommodation products should be removed from the Co-Mingling basket and put in separate baskets. Sky and TTG both noted that they spend a material amount on these services.

4.126 TTG said that Tie cable products are bought by BT and other CPs, while Accommodation products are bought only by other CPs.

4.127 TTG went on to say that "*the basket scope creates an incentive for BT to exploit the* flexibility *in the basket control by increasing the prices of accommodation products above FAC and so reduce the cost of tie cables below FAC*".[228] TTG also argued that "*different baskets will also reduce the potential volume growth differential gaming that can happen under a prior year weighting regime*".[229]

4.128 TTG and Sky also asked that we create baskets for certain services (SFIs, TRCs and Electricity) which were not included in the scope of the previous LLU charge control.

Our response and conclusions

4.129 Given the broad support from stakeholders for our proposal, we remain of the view that a three basket structure as proposed in the March 2011 Consultation is appropriate.

4.130 We also consider that we have addressed the risk which TTG notes, regarding the potential risk of volume growth differential gaming, through basket design. Specifically, we have decided that a prior year weights combined with a tighter inertia clause will be sufficient to prevent any potential risk of volume growth differential gaming. We set out our reasoning in more detail in paragraph 4.169 to 4.184.

4.131 We also do not consider that baskets are necessary for SFIs, TRCs and Electricity. We set out our approach to these services in paragraphs 4.322 to 4.385.

Basket specific controls

March 2011 Consultation proposal

4.132 In the March 2011 Consultation we proposed that each basket (i.e. MPF ancillary services basket, SMPF ancillary services basket and the Co-Mingling ancillary services basket) should be subject to a separate charge control, as opposed to one RPI-X charge control across all three baskets (as was the case with the previous control). We noted that LLU ancillary services baskets with separate controls would address a major disadvantage associated with having one control across all baskets, as identified by the CC, which is a perpetuation of the over and under-recovery of costs, which could disadvantage some CPs at the expense of others. [230]

4.133 In the March 2011 Consultation, we asked stakeholders the following question:

Question 4.3: *Do you agree that we should set basket-specific controls as opposed to a single control which is applied to all baskets?*

[226] Sky response to the March 2011 Consultation, page 2, paragraph 10.
[227] TTG response (July 2011) to the March 2011 Consultation, paragraphs 502 to 505.
[228] TTG response (July 2011) to the March 2011 Consultation, paragraphs 503 to 505.
[229] TTG response (July 2011) to the March 2011 Consultation, paragraphs 503 to 505.
[230] March 2011 Consultation, paragraphs 4.28 to 4.31.

March 2011 Consultation responses

4.134 All stakeholders were in favour of our preferred proposal to set separate controls for baskets. However, TTG also asked that we set separate controls for new baskets of other services which were not included in the scope of the LLU charge control (i.e. for TRCs, Electricity and SFIs).

Our response and conclusions

4.135 As explained in the March 2011 Consultation, while we noted that a single control for all baskets had an advantage over our preferred proposal (i.e. a single control for all baskets would allow a more robust recovery of efficiently incurred costs across baskets), we considered that our preferred proposal would address a major disadvantage associated with having a single control across all baskets (i.e. that having a single control across baskets would tend to perpetuate over and under recovery of costs in individual baskets).[231] We also noted that this major disadvantage was identified by the CC in its determination on the LLU charge control appeal where it found that Ofcom had erred in setting a single X across all baskets. The CC also considered that this misalignment of costs and revenues would disadvantage some CPs at the expense of others.[232]

4.136 Therefore, for these reasons and to ensure that basket costs and revenues are not misaligned, which would disadvantage some CPs over others, we have decided that separate controls for each of MPF, SMPF and Co-Mingling baskets (as opposed to a single control applied to these baskets) are appropriate.

4.137 We do not consider that separate basket controls are necessary for TRCs, electricity and SFIs. We set our reasoning for this in paragraphs 4.322 to 4.385.

Measures to prevent gaming of ancillary baskets

March 2011 Consultation proposals

4.138 In the March 2011 Consultation,[233] we proposed to implement a tighter inertia clause[234] alongside prior year volume weights[235] as a basis for setting charges for services with the MPF, SMPF and Co-Mingling ancillary services baskets.

4.139 In relation to the inertia clause applicable to the baskets, we sought stakeholder views on whether we should tighten the inertia clause from the current level of 10%. In the March 2011 Consultation, we proposed that the level of the inertia clause should be between 2% and 7.5%, across all three baskets.

4.140 In the March 2011 Consultation, we recognised that setting prices using prior year volumes had one potentially significant limitation (identified by the CC, in its determination of the LLU Appeal). If Openreach are able to predict volume changes, Openreach could manipulate prices (by increasing the prices of those products growing in volume, and reducing those prices which are declining in volume, to gain

[231] March 2011 Consultation, paragraphs 4.28 to 4.31.
[232] See the 2009 LLU Determination, paragraph 3.202.
[233] March 2011 Consultation, paragraphs 4.32 to 4.75.
[234] An inertia clause restricts relative service charge movements within a basket of services.
[235] A prior year volume weights approach sets prices for that year based on the previous year's volumes revenues for the basket services.

revenues beyond those permitted by the basket charge control) when prices are based on prior year weights.

4.141 However, in the March 2011 Consultation we went on to argue that, in practice, the scope to manipulate the control by increasing the price of products increasing in volume may be somewhat limited as CPs do not provide Openreach with volume forecasts at a level of detail that is sufficient or accurate enough for Openreach to effectively distort prices, CPs may not want to provide Openreach with the volume forecasts, and any substantial misalignment between prices and costs could be corrected in the next charge control.[236]

4.142 Further, we considered that there were considerable drawbacks associated with possible alternative remedies:[237]

- *Current year volume weights*.[238] We recognised that basing prices on current year volume weights, as an alternative to prior year volume weights, will practically eliminate Openreach's ability to manipulate prices within the ancillary services baskets. However, depending on how the approach is implemented, it can also introduce new possibilities for gaming (e.g. if the CP supplied incorrect forecasts to Openreach). We also noted there were other significant weaknesses that included an administrative burden (of having to adjust prices during the charge control period) and volatile movements in prices[239] (as prices are adjusted during the charge control period for cost recovery).

- *Prior year volume weightings and no pricing flexibility*. We discussed the option of combining prior year volume weights with either individual charge controls for all basket services, restricting individual basket services to the overall basket control, or setting sub-caps. However, we noted that these would significantly reduce Openreach's flexibility, and would be complex and impractical to implement.[240]

- *Prior year volume weightings and tougher basket controls*. We discussed the option of adjusting RPI-X basket controls to anticipate volume growth such that Openreach would only be likely to recover costs if it differentially adjusted its prices by increasing charges for products which are growing in volume relative to other products.[241] We recognised that in principle this approach could mitigate the risk of gaming, but that in practice it would be difficult to implement and could have unintended consequences.[242]

4.143 Having considered the other options available set against the level of risk identified, we reached the provisional view that using prior year weights alongside a tightening of the inertia clause was the most appropriate and proportionate solution. This was because it would substantially limit the scope for Openreach to engage in price manipulation whilst leading to a greater degree of price stability; and would incur a

[236] March 2011 Consultation, paragraph 4.43.
[237] March 2011 Consultation, paragraphs 4.45 to 4.65.
[238] Current year volume weights approach sets prices based on a forecast of the current year volumes/revenues weighting.
[239] To illustrate potential price volatility of LLU ancillary services, we set out Figure 4.1 in the March 2011 Consultation that showed that *2008/09 industry forecasts w*ere for 20% more MPF single migrations than actually occurred; and a slight decline in numbers of SMPF single migrations between 2007/08 and 2008/09, whereas in fact there was a 16% increase.
[240] March 2011 Consultation, paragraphs 4.58 to 4.62.
[241] March 2011 Consultation, paragraphs 4.45 to 4.63.
[242] March 2011 Consultation, paragraphs 4.64 to 4.65.

broadly lower administrative burden in setting and monitoring prices than the other options available. Therefore, we proposed to continue to use prior year weights in combination with tighter inertia clauses to mitigate the risk of price manipulation by Openreach.

4.144 We also noted that a prior year volume weights approach is consistent with our approach in other controls.[243]

4.145 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 4.4: *Do you agree that measuring compliance of basket controls against prior year volumes (as opposed to current year volumes) is an appropriate and proportionate approach to charge controlling ancillary services?*

Question 4.5: *Do you agree that inertia clauses applied to the ancillary services baskets should tightened from their current level of 10%? Please give views on the appropriate level of inertia clauses in the range 2% to 7.5%.*

March 2011 Consultation responses

4.146 C&WW said that current year volume weights could lead to price volatility, but that prior year weights could enable BT to game the controls. C&WW agreed that using prior year volume weights to set prices is *"a reasonable approach"*. However, C&WW said that a far tighter inertia clause, than we proposed, would be necessary to prevent Openreach gaming the control.[244]

4.147 EE noted that we had used prior year volume weights for previous charge control reviews, and added that "*the key objective for Ofcom should be to ensure that BT does not have the opportunity to set charges in a way which distorts competition (for example by favouring its own downstream operations)"*.[245]

4.148 GC felt that inertia clause range we consulted on is too loose, in particular as applied to the Co-Mingling basket.[246]

4.149 TTG argued that using current year volume weights, instead of prior year volume weights, would more effectively meet consumers' interests.[247] More specifically, TTG proposed that a combination of current year volume weights and other measures including the alignment of MPF, SMPF and WLR services, more services with separate charge controls and/or more baskets, and separate Xs for baskets and/or looser inertia clauses, would be more effective, than a combination of prior year weights and/or tighter inertia clauses, and/or sub-caps at preventing such gaming and undue price disruption.[248]

4.150 TTG argued that current year volume weights could be implemented broadly as we set out in our March 2011 Consultation.[249] While noting that using current year volume weights has some disadvantages, TTG felt our review of current year volume

[243] Leased Lines Charge Control (LLCC), Network Charge Controls, Mobile Call Termination Review.
[244] C&WW response to the March 2011 Consultation, page 22.
[245] EE response to the March 2011 Consultation, page 16.
[246] GC response to the March 2011 Consultation, page 5.
[247] TTG response (July 2011) to the March 2011 Consultation, paragraphs 506 to 520.
[248] TTG response (July 2011) to the March 2011 Consultation, paragraphs 515 to 517.
[249] With the exception that TTG proposed that any resetting to account for divergence between actual and forecast volumes could be carried out at the end of the year, as opposed to one or more time during the year.

weights was "*exaggerated and in some cases incorrect and/or misleading*". In particular, TTG argued that: [250]

- prior year volume weights can be gamed with "*even moderately accurate forecasts*", and disagreed that forecasts need to be accurate to enable gaming;
- "*Ofcom argue that BT might exploit the system by manipulating the forecasts to over-recover and that (if interest is not charged on the over-recovery the carry-over / rebate) will be insufficient to disincentivise such gaming. The simple approach is to charge interest on any over-/under-recovery";*[251]
- current year volume weights would not incur as much administrative burden as currently under prior year volume weights, largely because Openreach already has and should have forecasts and actuals for most products (and for those it does not it could use the prior year volume weights as a proxy). Openreach also said that "*the modelling of the allowed increases would be exactly the same process as done under PYW* [prior year weights] *(but using forecast volume to weight). Subsequently there will then be a calculation of carry-over which is a simple calculation relying on actual data which BT has. This carry-over calculation is anyway done under a PYW system";*
- it is *"highly unlikely"* that a current year volume weights regime will create incentive for wholesale customers to manipulate the forecasts they provide to BT for their own gain;
- while current year weights would result in price volatility from carryover/rebates,[252] "*such forward-looking corrections can be largely a good thing"* as:
    - "*it is fairer to wholesale customers who pay a fair and 'ungamed' price*
    - *it means that BT does not bear the risk of inaccurate forecast (by its customers or by itself)*
    - *Ofcom allows for such correction in the current regime (see §9.22) and at no point has suggested that they are in any way problematic*
    - *there is not any uncertainty as is associated with retrospective corrections*
    - *if the same argument was applied to Ofcom decisions then one would argue that appeals should not be allowed to correct erroneous decisions*".[253]

[250] TTG response (July 2011) to the March 2011 Consultation, paragraphs 513.

[251] To put TTG's comment in context we explained in the March 2011 Consultation (paragraph 4.48) "*that a risk of gaming could be mitigated by applying an "incentive interest rate" to any over or under charge. In principle an incentive interest rate (if set at the right level) would reduce or remove any incentive for Openreach to "overcharge" or "for CPs to try to influence Openreach's pricing to "undercharge".*

[252] In the March 2011 Consultation, paragraph 4.53, in explaining how a current year weights system might, we explained that Openreach could instead issue rebates to each of its customers as a result of any over charge or directly recover any underpayment from each of its customers in the previous year.

[253] TTG response (July 2011) to the March 2011 Consultation, paragraphs 513.

4.151 Openreach considered that an inertia clause is unnecessary, given that "*there are a large range of other regulatory and competition law restrictions and prohibitions which limit Openreach's pricing freedom*".[254] Openreach also considered that gaming was not an issue, given that we proposed to remove the largest products (the key migration services) from the baskets and as we have proposed that there should be separate controls for each of the MPF, SMPF and Co-Mingling baskets.[255]

4.152 Openreach went on to say that the purpose of a basket is to provide pricing flexibility, and considered that an inertia clause in the range of 2% to 7.5% conflicts with this objective, is too restrictive, and goes beyond the findings of the CC. Openreach argued that the proposed inertia clause range would:

- remove its ability to maintain the price of a basket service at its current level (depending on the level of RPI and/or the inertia clause);
- remove its flexibility to ensure that prices reflect costs; and
- remove its flexibility to enable it to achieve price alignment for products which have a similar cost or function.[256]

4.153 Openreach suggested that if we "*consider it appropriate and proportionate to impose an inertia clause, then it should be the greater of either the 10% level which was used in the 2009 LLU Statement, or the largest absolute value of RPI-X for a basket*".[257]

4.154 Openreach agreed with our proposal and reasons to continue to use prior year volume weights (and not to use current year volume weights). In particular, Openreach argued that current year volume weights would pose "*significant practical problems*" and create price volatility. Openreach also argued that it would or could not, in practice, game the baskets by increasing prices of services growing in volume relative to other services.[258]

4.155 Openreach set out how current year volume weights would work (in broad terms to how we proposed in the March 2011 Consultation) and argued that current year volume weights would lead to inaccurate forecast revenues, which, in turn, would lead to large amounts of rebate/carry over after actual revenues become available later on, and further uncertainty for CPs and Openreach. Openreach argued that it would be difficult to forecast revenues because of:

- the burden of forecasting separately for over 100 basket services;
- the fact that CPs are unlikely to pass on confidential forecasts;
- ancillary volumes being volatile *per se*;
- Openreach's inability to forecast significant changes in demand without accurate CP forecasts or public announcements; and

[254] Openreach response to the March 2011 Consultation, paragraph 2.59.
[255] Openreach response to the March 2011 Consultation, paragraph 377.
[256] Openreach response to the March 2011 Consultation, paragraphs 379 to 383.
[257] Openreach response to the March 2011 Consultation, paragraph 378.
[258] Openreach response to the March 2011 Consultation, paragraph 284 to 291.

- the propensity for other CPs to game the process.[259]

4.156 Openreach also argued that there are no precedents in other charge controls for using current year weights.[260]

November 2011 Consultation proposals

4.157 As part of Openreach's response to the March 2011 Consultation (see paragraph 4.152 above for summary of response) Openreach noted that it was concerned that the range and level of the inertia clause that we had proposed in the March 2011 Consultation level could unduly reduce its pricing flexibility within the baskets.

4.158 In response to Openreach's comments we considered that it was appropriate to consult further (in the November 2011 Consultation) as we recognised that there could be grounds for concern where the proposed inertia clause level forced the downward adjustment of all service charges even where certain charges may be already set equal to their CCA FAC cost.[261]

4.159 Accordingly, in the November 2011 Consultation, we included a proposal for a possible exemption to the inertia clause we had proposed in the March 2011 Consultation.

4.160 Specifically, the exemption would remove the inertia clause from the basket when the absolute value of RPI-X is greater then the absolute value of the inertia clause percentage, so that BT has increased flexibility to adjust charges without changing the price of those services at CCA FAC.[262]

4.161 However, we noted that only two services (MPF Singleton Jumper Removal and SMPF Singleton Jumper Removal) across the MPF, SMPF and Co-Mingling baskets, would be affected (and so would be within the scope of our exemption). In the November 2011 Consultation, we also explained that there may be significant negative unintended consequences associated with the exemption, given that if it was applied, the exemption would mean that the inertia clause would cease to apply to all the services within the basket in question (as well as the affected service(s)).[263] In particular, we considered that the risk of removing the inertia clause, even in these circumstances is greater than the risk of negative consequence these services being forced below CCA FAC (given that they are unlikely to be forced below LRIC).[264]

4.162 Accordingly, we proposed not to modify our March 2011 Consultation proposal with respect to the inertia clause.

4.163 In the November 2011 Consultation, we asked stakeholders the following question:

> ***Question 2.9****: Do you agree that we should not modify the inertia clause set out in the March 2011 Consultation? If not, do you agree with our proposed alternative set out in the draft legal instrument at Annex 5?*

[259] Openreach response to the March 2011 Consultation, paragraph 288.
[260] Openreach response to the March 2011 Consultation, paragraph 292.
[261] November 2011 Consultation, paragraph 2.122.
[262] November 2011 Consultation, paragraph 2.125.
[263] November 2011 Consultation, paragraphs 2.124 and 2.127.
[264] November 2011 Consultation, paragraph 2.128.

November 2011 Consultation responses

4.164 TTG agreed that we should not modify the inertia clause set out in the March 2011 Consultation, noting that "*the inertia clause is one of the few protections against pricing abuse particularly gaming of different volume growth (see §2.127*)". *Further, it is highly plausible that BT would game the CCA FAC allocations to engineer a situation whereby the inertia clauses would be set aside*".[265]

4.165 However, TTG reiterated its view from its March 2011 Consultation response that there are "*are more effective tools* [than the inertia clause] *that address the abuse in a targeted way and are less likely to result in unintended consequences. For example, current year weightings, better basket design (e.g. narrower baskets), more individual charge controls and/or alignment/differential obligations are all more effective*".[266]

4.166 EE agreed with our preferred proposal noting that "*the relative risks of retaining this clause (compared to the risks of negative consequences) support this approach*".[267] EE noted that the alternative exemption would only apply to few services, and there is "*no suggestion that BT will not be* able *in aggregate to recover its common costs, or that the individual prices will be regulated below any LRIC based cost floor*" under our preferred March 2011 Consultation proposal.[268]

4.167 Openreach supported the alternative proposal to remove the inertia clause arguing that "*any basket control should provide Openreach with the flexibility to respond to changes in market conditions while moving prices to FAC over the charge control period. Not dis-applying the inertia clauses as outlined above means that a fundamental principle of the basket for prices to reflect underlying costs is not being observed*".[269]

4.168 Openreach also reiterated its view, as set out in its response[270] to the March 2011 Consultation, that the inertia clause is unnecessary, but that if we do implement the inertia clause, it should stay at 10%. Openreach argued again that any tightening of the inertia clause goes beyond the CC findings, noting that "*the concerns with the inertia clause only arose in the context of the co-mingling basket, which contained products purchased by both internal and external customers;* [….] *the CC acknowledged that Openreach had not gamed the basket;* [and….] *The CC did not express a view on this proposal* [to tighten the inertia clause, set out by Ofcom in the LLU Appeal]".[271]

Our response

4.169 We discuss our response directly below, and then we turn to our conclusions.

Prior year volume weights vs. current year volume weights

4.170 We note TTG's comments in favour of current year volume weights, but consider that when the practical and administrative limitations (i.e. price volatility, risk of gaming and administrative burden) of current year volume weights are considered in the

[265] TTG response to the November 2011 Consultation, paragraph 52.
[266] TTG response to the November 2011 Consultation, paragraph 50.
[267] EE response to the November 2011 Consultation, Section 4.1, response to question 2.9.
[268] EE response to the November 2011 Consultation, Section 4.1, response to question 2.9.
[269] Openreach response to the November 2011 Consultation, paragraph 54.
[270] Openreach response to the March 2011 Consultation, paragraph 377.
[271] Openreach response to the November 2011 Consultation, paragraphs 49 to 51.

round, as set out in the March 2011 Consultation, prior year volume weights is a relatively more appropriate and proportionate approach to set prices.

4.171 In particular, we disagree with TTGs view that price volatility under current year volume weights which results in "*such forward-looking corrections can be largely a good thing.*"[272] We consider that price volatility would be significantly problematic for CPs and Openreach affecting their ability to forward plan. It would also present a large risk that prices would not meet the basket controls (neither problem being present to any similar degree or extent under an prior year weights system). This is likely to be exacerbated given the volatile nature of LLU ancillary services.

4.172 We note that TTG also does not take account of the fact that any 'incentive interest rate scheme', which may be necessary to reduce the risk of gaming under current year volume weights, would further exacerbate price volatility (including relative to prior year volume weights basis).[273]

4.173 We recognise that that on balance both current year volume and prior year volume weights are likely to incur broadly similar levels of administrative burden, but we note that TTG's analysis failed to acknowledge that in order to limit pricing volatility under current year volume weights, it is likely that we would need to reset prices one or more times during a year (and not simply at the end of the each charge control year), in order to avoid a large price shock at the end of the year. Re-setting prices during the year would increase administrative burden relative to the prior year volume weights approach.

4.174 In respect to TTG's comment that the potential risk of Openreach manipulating prices using prior year volume weights is not as low as we suggested in the March 2011 Consultation, while we accept that in order for Openreach to fully maximise such gaming accurate forecasts would be required, we consider that, as set out in the March 2011 Consultation, the scope to game the control would still be somewhat limited given what information is currently shared between CPs and Openreach.[274]

Inertia clause

4.175 We consider that an inertia clause, across the MPF, SMPF and Co-Mingling baskets, should be set to 7.5% (i.e. at the top of the range that we consulted on in the March 2011 Consultation).

4.176 We note stakeholders comments that we should tighten the inertia clause further than what we preferred (i.e. 7.5%) in the March 2011 Consultation. However, as set out in the March 2011 Consultation, we consider that a balance is unnecessary to reduce any potential risk of gaming and allowing sufficient pricing flexibility.[275] Therefore, we do not consider that any further tightening of the inertia clause, beyond 7.5%, is appropriate.

4.177 We disagree with Openreach's comments that an inertia clause is unnecessary *per se*. In doing so, we note that a primary function of the inertia clause is that it prevents significant changes in individual prices within the basket (over and above the basket control). We therefore consider an inertia clause is necessary to prevent price volatility of individual services within the MPF, SMPF and Co-Mingling baskets.

[272] TTG response (July 2011) to the March 2011 Consultation, paragraph 513.
[273] March 2011 Consultation, paragraphs 4.49 to 4.50.
[274] March 2011 Consultation, paragraph 4.43.
[275] March 2011 Consultation, paragraph 4.69.

4.178 We consider that an exemption that removes the inertia clause from the basket when the absolute value of RPI-X is greater than the absolute value of the inertia clause percentage (as set out in the November 2011 Consultation[276]) would not be targeted (as it would only apply to two services in all three baskets). Crucially, as set out in the November 2011 Consultation, we consider that the risk of removing the inertia clause in such a way, is greater than the risk of negative consequences of these services being forced below CCA FAC.[277]

4.179 We also consider that Openreach will be able recover all its efficiently incurred common costs in aggregate, and that individual basket services are unlikely to be reduced below their individual LRICs, with the inertia clause set at 7.5%.

Other proposals suggested by stakeholders to prevent potential gaming

4.180 We note TTG's counter-proposal that a combination of other regulatory measures[278] would be more effective, than a combination of prior year volume weights and/or tighte*r* inertia clauses (and/or sub-caps) at preventing gaming and undue price disruption.

4.181 However, we do not consider TTG's counter proposal is necessary or proportionate. We consider that our approach is more targeted, appropriate and less interventionist means of addressing to addressing the potential risk of gaming.

<u>Our conclusions</u>

4.182 In the light of the comments received from stakeholders, and our response above, we have decided to tighten the inertia clause (from 10% to 7.5%) across MPF, SMPF and Co-Mingling baskets, and continue to base basket specific controls on prior year volume weights.

4.183 We consider that these decisions are appropriate and proportionate to prevent any potential risk of gaming. However, we also note that our decision to implement a sub-cap on MPF Stopped Line Provide at the controlling percentage of the MPF ancillary services basket, will further reinforce our proposals, with respect to the MPF basket (see our decision set out in paragraphs 4.200 to 4.206).

4.184 We do not consider that the alternative exemption with respect to the inertia clause (as set out in the November 2011 Consultation[279]) across the MPF, SMPF and Co-Mingling baskets, is appropriate or necessary.

MPF Stopped Line Provide

4.185 MPF Stopped Line Provide is used by CPs to provide an MPF service to premises that have an existing but inactive copper line. We understand that this is predominantly used by CPs to provide service when a consumer moves home (the line in the new property having been disconnected).

4.186 This service charge directly affects the set up costs for a new service provision and can directly influence consumer contract terms. We understand that some CPs are

[276] November 2011 Consultation, Section 2, paragraphs 2.124 to 2.125.
[277] November 2011 Consultation, Section 2, paragraphs 2.124 to 2.128.
[278] Current year volume weights; alignment of MPF, SMPF and WLR services; more services with separate charge controls and/or more baskets, and; and separate Xs for baskets and/or looser inertia clauses (TTG response (July 2011) to the March 2011 Consultation, paragraphs 515 to 517).
[279] November 2011 Consultation, Section 2, paragraphs 2.121 to 2.129.

forecasting a rise in the number of such services. This raises a gaming concern as potentially Openreach could structure charges to exploit this rise. We consider this below.

November 2011 Consultation proposals

4.187 In our March 2011 Consultation, we proposed that MPF Stopped Line Provide should continue to be regulated within the MPF and SMPF ancillary services baskets.[280]

4.188 In its response to the March 2011 Consultation, Sky asked that we individually charge control the MPF Stopped Line Provide.[281] Sky said that Openreach can *"price services that are growing in demand in such a way as to* generate *greater profits than the charge controls would allow if volumes were in a steady state* [and] *BT retains the flexibility under Ofcom's proposals to earn excess returns and discriminate against individual operators (and their customers)".*[282]

4.189 In our November 2011 Consultation we recognised that since we commenced this LLU charge control review, Sky's spend on this migration service had become more material, and was forecast to continue to be material over the duration of this LLU charge control. We acknowledged that the charges for this service can have an impact on the cost of migrating customers. [283]

4.190 Accordingly, we considered that this level of activity questions our assessment of the materiality of this service and the potential for the service to be priced in a manner which could have a significant consequence for consumers and the competitive environment.[284]

4.191 We noted that while individually charge controlling MPF Stopped Line Provide instead would better ensure its price reflects its costs over the charge control period, there are practical difficulties in doing so (i.e. because the growth of this service has been relatively nascent there is no CCA FAC information to allow us to robustly set a separate charge control).[285]

4.192 We, therefore, proposed to set a sub-cap on MPF Stopped line provide set at the controlling percentage of the MPF basket (RPI-9%) on the basis that this would be proportionate and appropriate.[286]

4.193 We asked stakeholders the following question in the November 2011 Consultation:

Question 2.6*: Do you agree with the imposition of a sub-cap on MPF Stopped Line Provide set at the controlling percentage of the MPF basket? If not please give your reasons.*

November 2011 Consultation responses

4.194 C&WW agreed with the proposal noting that "*over the coming period this charge will have greater material effect upon"* its business.[287]

[280] See March 2011 Consultation, Annex 13, Annex to condition FAA4(A), Parts 1 and 2.
[281] Sky further response to the March 2011 Consultation, paragraphs 6 to 9.
[282] Sky further response to the March 2011 Consultation, paragraphs 8 to 9.
[283] November 2011 Consultation, paragraph 2.94.
[284] November 2011 Consultation, paragraph 2.95.
[285] November 2011 Consultation, paragraph 2.96.
[286] November 2011 Consultation, paragraphs 2.97 to 2.100.

4.195 Sky said that our proposal "*will go some way towards protecting Sky's customers from disproportionately less favourable price reductions. However, a single control would ensure that the price of MPF Stopped Line Provide was more closely aligned with BT's costs by the end of the charge control period and, as such, would be more stringent in ensuring that the prices Sky pays for this important service are reflective of the actual costs of provision*".[288]

4.196 TTG said that our proposal was "*a marginal improvement on the previous situation but we think better alternatives exist*".[289] TTG considered that we could implement a separate charge control for MPF Stopped Line Provide, noting that "*CCA FAC costs are available for MPF New Provide. Therefore, estimating CCA FAC costs for MPF stopped line (which has similar costs since the final drop cost is not included) is unlikely to be difficult*".[290]

4.197 Alternatively, TTG argued that a "'*differential obligation*'" *could be used whereby the MPF stopped line provide charge is at least (say) £5 less than MPF new line provide (reflecting the difference in relevant LRIC)*". TTG argued this would preferable to a sub-cap as a "*sub-cap approach may be ineffective in preventing excessive MPF stopped line provide prices. Under the current proposals the MPF stopped line provide required price reduction (RPI –10.0%) is significantly less than the MPF new provide price reduction (RPI –13.8%);* [a 'differential obligation] *is far more transparent* [and is …] *more targeted and is less likely to have unintended consequences*".[291]

4.198 Openreach felt our proposal was unnecessary as "*Openreach does not have a commercial incentive to increase the price for the service and any such increase would drive inefficiencies and higher costs*". Openreach explained that "*without a sufficient differential* [between MPF New Provide and MPF Stopped Line Provide]*, CPs may be incentivised to purchase MPF New Provide, which involves an inefficient engineering visit to the end-user, instead of purchasing the products which re-use the existing line*".[292]

Our response and conclusions

4.199 We note stakeholder comments that a sub-cap will either be ineffective at addressing potential harm relative to other potential options (i.e. a 'differential obligation' or individual charge control); is unnecessary; and/or may have unintended consequences.

4.200 We consider that the risk of inefficient investment in MPF New Provide that would otherwise have gone to MPF Stopped Line Provide, during the charge control period, is likely to be low.

4.201 Firstly, this is because we do not consider that MPF New Provide and MPF Stopped Line Provide are clear substitutes. In considering this, we understand that MPF Stopped Line Provide is generally used for home moves where there is a copper line but which has been recently disconnected, or for the connection of some cable

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[287] C&WW response to the November 2011 Consultation, page 7, answer to question 2.6.
[288] Sky response to the November 2011 Consultation, paragraph 15.
[289] TTG response to the November 2011 Consultation, paragraph 26.
[290] TTG response to the November 2011 Consultation, paragraph 27.
[291] TTG response to the November 2011 Consultation, paragraph 28.
[292] Openreach response to the November 2011 Consultation, Section 4.2, paragraphs 42 to 44.

customers. This is in contrast to MPF New Provide which is used to connect a customer to MPF where there is no existing copper line.

4.202 Secondly, even if there were a stronger degree of substitutability between these services, at no point during the 2 year charge control period will MPF New Provide become cheaper than MPF Stopped Line Provide, under the different RPI-X movements for each service (i.e. MPF New Provide is individually charge controlled at RPI-14.2%, whereas MPF Stopped Line Provide would be subject to an RPI-9%).[293]

4.203 As set out in the November 2011 Consultation,[294] we note that the demand for MPF Stopped Line Provide product is forecast to grow materially over the charge control period, and that Openreach may still have some incentive and ability to price excessively, were we not to intervene further. Therefore, we consider that some form of protection, but proportionate to level of potential harm, is necessary. We now consider what type of intervention would be proportionate and appropriate.

4.204 While an individual charge control or a 'differential obligation' may, in theory, be effective in addressing potential increases in the price MPF Stopped Line Provide, we consider that the proposed sub-cap would also provide an adequate level of protection for consumers during the charge control period, would be more proportionate, and would not suffer from the practical limitations of the alternatives proposed by respondents. In particular, in terms of practical limitations, we do not have reliable CCA FAC information for MPF Stopped Line Provide given that the volumes for this service have been low until recently. Therefore, we do not consider that any estimated CCA FAC or LRIC based approach is appropriate.

4.205 Therefore, in the light of consultation responses received, and our responses above, we have decided to impose a sub-cap on MPF Stopped Line Provide set at the controlling percentage (RPI-9%) of the MPF basket.

LLU Bulk migrations (MPF Bulk Migrations services and SMPF Same CP Mass Migration)

4.206 SMPF Same CP Mass Migration and MPF Bulk Migrations services are bulk migration variants of the MPF and SMPF Single Migration services. They allow a CP to migrate multiple customers at a time to an LLU service.

4.207 SMPF Same CP Mass Migration and MPF Bulk Migrations services are of particular concern to those CPs who are migrating their customer base to a new set of access products, either due to change in the product used (i.e. from SMPF to MPF) or rationalisation of provision to use a common set of equipment (for example, due to acquisition of another CP).

[293] We recognise that the price differential between MPF New Provide and MPF Stopped Line Provide will decrease during the 2 year control period given the different RPI-Xs these services would be subject to.
[294] November 2011 Consultation, paragraph 2.94.

November 2011 Consultation proposals

4.208 In the March 2011 Consultation, we proposed that LLU Bulk Migrations services should continue to be regulated within the MPF and SMPF ancillary services baskets.[295]

4.209 In response to the March 2011 Consultation, Sky asked that we individually charge control the MPF Bulk Migration services.[296] Sky said that Openreach can *"price services that are growing in demand in such a way as to generate greater profits than the charge controls would allow if volumes were in a* steady *state* [and] *BT retains the flexibility under Ofcom's proposals to earn excess returns and discriminate against individual operators (and their customers)".*[297]

4.210 In our November 2011 Consultation,[298] we noted that LLU Bulk Migration charges are intended to reflect the economies of scale achieved by multiple simultaneous engineering changes. Therefore, we consider it necessary to set an appropriate differential between the starting charges of single and bulk migration services.

4.211 However, we felt that individual charge controls for LLU Bulk Migrations were unnecessary as the levels of bulk migration are by necessity set in reference to LLU Single Migrations where individual charge controls apply.[299]

4.212 Our preferred option in the November 2011 Consultation was to set an aligned starting charge for the LLU Bulk Migration services which is equal to the aligned starting charge for the MPF Single Migration/SMPF Single Migration/Provide services less the difference between the MPF Single Migration/SMPF Single Migration/Provide and LLU Bulk Migration average 2011/12 CCA FACs costs, so that the difference in charges remain consistent with incremental cost differentials.[300]

4.213 We also noted in the November 2011 Consultation that we would expect that Openreach, when setting charges in the future, maintain an appropriate differential between the single and bulk migration charges, as long as this would not unduly constrain the basket flexibility.[301]

4.214 In the November 2011 Consultation we asked stakeholders the following questions:

Question 2.7: *Do you agree with our proposal to set an aligned starting charges of both the LLU Bulk Migration variants by creating a volume weighted average of both their 2011/12 CCA FACs, where we choose to align the MPF Singleton Migration and SMPF Singleton Migration/provide variants. If you do not agree please give you reasons.*

Question 2.8: *Do you agree that, in the event of an aligned single migration charge, we should set the starting charges of MPF and SMPF Bulk migration to set an aligned starting charge for both the LLU bulk migration charges which is equal to the starting charge for the single migration services less the difference between the single and bulk migration average 2011/12 CCA FACs costs. Or in the event that single migration charges are not aligned set starting charges equal to the single*

[295] See March 2011 Consultation, Annex 13, Annex to condition FAA4(A), Parts 1 and 2.
[296] Sky response to the March 2011 Consultation, paragraphs 6 to 9.
[297] Sky response to the March 2011 Consultation, page 2, paragraphs 8 to 9.
[298] November 2011 Consultation, paragraph 2.109.
[299] November 2011 Consultation, paragraph 2.104.
[300] November 2011 Consultation, paragraph 2.107.
[301] November 2011 Consultation, paragraph 2.109.

migration charge less their respective difference in single and bulk migration 2011/12 CCA FACs. If not please give your reasons.

November 2011 Consultation responses

4.215 Sky agreed with our preferred option, for consistency with, and for the reasons it gave for supporting our proposal to align MPF Single Migration and SMPF Single Migration/Provide (i.e. Sky said that "*the costs of these activities are similar; the incremental costs relating to the SMC function (where some cost differentials arise) are very low; there is a lack of clear explanation as to the drivers to the outstanding cost differentials*").[302]

4.216 TTG also agreed with our preferred proposal, noting that it was a "*targeted approach*". However, TTG went further than Sky, arguing that we should retain the differential for the remainder of the control, as Openreach may not do so.[303]

4.217 Telefonica UK asked for further explanation why, under the alternative proposal, "*the charge for bulk MPF migrations will be less than the bulk charge for SMPF* [bulk Migrations]" whereas Telefonica UK noted that the opposite is true in respect of MPF Single Migration and SMPF Single Migrations/Provide.[304]

4.218 EE "*agree*[d] *that LLU bulk migration charges should be set in reference to and consistently with the singleton migration charges*", but echoed Telefonica UK's view for clarification in relation to the alternative option (where MPF and SMPF variants are not aligned) which we had proposed in the November 2011 Consultation.

4.219 EE also added that if we accept its suggested counter-proposal for MPF Single Migration and SMPF Single Migration/ Provide, then we should adopt a consistent approach to LLU Bulk Migrations (base differential on LRIC rather than CCA FAC).[305]

4.220 Openreach disagreed with both our preferred and alternative proposals, arguing that they were unnecessary and impractical. Openreach said that it "*has a commercial incentive to maintain the price of the bulk variants of MPF Transfer and SMPF Migrations at an appropriate price*". Openreach also said that it "*does not support Option 1* [our preferred option] *as the bulk variant of MPF Transfer would similarly be below cost*".[306]

4.221 Finally, Openreach said that our proposals would have knock on effects on its wider portfolio and its ability to recover costs as "*bulk migration products have high prior year revenues, meaning that the initial start price adjustments have a significant impact in the first year of the basket. To achieve the overall revenue target for the basket, while implementing these significant price decreases, will require offsetting increases in the prices of other products in the basket – which will distort our pricing hierarchy*".[307]

Our response and conclusions

4.222 We note Openreach's comments that our proposals are unnecessary and impractical. With respect to whether our proposals are necessary, while we agree

[302] Sky response to the November 2011 Consultation, paragraph 25.
[303] TTG response to the November 2011 Consultation, paragraphs 30 to 31.
[304] Telefonica UK, paragraph 34.
[305] EE response to the November 2011 Consultation, Section 4.1, response to question 2.7.
[306] Openreach response to the November 2011 Consultation, Section 4.13, paragraphs 38 to 39.
[307] Openreach response to the November 2011 Consultation, Section 4.13, paragraphs 40 to 41.

that Openreach has a commercial incentive to maintain a differential between LLU Single and Bulk Migration services, we do not agree that it necessarily has the incentive to maintain an appropriate differential between the respective services. This is because it has the ability and incentive to price excessively certain services by virtue of its SMP.

4.223 However, we have considered the points raised by Openreach as to the wider knock-on effects. Our analysis confirmed Openreach's concerns that an immediate adjustment of the MPF Bulk Migration charges has a high a risk of unintended consequences to the MPF basket. In particular, such an adjustment would necessitate Openreach significantly raising the other charges in the basket as Openreach is required to adhere to the overall basket control.[308]

4.224 This impact is due to the revenue weight of MPF Bulk Migrations as a proportion of the respective overall MPF basket revenue weight, and the degree to which MPF Bulk Migrations would have to fall from their current prices to starting charges under our November 2011 proposals (i.e. from £35.83 for MPF Bulk Migration to £25.70 under our preferred proposal).[309] Thus Openreach would need to raise the prices of other basket services significantly in the first year of the charge controls.

4.225 While we do not consider the risk is as high with respect to the impact of starting price adjustments for SMPF Same CP Mass Migration on other SMPF basket services, we estimate that the impact of the adjustment to the MPF Bulk Migration starting price would mean that other MPF basket service starting prices would have be raised (on average) by approximately 28%.

4.226 We have considered whether to we could set a starting charge for MPF Bulk Migration at the overall RPI-X of the MPF ancillary services basket (i.e. RPI-9%). While this would prevent the unintended consequences that we have discussed above in paragraphs 4.223 to 4.224, we note that this would result in a 2012/13 starting charge MPF Bulk Migration which is only approximately £1 below the starting charge starting for MPF Single Migration.

4.227 As we noted in paragraph 4.222 above, we consider that Openreach has a commercial incentive to maintain a charge differential between LLU Single and Bulk Migration services. Accordingly, given the risk of unintended consequence of our intervention, we consider that BT is in a better position to structure an appropriate set of basket charges. Accordingly, we do not consider that it would be appropriate to implement either of our proposals, as set out in the November 2011 Consultation.

4.228 We note that the levels of LLU Bulk Migration are by necessity set in reference to LLU Single Migrations where individual charge controls apply, and that we have decided to set the LLU Single Migrations on a glidepath of RPI-11.3%, during the charge control period. This will mean that consumers of LLU Bulk Migration services will be afforded a level of protection during the control, given that Openreach has an incentive to keep LLU Bulk Migration prices lower than LLU Single Migrations, and LLU Bulk Migration services will have to fall during the control (though not to the same degree as we proposed in the November 2011 Consultation).

[308] Openreach response to the November 2011 Consultation, Section 4.13, paragraphs 40 to 41.
[309] We note that the impact based on current updated information, since the November 2011 Consultation publication, would also entail a high risk of similar unintended consequences, as set out in paragraphs 4.224 to 4.225.

4.229 We consider that retaining LLU Bulk Migrations in the respective MPF and SMPF baskets will allow Openreach more flexibility to restructure LLU Bulk Migration prices, by reference to the LLU Single Migration services, than if we set a separate charge control.

LLU Expedite Connection services

4.230 LLU Expedite Connection services allow CPs to expedite LLU New Provide services. This allows CPs to respond more flexibly to customer needs. We note that there are differences in engineering effort in the standard SMPF New Provide and MPF New Provide services available for expediting; and as with services which require re-prioritising of work there are also differences in the opportunity cost of providing such an expedite service.

March 2011 Consultation proposals

4.231 In the March 2011 Consultation, we proposed that the MPF Expedite Connection service and SMPF Expedite Connection services should be charge controlled in the respective MPF and SMPF baskets.[310]

4.232 In doing so we considered that pricing regulation was appropriate for these services and noted that currently MPF Expedite Connection is charge controlled in the MPF ancillary services basket, but SMPF Expedite connection is not charge controlled in the SMPF ancillary services basket, and so our proposal would ensure consistency. We also considered that any market driven constraint on the charges of LLU Expedite Connections from the standard LLU New Provide services is likely to be weak.[311]

4.233 We considered that a basket, instead of separate controls, was an appropriate form of price regulation, given that these are low volume services and not core migration services (unlike MPF and SMPF New Provide, for example).[312]

4.234 In the March 2011 Consultation, we asked stakeholders the following question:

> ***Question 4.18:*** *Do you agree that both MPF and SMPF expedited connections should be charge controlled within the MPF and SMPF ancillary services baskets?*

March 2011 Consultation responses

4.235 Openreach said that the LLU Expedite Connections should not be subject to a cost orientation obligation or a charge control. Openreach argued that these remedies were inappropriate, given that LLU Expedite Connection service are discretionary "*value added proposition*[s]".[313] Openreach also argued that our proposals were inconsistent with March 2011 Consultation proposals for LLU Enhanced Care services (where we proposed to remove cost orientation and rely on a market driven constraint), and argued that MPF Expedite Connections were included in error in 2009 Openreach Financial Framework Statement so these services should not be regulated in this LLU charge control.[314]

[310] March 2011 Consultation, paragraphs 4.131 to 4.138.
[311] March 2011 Consultation, paragraphs 4.139 to 4.140.
[312] March 2011 Consultation, paragraphs 4.141.
[313] Openreach response to the March 2011 Consultation, paragraph 4.11.
[314] Openreach response to the March 2011 Consultation, paragraphs 4.09 to 4.12.

4.236 C&WW agreed with our proposals but thought that SFI services were more important for consumers and should be charge controlled if we decided to impose a charge control on LLU Expedite Connection services.[315]

Our response and conclusions

4.237 As proposed in our March 2011 Consultation,[316] we have decided that MPF Expedite Connection and SMPF Expedite Connection services should be subject to the MPF and SMPF (respectively) ancillary services basket charge controls. We consider that a basket control is an appropriate and proportionate intervention.

4.238 We have taken note of Openreach's comment that LLU Expedite Connection services are discretionary, however, given that LLU Expedite Connection services are not contestable (i.e. they are supplied on Openreach's network and therefore can not be offered by other CPs or third parties) we do not consider that LLU Expedite Connection services are discretionary.

4.239 We also do not consider that our proposals set out in the March 2011 Consultation (or our decision in this Statement) are inconsistent with the position we have adopted in relation LLU Enhanced Care services, or that our decision is disproportionate. We discuss LLU Enhanced Care services in paragraphs 4.386 to 4.403 below. In reaching our conclusion, we note that while volumes are currently quite low, we consider that a charge control and the general remedies (imposed following the WLA 2010 Market Review) are appropriate given LLU Expedite Connection services can affect switching behaviour, and in turn the competitive conditions in the market. We also have not seen any robust evidence that there is a market driven constraint between the standard LLU New Provide services and LLU Expedite Connection services, as there is for LLU Enhanced Care services.

Alignment of charges for ancillary MPF and SMPF baskets services

LLU Expedite connection services

4.240 As explained above in paragraph 4.230 LLU Expedite connection services allow CPs to expedite LLU New Provide services,[317] which allows CPs to respond more flexibly to their customer needs. We note that there are differences in engineering effort in the standard SMPF New Provide and MPF New Provide services available for expediting; and as with services which require re-prioritising of work there are also differences in the opportunity cost of providing such an expedite service.

March 2011 Consultation proposals

4.241 In the March 2011 Consultation we proposed not to align (i.e. not to set at the same level) the charges for MPF Expedite connection and SMPF Expedite connection over the course of the charge controls, or to narrow the price differential by the amount of the differential in price between standard MPF New Provide and SMPF New Provide services in the first year of the LLU charge control.[318]

[315] C&WW response to the March 2011 Consultation, page 26.
[316] March 2011 Consultation, paragraphs 4.131 to 4.138.
[317] We do not consider that Expedite connections are used to expedite LLU Single Migrations, as argued by TTG. This was confirmed in emails between Ciaran MacCann (08 November 2011) and Elizabeth Carlile Openreach (09 November 2011).
[318] March 2011 Consultation, paragraphs 4.84 to 4.89.

4.242 We explained in the March 2011 Consultation that we had been unable to estimate the LRIC costs (but noted that there is likely to be some difference in activity between the LLU Expedite connection variants) and the volumes of the LLU Expedite services are low. We went on to note that the standard LLU New Provide variant (i.e. MPF New Provide and SMPF New Provide) charges are not aligned.

4.243 Accordingly, we considered that it was unnecessary to align the charges for LLU Expedite connection service charges. We also proposed not to align the differential between the LLU Expedite connection services, and the corresponding standard LLU New Provide variant charges.

4.244 We also said in the March 2011 Consultation that we were proposing to put both MPF Expedite connection and SMPF Expedite connection in their respective MPF and SMPF ancillary service baskets, noting that this would provide a degree of protection for consumers.[319]

4.245 We provided the following information on charges in the March 2011 Consultation.

Figure 4.6: Standard LLU New Provide charges and Expedite connection service charges (reproduced from Figure 4.4 in the March 2011 Consultation)

(Note that the prices listed are not current)

	LLU New Provide	**LLU Expedite connections**
MPF	£62.11	£158.40
SMPF	£38.64	£103.20
MPF/SMPF price difference	£23.47	£55.20

4.246 In the March 2011 Consultation, we asked stakeholders the following question:

> ***Question 4.6:*** *Do you agree that we should not align or intervene to narrow the differential in charges for MPF and SMPF Expedite connections?*

March 2011 Consultation responses

4.247 Both Openreach[320] and C&WW[321] agreed that we should not align LLU Expedite connection variants or narrow the differential between these services.

4.248 GC said "*that the installation of SMPF facilities is inherently more complex and hence should be more expensive to supply than the MPF variant*".[322]

4.249 On the other hand, TTG considered that we should align the two LLU Expedite connection variants and that the price should be based on an average of both MPF and SMPF variants. TTG disagreed with our analysis on the basis that the standard LLU New Provide variants are not aligned, noting that *"Ofcom's approach to alignment of expedite services seems to be based on a misunderstanding of the MPF connection activity. It appears (given the activity described) that the expedite service refers to connection activity (e.g. MPF connection or SMPF connection) [i.e. MPF*

[319] March 2011 Consultation, paragraph 2.39.
[320] Openreach to the March 2011 Consultation, paragraph 2.84.
[321] C&WW response to the March 2011 Consultation, page 22.
[322] GC response to the March 2011 Consultation, page 5.

and SMPF Single Migration charges] not a new provide activity i.e. the provision of a new line".[323]

November 2011 Consultation proposals

4.250 In the November 2011 Consultation (having reviewed stakeholder responses to the March 2011 Consultation) we explained that we considered that our March 2011 Consultation proposal was appropriate and proportionate. However, we noted that since we were consulting further on the remaining aspects of our approach to alignment of services in the MPF and SMPF baskets (i.e. on LLU Singleton Jumper removals and the alignment of charges in the baskets more generally) we considered that it was appropriate to invite further comments on our March 2011 Consultation proposals with respect to LLU Expedite connections.[324]

4.251 In the November 2011 Consultation, we proposed to maintain our March 2011 Consultation proposals not to align or narrow the differential between these services. In doing so we reiterated the reasons set out in the March 2011 Consultation, and also noted that LLU Expedite Connection services require re-prioritising of work meaning there are also likely differences in the opportunity cost of providing such services.[325] However, we invited further comments from stakeholders on this proposal and asked stakeholders the following question in the November 2011 Consultation:

Question 2.10: *Do you agree that we should not align or intervene to narrow the differential in charges for MPF and SMPF expedite?*

November 2011 Consultation responses

4.252 Telefonica UK and Openreach supported our proposal.

4.253 C&WW revised its view from that provided in response to the March 2011 Consultation, explaining that it was against our proposal on the basis of a "*huge differential between the services.* C&WW said that Ofcom *"should seek to reduce difference / align the charges*".[326]

4.254 TTG reiterated its view from the March 2011 Consultation[327] that LLU Expedite connection services can be used for MPF and SMPF Single Migrations (as well as LLU New Provides and MPF Stopped Line Provide services). TTG also said that the LLU Expedite connection charges are "*excessive*", and while it may not be appropriate to align their charges, we should ensure that the "*price differential in expedite variants is consistent with the price differential in the standard variants*". TTG set out two methods we could use to implement this suggestion (one where the MPF Expedite differential is same as the absolute difference between current standard MPF New Provide/Stopped Line provide charges, and the other where the MPF Expedite differential is same as the percentage difference between current standard MPF New Provide/Stopped Line provide charges).

[323] TTG response (July 2011) to the March 2011 Consultation, paragraph 4.47.
[324] March 2011 Consultation, paragraph 2.39.
[325] March 2011 Consultation, paragraph 2.31.
[326] C&WW response to the November 2011 Consultation, page 8, response to question 2.10.
[327] TTG response to the November 2011 Consultation, paragraph 33.

Our response and conclusions

4.255 As we explained in the March 2011 Consultation and the November 2011 Consultation, the SMPF and MPF Expedite connection services are substantially different services, as they provide enhanced engineering support for the provision of SMPF New Provide and MPF New Provide (and not MPF Single Migration and SMPF Single Migration as suggested by TTG), which are significantly different services in terms of planning, capital and engineering effort.[328]

4.256 Accordingly, there is no case for an alignment of the service charges given that it would not be consistent with the underlying costs.

4.257 We note that it is difficult to estimate the cost of LLU Expedite connection services for two main reasons. Firstly, the low volumes associated with these services make the allocation of costs difficult and secondly, the primary cost for expediting a service is the opportunity cost with respect to the other activities the engineer may otherwise be engaged in.

4.258 Nevertheless, we would expect that the differential in the MPF Expedite connection and SMPF Expedite connection charges to be broadly consistent with the differential in the charges for the underlying standard MPF New Provide and SMPF New Provide, as we consider that this would reflect the opportunity cost difference in terms of engineering time. We note that the percentage difference between the LLU Expedite connection services is broadly consistent with the percentage difference between the standard LLU New Provide services (SMPF Expedite connection charge is 62% of the charge of SMPF New Provide, MPF Expedite charge is 68% of the charge of MPF New Provide), which suggests that there is no basis for a resetting of the charge differentials.

4.259 While we do not consider that there is a basis for a specific adjustment of the MPF and SMPF Expedite connection charges, we consider that it is appropriate to include these charges in the respective MPF and SMPF ancillary services baskets (see paragraphs 4.237 to 4.239). We consider that this will ensure that Openreach is constrained in setting the LLU Expedite Connection charges and the net outcome across all MPF and SMPF ancillary services are in line with regulated returns.

4.260 Accordingly, in light of stakeholder comments and our response above, we have decided not to align or intervene to narrow the differential in charges for MPF and SMPF Expedite Connection services.

LLU Singleton and Bulk Jumper removal services

4.261 LLU Singleton Jumper removal services are used by CPs when they require Openreach physically to disconnect cabling they use to connect a copper line to their equipment. This is normally done when the CP needs space for other services or Openreach requires the CP to rationalise the frame space that the CP uses. Where a CP wishes to disconnect a service but is content to leave the cabling in place they would normally only use a LLU Cease service (i.e. a record only transaction).

March 2011 Consultation proposals

4.262 In the March 2011 Consultation, we noted that LLU Singleton Jumper charges are passed onto consumers and, therefore, any differential in the prices for MPF and

[328] November 2011 Consultation, paragraph 2.130.

SMPF variants would potentially have an impact on the competitive position between those services.[329]

4.263 We also said that we would be concerned if SMPF customers faced higher barriers to switching (which do not relate to the underlying costs of the service) than MPF customers.[330] We also noted that the physical difference between SMPF Singleton Jumper removal and MPF Singleton Jumper removal is that SMPF Singleton Jumper removal requires one jumper provision whereas MPF Singleton Jumper removal does not.[331]

4.264 Accordingly, we proposed to align the starting charges for MPF Single Jumper removal and SMPF Singleton Jumper removal services on a weighted average of current prices of the two variants.

4.265 The CCA FAC and price information which we set out in the March 2011 Consultation is reproduced below:

Figure 4.7: LLU Singleton Jumper removals (reproduced from Figure 4.6 in the March 2011 Consultation)

	LLU Singleton Jumper removal	
	MPF	**SMPF**
Price	£16.80	£29.89
Volume	77,000	415,000
FAC (2010/11)	£26.85	£29.22
Weighted average price	£27.85	
Weighted average FAC	£28.85	

March 2011 Consultation responses

4.266 Openreach agreed with our proposals for LLU Singleton Jumper removals.

4.267 TTG said that there were benefits to alignment even where costs are dissimilar, and felt we should retain alignment throughout the duration of the charge control (and not just align the starting charges).[332]

4.268 C&WW also agreed that we should align the MPF Singleton Jumper removal and SMPF Singleton Jumper removal services, arguing that the difference in the current price between the two services is not reflective of the difference in the underlying activity (i.e. one jumper provision). [333]

4.269 However, C&WW disagreed with a weighted average approach to implementing the alignment, noting that the SMPF Single Migration charge was already too high. C&WW argued that the MPF Singleton Jumper removal price should not increase, as we have not suggested it is being provided below cost, and suggested that we should either align the SMPF Singleton Jumper price to the MPF Singleton Jumper removal

[329] March 2011 Consultation, paragraph 4.90.
[330] March 2011 Consultation, paragraph 4.90.
[331] March 2011 Consultation, paragraph 4.91.
[332] TTG response (July 2011) to the March 2011 Consultation, paragraph 4.66.
[333] C&WW response to the March 2011 Consultation, page 23.

price, or we should moderately increase the SMPF price to account for additional activity.[334]

4.270 In contrast, both GC and EE disagreed with our approach. GC said we should not align MPF Singleton Jumper removal and SMPF Singleton Jumper removal services arguing that "*the situation is inherently more complex for SMPF*".[335] Similarly, EE argued that we had identified more activity being required for SMPF than an MPF jumper removal and that "*from a cost causation perspective, it would seem that some difference in price is objectively justified*".[336] EE also noted that this may encourage inefficient switching from SMPF to MPF providers.

November 2011 Consultation proposals

4.271 In light of comments received from stakeholders in response to the March 2011 Consultation we carried out further analysis. In particular, we considered in more detail whether, in the March 2011 Consultation, we attached too little weight to the physical differences between the MPF and SMPF variants and also re-considered the CCA FAC information provided for these variants.

4.272 We set out our analysis in the November 2011 Consultation. We considered that the difference in the prices between MPF and SMPF variants that we set should be broadly reflective of the relevant LRIC of providing these MPF and SMPF variants. However, we noted in the November 2011 Consultation that we did not have precise LRIC costs for these services and as such, we assessed what activities are required to provide the LLU Singleton Jumper Removal services and checked the CCA FAC costs against these. We also explained that the CCA FAC information indicates that the difference in CCA FAC allocated between the MPF and SMPF variants is due to more jumpering work being required for the SMPF variant, than the MPF variant. Given that we identified that the difference in underlying activity required between the services is also due to jumpering we considered that the CCA FACs provide a reasonable estimate of the difference in the underlying costs of providing these services.

4.273 In light of this analysis, we proposed to set the starting charges of both MPF Singleton Jumper removal services and SMPF Singleton Jumper removal services to their respective 2011/12 CCA FACs as set out in Figure 4.8 below:

Figure 4.8: LLU Singleton Jumper removal current prices and proposed starting charges (reproduced from Figure 2.13 in the November 2011 Consultation)

	Jumper removal	
	MPF	**SMPF**
Current prices	£17.30	£30.78
1 April 2012 Starting Charges (2011/12 CCA FACs)	£25.40	£27.70

4.274 In the November 2011 Consultation, we asked stakeholders the following question:

Question 2.11: *Do you agree that we should set the starting charges of both MPF and SMPF Singleton Jumper removals to their respective 2011/12 CCA FACs.*

[334] C&WW response to the March 2011 Consultation, page 23.
[335] GC response to the March 2011 Consultation, page 5.
[336] EE response to the March 2011 Consultation, page 16.

November 2011 Consultation responses

4.275 Sky agreed with our proposal, given that *"there is additional jumpering activity required for SMPF Jumper Removal"*. In furthering its argument to support our proposal Sky also noted that "*were prices to be aligned, and given that the proposed basket control for SMPF Ancillary services requires aggregate prices to fall more quickly than for the MPF Ancillary service basket, then the result would be that at the end of the charge control period the MPF Jumper Removal price could be higher than the SMPF Jumper Removal price, even though its cost is lower and its price today is lower still*".[337]

4.276 EE and Telefonica UK[338] both also agreed with our proposal. EE agreed "*for the same reasons as set out in* [its] *original response to the* [March 2011] *Consultation*" (see paragraph 4.270 above).[339]

4.277 Openreach agreed with our proposal, but noted that if we implement this proposal then we "*must also introduce a starting price increase for the bulk variants to ensure an appropriate price/cost differential is maintained"*. Openreach proposed starting prices of £21.25 and £23.18 for MPF and SMPF Bulk Jumper removal services respectively.[340]

4.278 In respect of our proposal, TTG said that "*Ofcom has proposed that prices should be set to reflect the cost differential between the two services i.e. a 'differential obligation'. We agree with this proposal with two notable provisos* […] *the 'differential obligation' should apply in 2013/14,* [and the MPF and SMPF Single Jumper removal charge differential] *should assume the use of single jumpering for MPF (rather than double jumpering which is implicit in the current costs)"*.[341]

4.279 C&WW did not support our proposal arguing that it "*do*[es] *not support a rise to the MPF charge of this magnitude. CWW is supportive of alignment when this results in the SMPF charge being brought down toward the £16.80 mark rather than the MPF charge being increased to align with the SMPF charge"*.[342]

Our response and conclusions

4.280 We have taken note TTG's comment that we should also set charges for the second year of the control (2013/14), but we do not consider that this is necessary. We consider that setting prices in the MPF and SMPF ancillary services baskets beyond the first year may unduly reduce Openreach's flexibility. We also do not consider that prices should be based on use of Single Jumpering (we set our approach to single jumpering in Annex 9).

4.281 We also note C&WW's comment that MPF Singleton Jumper removal prices should not be raised and should be maintained at the current level. However, we consider that the CCA FAC information (which our proposed charges are based on) better reflect the costs incurred.

[337] Sky response to the November 2011 Consultation, paragraphs 28 to 29.
[338] Telefonica UK response to the November 2011 Consultation, paragraphs 39 to 40.
[339] EE response to the November 2011 Consultation, page 12.
[340] Openreach response to the November 2011 Consultation, Section 4.3, paragraph 45.
[341] TTG response to the November 2011 Consultation, paragraphs 44 to 46.
[342] C&WW response to the November 2011 Consultation, page 8, response to question 2.11.

4.282 As part of our approach to LLU Bulk Migration services (see paragraph 4.224) we considered that an immediate adjustment to the MPF Bulk Migration charge has too high a risk of unintended consequences to the MPF basket. In relation to LLU Bulk Migration services, we said that such an adjustment would leave limited scope for Openreach to adjust other charges in the basket appropriately, due to the requirement to adhere to the overall basket control.

4.283 However, we do not consider that this risk applies with respect to the LLU Singleton Jumper removals. This is because both MPF and SMPF Singleton Jumper removal revenue weights as a proportion of the respective MPF and SMPF baskets will leave Openreach with sufficient scope to adjust the other charges in the basket appropriately and to adhere to the overall basket control.

4.284 Therefore, in the light of the consultation responses received and our response above, we have decided to implement our proposal set out in the November 2011 Consultation; that is, to set starting charges for both MPF and SMPF Singleton Jumper removals at their respective 2011/12 CCA FACs.

Figure 4.9: Starting charges (and current prices) for LLU Singleton Jumper removal services.

	MPF Singleton Jumper Removal	SMPF Singleton Jumper Removal
Current prices	£17.30	£30.78
New starting charges (1 April 2012)	£25.81	£28.15

4.285 Openreach also argued that we "*must also introduce a starting price increase for the bulk variants to ensure an appropriate price/cost differential is maintained*".[343] Openreach's method of calculating the price differential was to create a volume weighted average of MPF and SMPF Singleton Jumper removal charges and a volume weighted average for MPF and SMPF Bulk Jumper removal charges, and then apply the resulting differential to create a starting price adjustment for LLU Bulk Jumper removal charges.

4.286 After careful consideration, we recognise that there should be an appropriate price differential between the LLU Singleton Jumper removal and LLU Bulk Jumper removal services, to maintain an appropriate price differential between these respective Singleton and Bulk services.

4.287 Accordingly, in order to set an appropriate differential between these services we have decided to set starting charges for the MPF Bulk Jumper removals and SMPF Bulk Jumper removal services.

4.288 However, as can be seen from the Figure 4.10 below, we disagree with Openreach's suggested method of calculating the price differential (as described above in paragraph 4.285). Firstly, this is because its suggested price differential is based on an aligned volume weighted average of MPF Bulk Jumper removal and SMPF Bulk Jumper removal charges, which is not consistent with the approach we have adopted in relation to Singleton charges (i.e. we have set separate charges). Secondly, we

[343] November 2011 Consultation, paragraphs 45 to 47.

consider that our charges will have a slightly lower risk of any unintended consequences on the ancillary services baskets than Openreach's proposed prices (i.e. the risk of having to significantly change the first year price of other products in the MPF and SMPF baskets to offset these price changes in order to comply with the overall revenue target for the baskets).

4.289 While we do not have CCA FAC information for the MPF Bulk Jumper removals and SMPF Bulk Jumper removal services, we consider that the current absolute differences in price between the Singleton and Bulk products of the MPF and SMPF variants would be an appropriate measure of the minimum differential between our new starting charges for LLU Singleton Jumper removals and the Bulk products, given Openreach's interest in structuring the differential to encourage bulk orders.

4.290 Accordingly, we have decided to set starting charges for MPF and SMPF Bulk Jumper removals as set out in Figure 4.10 below:

Figure 4.10: Starting charges (and current prices) for LLU Singleton and LLU Bulk Jumper removal services.

	MPF Singleton Jumper Removal	MPF Bulk Jumper Removal	SMPF Singleton Jumper Removal	SMPF Bulk Jumper Removal
Current prices	£17.30	£11.12	£30.78	£25.62
New starting charges (1 April 2012)	£25.81	£19.63	£28.15	£22.99

4.291 We consider that both MPF Bulk Jumper removal and SMPF Bulk Jumper removal revenue weights as a proportion of the respective MPF and SMPF baskets will leave Openreach with sufficient scope to adjust the other charges appropriately in the basket, to adhere to the overall basket control. We consider that this approach we adopt will allow Openreach to recover its efficiently incurred costs.

Options for aligning other MPF and SMPF basket service charges during the period of the charge control

4.292 We now set our approach with respect to whether we should align the remaining charges in the MPF and SMPF baskets.

4.293 These services are:

- Tie Pair Modification (3 working day lead time Re-termination);
- Tie Pair Modification (Multiple Re-termination);
- Order rejected at initial validation, Order rejected at detailed validation and Order returned for Amendment;
- Cancellation of orders for Migration, Modification or Amend;
- Amend Orders;

- Standard Line Test; and
- Network RWT.

March 2011 Consultation proposals

4.294 In the March 2011 Consultation we proposed to align (i.e. to set charges to the same level) equivalent service charges at the beginning of the charge control (but not to impose further alignment during the control). In the March 2011 Consultation we considered options for aligning other basket services (that we considered were equivalent), in addition to our proposals on LLU Jumper removal and LLU Expedite connection services.[344]

4.295 We also explained in the March 2011 Consultation that we wanted to prevent competitive distortions and ensure price transparency. In doing so we noted that, as a consequence, we would not want to increase the complexity of the baskets or reduce Openreach's flexibility to adjust prices efficiently.[345]

4.296 In the March 2011 Consultation, we then set out the following options for aligning services in the MPF and SMPF ancillary services baskets, on which we invited comments (see paragraphs 4.93 to 4.95):

- 'Option 1' - to align equivalent services at the beginning of the charge control (but not impose further alignment throughout the controls);
- 'Option 2' - ensure that similar charges are aligned for the duration (including the start) of the charge controls using sub-caps or an alignment obligation; or
- 'Option 3' - merge each pair of similar charges into a single service and put each merged single service into a single basket.[346]

4.297 In the March 2011 Consultation, we indicated that we were minded to pursue Option 1 as we considered that this would reduce any distortion at the start of the charge control, would be simple to implement and would not unnecessarily limit Openreach's flexibility to set prices. We proposed to reject Option 2 largely on the basis that it would add complexity to the controls and also Option 3 largely on the basis that it could introduce the risk of gaming by Openreach.

4.298 In the March 2011 Consultation, we asked stakeholders the following question:

> ***Question 4.9:*** *Do you agree that option 1, that is ensuring alignment of similar charges at the beginning of the charge control period but not imposing any further obligation on Openreach to keep charges aligned, is the most appropriate and proportionate way to avoid competitive distortion caused by misalignment of prices?*

March 2011 Consultation responses

4.299 All stakeholders who responded to our March 2011 Consultation disagreed with our proposal, but were broadly in favour of some form of alignment (i.e. they had different views on how we should implement this and over what duration of the charge control period we should align the services).

[344] March 2011 Consultation, paragraphs 4.93 to 4.95.
[345] March 2011 Consultation, paragraph 4.93.
[346] March 2011 Consultation, paragraph 4.94.

4.300 EE was uncertain as to what other basket services (beyond Jumper removals and Expedite connections) were in the scope of this proposal,[347] but noted that where there are no relevant differences in the activities between the LLU variants, EE was content that we align the services which are not already aligned.[348]

4.301 Openreach agreed with aligning similar services, in principle, and agreed with Option 1. However, Openreach wanted us to align the "*bulk* variants *of the MPF and SMPF jumper removal order products*" and noted a concern that because the baskets have different Xs and the inertia clause range which we proposed does not provide sufficient flexibility, it would not be able to maintain alignment of similar products during the charge control period (i.e. rejected, amended or changed orders; or standard line tests).[349]

4.302 TTG disagreed with our proposal (Option 1). TTG argued that we should retain alignment for the duration of the control, if we are proposing to align at the start of the control. TTG proposed that we could, either:

- introduce individual charge controls on similar services and then create an aligned starting charge for these services that would glide to an average FAC CCA in 2013/13 (TTG considered that "*no specific alignment obligation is required*"); or

- for services that are not charge controlled, we could create an obligation that aligns the services throughout the charge control, but which allows Openreach flexibility to set the prices of the services within the basket constraints.[350]

4.303 C&WW wanted "*a simple obligation to keep charges aligned within a percentage range"*.[351]

4.304 GC supported Option 2.[352]

November 2011 Consultation proposals

4.305 After reviewing responses to the March 2011 Consultation, we explained in the November 2011 Consultation that we considered that we may have been unclear as to our intentions with regard to aligning such changes. We noted that there are a number of other services in the MPF and SMPF ancillary services basket (see paragraph 4.293 for these services) which have equivalent description (e.g. there is a Standard Line Test service in both MPF and SMPF ancillary services baskets), but that such descriptions can often mask significant differences in activity.[353] We also explained that we considered that it would be useful to re-visit our broader approach

[347] Specifically, EE referred to the services in Figure 4.2 of the March 2011 Consultation (page 54) as those which EE thought we were considering. These services included Expedited connections, MDF remove jumper/hard cease, Tie pair modifications (next day working, re-termination), Tie pair modifications (multiple re-termination), Tie pair modifications (3 working day lead time re-termination), Bulk migration, Connections and transfers, Cancellation of orders, Amend order, Standard line test and RWT.
[348] EE response to the March 2011 Consultation, page 17.
[349] Openreach response to the March 2011 Consultation, paragraphs 392 to 394.
[350] TTG response (July 2011) to the March 2011 Consultation, 429 to 435.
[351] C&WW response to the March 2011 Consultation, page 23.
[352] GC response to the March 2011 Consultation, page 6.
[353] November 2011 Consultation, paragraph 2.164.

to alignment given that we had re-visited our approach to alignment for LLU Singleton Jumper removals and LLU Expedite connections.[354]

4.306 After further consideration of the issues, in the November 2011 Consultation we proposed to revise our proposal set out in the March 2011 Consultation and not align the remaining MPF and SMPF basket service charges.

4.307 In reaching the revised proposal set out in the November 2011 Consultation, we explained that no alignment obligation is necessary for the services (set out in paragraph 4.308 below) given that we consider that they either do not have a material impact on competition and/or, are likely to be aligned when we start the charge control and/or there is no CCA FAC information available, and so any meaningful alignment obligation would not be practical.[355]

4.308 In particular, the services referred to in paragraph 4.307 above included:

- Tie Pair Modification (3 working day lead time Re-termination);
- Tie Pair Modification (Multiple Re-termination);
- Bulk Jumper removal order charge;
- Order rejected at initial validation and Order rejected at detailed validation, Order returned for Amendment;
- Cancellation of orders for Migration, Modification or Amend;
- Amend Orders;
- Standard line test; and
- Network RWT.

4.309 In the November 2011 Consultation, we also said that as we were not aligning LLU Singleton Jumper removal order services there is no basis for aligning LLU Bulk Jumper removal order charges.[356]

4.310 In the November 2011 Consultation, we asked stakeholders the following question:

Question 2.12*: Do you agree that we should not align (at any point of the charge control) the SMPF and MPF services set out in paragraph 2.177?*

November 2011 Consultation responses

4.311 Sky agreed with our proposal arguing that "[g]*iven the relative unimportance of these services, alignment may not be proportionate at this time. The basket control with a tight inertia clause could be sufficient in preventing BT from making excessive returns*".[357]

[354] November 2011 Consultation, paragraph 2.177.
[355] November 2011 Consultation, paragraph 2.177.
[356] November 2011 Consultation, paragraph 2.179.
[357] Sky response to the November 2011 Consultation, paragraph 31.

4.312 C&WW agreed with our *"rationale that these services are not sufficiently material. The next charge control review should again examine the situation"*.[358]

4.313 Openreach agreed with our proposal noting that *"most of the prices of these products are already aligned and we can see no reason for additional controls to be put in place to ensure alignment over the control period"*.[359]

4.314 EE said "*we agree with Ofcom's proposal that bulk jumper removals should not be aligned, for the same reasons that we agree that LLU Singleton Jumper removals should not be aligned"*. However, EE noted that in relation to the other services listed in paragraph 2.178 of the November 2011 Consultation,[360] EE considered that there was insufficient information for EE to provide a definitive view regarding alignment.[361]

Our response and conclusions

4.315 We note that all stakeholders broadly agreed with our proposals. Therefore, in light of consultation responses received and for the reasons set out in the November 2011 Consultation,[362] we have decided that we should not align (i.e. not set equal) the SMPF and MPF basket service charges set out in paragraph 4.317 below.

4.316 Specifically, we have decided that that no alignment obligation is necessary for these services (set out in paragraph 4.317 below) given that we consider that they either, do not have a material impact on competition and/or, are likely to be aligned when we start the charge control and/or, there is no CCA FAC information available, and so any meaningful alignment obligation would not be practical. We note that we have separately set out our approach to how we should regulate LLU Bulk Jumper removal order services in paragraphs 4.285 to 4.291 above, and LLU Bulk Migration services in paragraphs 4.223 to 4.229 (we note that we have also decided not to align these services during the charge control).

4.317 We have therefore decided that the we should not align the following services during the charge control period:

- Tie Pair Modification (3 working day lead time Re-termination);
- Tie Pair Modification (Multiple Re-termination);
- Order rejected at initial validation and Order rejected at detailed validation Order returned for Amendment;
- Cancellation of orders for Migration, Modification or Amend;
- Amend Orders;
- Standard line test; and
- Network RWT.

[358] C&WW response to the November 2011 Consultation, page 8, response to question 2.12.
[359] Openreach response to the November 2011 Consultation, Section 5, paragraph 71.
[360] Specifically, Tie Pair Modification (3 working day lead time Re-termination);Tie Pair Modification (Multiple Re-termination); Order rejected at initial validation and Order rejected at detailed validation Order returned for Amendment; Cancellation of orders for Migration, Modification or Amend; Amend Orders; Standard line test; and Network RWT.
[361] EE response to the November 2011 Consultation, Section 4.1, response to question 2.12.
[362] November 2011 Consultation, Section 2, Paragraphs 2.176 to 2.179.

Other LLU ancillary services

4.318 In the March 2011 Consultation we explained how we proposed to treat other LLU ancillary services (i.e. whether these services should be in the scope of the charge control or not).[363]

4.319 We decided to review the rest of the services (Low volume ancillary services, TRCs, SFIs, electricity service charges, Enhanced Care services) in response to specific concerns raised by stakeholders in the March 2011 Consultation.[364]

4.320 In summary, we have decided, that:

- where TRCs are reasonably necessary for the use of LLU services, TRCs should remain subject to the general remedies set out in the WLA 2010 Market Review (see paragraphs 4.322 to 4.342);

- where SFI2[365] services are reasonably necessary for the use of LLU services, SFI2 services should be subject to the general remedies set out in the 2010 WLA market review. We will also maintain the current alignment of MPF and SMPF SFI2 service charges (i.e. to keep service charges equal); (see paragraphs 4.343 to 4.369);

- electricity should remain outside the scope of the LLU charge control, but remain subject to general remedies set in the 2010 WLA market review, where reasonably necessary for the use of LLU services; (see paragraphs 4.370 to 4.385);

- LLU Enhanced Care service charges should be aligned with WLR Enhanced Care Services charges over the duration of the charge control period. Accordingly, the cost orientation general remedy would then not apply to LLU Enhanced Care services; (see paragraphs 4.386 to 4.403);

- the low volume products will remain in the Co-Mingling ancillary services basket; (see paragraphs 4.404 to 4.409);and

- we will provide guidance to industry regarding new services (i.e. a product or service wholly or substantially in substitution for that existing product or service that is included within the scope of the LLU / WLR charge control) introduced by Openreach during the period of the LLU / WLR charge control (see paragraphs 4.18 to 4.130);

4.321 We also discuss an issue raised by Openreach regarding overlapping regulation with respect to the services in the Co-Mingling ancillary services basket between this LLU charge control and those in place for Leased Line services.

[363] Specifically, low volume ancillary services, TRCs, SFIs, Electricity service charges, Enhanced Care services. Note that we have set out our response to charge controlling LLU Expedite connection services in paragraphs 4.237 to 4.239 above.
[364] Note that we have set out our response to charge controlling LLU Expedite connection services in paragraph 4.237 to 4.239 above.
[365] We note that the SFI services which were replaced by SFI2 no longer exist and are not subject to any regulation.

TRCs

4.322 TRCs are related to the provision of additional services where the work is not covered within Openreach service level agreements.[366] TRCs are provided across Openreach's portfolio of products and not just for LLU services. These are charged on a per visit or per hour cost of an engineer's visit. TRC charges can vary depending on when the work takes place – i.e. weekday, business hours, outside normal business.

March 2011 Consultation proposals

4.323 We proposed in the March 2011 Consultation that LLU TRCs should remain outside the scope of the charge control, but remain subject to general remedies set out in the WLA 2010 Market Review where they are reasonably necessary for the use of LLU services. In the March 2011 Consultation, we noted that while LLU TRCs may to some extent be contestable, it is debatable how far some CPs are practically able to use alternative suppliers to Openreach.[367]

4.324 We also considered that separate reporting arrangements for TRCs in Openreach's regulatory accounts would not be appropriate or proportionate. This is because it would be difficult from a practical perspective to identify whether each provision of a TRC was supplied in the WLA market, because TRCs are also levied in other markets. We also considered that the structure of the charges (which are charged on a per visit or per hour of engineer time basis) provides enough information for CPs to assess whether charges are reasonable and cost-orientated.[368]

4.325 Finally, we recognised that further guidance on the application of cost-orientation due to take place in our forthcoming Cost Orientation and Regulatory Reporting review may be helpful to CPs.[369]

4.326 We asked stakeholders the following question in the March 2011 Consultation:

> ***Question 4.14****: Do you agree that time-related charges should remain out of the scope of the charge control and subject to general remedies applied in the WLA market review?*

March 2011 Consultation responses

4.327 Openreach agreed that TRCs should not be charge controlled. Openreach explained that these services are provided across different markets (e.g. Leased Lines), and so would be complex to control, are contestable, and "*are used for activities outside-of-the-normal*".[370]

4.328 EE supported further consideration of TRCs in the forthcoming cost orientation review.[371]

4.329 However, both TTG and Sky disagreed that TRCs should remain outside the scope of the LLU charge control. Both Sky and TTG proposed that we charge control TRCs

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[366] http://www.openreach.co.uk/orpg/home/products/serviceproducts/timerelatedcharges/timerelatedcharges/downloads/TRCs.pdf.
[367] March 2011 Consultation, paragraphs 4.120 to 4.122.
[368] March 2011 Consultation, paragraphs 4.123 to 4.125.
[369] March 2011 Consultation, paragraph 4.125.
[370] Openreach response to the March 2011 Consultation, paragraph 4.01.
[371] EE response to the March 2011 Consultation, page 19.

in a new basket (together with SFIs). Sky[372] and TTG[373] argued that TRCs charge controlled in a basket would be better than our proposals because:

- Sky and TTG's spend on TRCs can often exceed spend for certain ancillary services and so is proportionate to charge control TRCs. TTG said industry spend was likely to be around £100 million in 2009/10, and these charges are above efficient cost;

- TRCs are mostly SMP services, cannot be purchased elsewhere, and it would be relatively simple to distinguish and identify TRCs which are subject to SMP from TRCs which are not subject to SMP;

- Cost orientation obligations, instead of charge controls, would be insufficient, as it would allow Openreach to price TRCs above efficient cost and not incentivise Openreach to be efficient. Separately, TTG also argued that Openreach are currently charging excessively for TRCs, but that, in any case, our proposals should also be based on potential for abuse, that cost orientation obligations do not provide the certainty that a charge control provides, and that enforcing a charge control would be more administratively efficient for Ofcom to enforce cost orientation obligations; and

- A charge control would prevent over-allocation of costs to TRCs (and mean under-allocation elsewhere for other services) so that the "*overall amount consumers pay is broadly unchanged*"[374] which would reduce Openreach's incentives to game the charges.

4.330 TTG also argued that the forthcoming review on cost-orientation guidance may not be helpful because the review may not actually take place, and if it does take place the guidance from the review may not be sufficiently useful and prescriptive to determine whether Openreach is charging excessively and provide TTG with a sufficient basis to allow it to raise a potential dispute.[375]

4.331 TTG also argued that TRCs service charges for MPF, SMPF and WLR should be aligned (but that this measure on its own would not be sufficient).

4.332 Finally, TTG said a basket (with SFIs) would provide Openreach with flexibility to restructure and re-balance prices.[376]

Our response and conclusions

4.333 We do not consider that implementation of a charge control (by way of a basket or other means) is appropriate or a proportionate approach for LLU TRCs.

4.334 We note that the cross-market nature of TRCs and the nature of the service itself means that a charge control (by way of a basket or other means) may not be a sufficiently targeted intervention. For example, TRCs can be provided in the Leased Lines and WFAEL markets (in addition to the WLA market), making it difficult to identify robustly all LLU TRC costs (which are reasonably necessary for the use of

[372] Sky response to the March 2011 Consultation, paragraphs 11 to 21, pages 2 to 4.
[373] TTG response (July 2011) to March 2011 Consultation, paragraphs 470 to 484.
[374] TTG response (July 2011) to the March 2011 Consultation, paragraph 483.
[375] TTG response (July 2011) to the March 2011 Consultation, paragraph 4.77.
[376] TTG response (July 2011) to the March 2011 Consultation, paragraphs 4.85 to 4.86.

LLU services). As noted in the March 2011 Consultation,[377] we do not consider that separate reporting arrangements in Openreach's regulatory accounts would be appropriate or proportionate. Further, the structure of the charges, given the nature of the service, also means that charges can be variable. For example, TRC charges can vary depending on when the work takes place (i.e., on a weekday or during business hours or outside normal business hours).

4.335 We note that Openreach does not currently charge on a separate basis for TRCs for MPF or SMPF or WLR products (unlike SFI, for example, where there is an MPF SFI and an SMPF SFI). We consider that any potential risk in Openreach discriminating between types of product user to distort competition between users, is therefore likely to be extremely low. We note that TRCs are currently the same price regardless of what product the work is carried out on and we do not consider that any service charge alignment obligation (i.e. that a TRC carried out for MPF, SMPF and WLR should be set equal) is necessary or practical given the nature of the product (including for the reasons above - see paragraph 4.334).

4.336 We recognise that LLU (and WLR) TRCs can represent a significant item of spend for CPs (although we note that 2009/10 industry spend on LLU and WLR TRCs is likely to be approximately at least 30% less than what TTG stated in its March 2011 Consultation response[378] for 2009/10).

4.337 However, we have reviewed Openreach's overall returns (which are commercially confidential) for TRCs. We consider that these are in line with our normal expectations for Openreach services, suggesting that they are not overcharging for TRCs by Openreach.

4.338 In response to TTG's comment in relation to the prospect of abuse by Openreach, we consider that Openreach is aware that were Openreach to begin to make above normal levels of returns against TRCs we would both consider a re-allocation of more common costs to TRCs (given they draw largely on a common cost pool which also supports the charge controlled services) in setting future charge controls and possible options for more direct intervention.

4.339 We consider that the cross market and flexible nature of TRCs means that regulation through cost orientation rather than an explicit charge control is more appropriate.

4.340 However, we recognise stakeholder's concerns with respect to transparency around setting charges for services subject to cost orientation obligations. In response to this, as noted above, we are undertaking a Cost Orientation and Regulatory Reporting Review. Stakeholder concerns regarding cost orientation obligations imposed on BT (Openreach) and the reporting and monitoring requirements associated with regulated services will be considered in the context of this review.

4.341 We conclude that where TRCs are reasonably necessary for the provision of LLU services, they should be subject to the general remedies as set out in WLA 2010 Market Review.

4.342 For consistency, we have taken the same approach with respect to WLR TRCs. This approach is set out in Section 5 of this Statement (paragraph 5.130-5.150).

[377] March 2011 Consultation, paragraphs 4.123 to 4.125.
[378] TTG response (July 2011) to the March 2011 Consultation, paragraph 2.71.

SFI2s

4.343 SFI2s are products requested by CPs to further investigate faults on the MPF/SMPF line, where the MPF/SMPF line seems to be testing as 'ok' on Openreach's system. The product is sold in individual modules for both MPF and SMPF (Base, Network, Frame, Internal wiring, Internal equipment, Coop, and Frame direct).

4.344 The investigative work is carried at various points between (and including) the exchange and customer premise/wiring. CPs often request more than one module to locate and fix a fault. Modules are charged on a per hour cost of an engineers visit, and can vary per module chosen from £25 up to £105 (for the new SFI2 services which replaced the pre-existing SFI service).[379]

March 2011 Consultation proposals

4.345 We proposed that LLU SFIs should remain outside the scope of the charge control but remain subject to the general remedies imposed in the WLA 2010 Market Review, where they are reasonably necessary for the use of LLU service. We proposed to maintain the alignment of the MPF and SMPF variant service charges, during the charge control period, to ensure competitive distortions do not arise.[380]

4.346 In the March 2011 Consultation, we considered that most LLU SFIs are likely to be reasonably necessary for the use of LLU services, and are therefore, subject to the general remedies imposed in the WLA 2010 Market Review.[381]

4.347 In the March 2011 Consultation, we noted that Openreach would shortly (in April 2011) introduce a new range of SFIs (called SFI2) products design on a modular basis, and had broadened the range of prices for SFIs (i.e. from £25 to £105 for various modules).[382]

4.348 We went on to explain that given these recent product and pricing innovations, we did not consider a charge control was appropriate. However, we recognised that CPs can spend a large amount on SFI2s, and noted that further guidance on the application of cost-orientation due to take place in our forthcoming review may be helpful to CPs. [383]

4.349 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 4.15*: Do you agree that special fault investigations should remain out of the scope of the charge control and subject to general remedies applied in the WLA market review?*

Question 4.16*: Do you agree that the charges for special fault investigations should remain aligned between MPF and SMPF?*

[379] http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPrices.do?data=%2Bs55xT91%2FPruY0Pxlyi4HVnqs1m6OcKz301sgolk8P2FdiaKKPEfrCsJCb3sZkzJ, as at 31/01/12.
[380] March 2011 Consultation, paragraphs 4.126 to 4.130.
[381] March 2011 Consultation, paragraph 4.127.
[382] March 2011 Consultation, paragraph 4.128.
[383] March 2011 Consultation, paragraph 4.129.

March 2011 Consultation responses

4.350 GC thought that "*SFI SMPF costs should be higher than SFI MPF as SMPF design is more complex*".[384] GC did not provide additional reasoning in support of this proposition.

4.351 EE supported further consideration of SFI2s in the forthcoming Cost Orientation and Regulatory Reporting Review. With respect to our proposal in the March 2011 Consultation to align the MPF and SMPF variant service charges, EE noted that competitive distortions can arise where services are aligned but have different costs, and requested that we undertake a further examination of the costs.[385]

4.352 C&WW argued that SFI2s are important services for consumers, and was concerned that their price could be "*barrier to end users achieving the broadband service that their line could support*", especially given the nature of how CPs purchase SFI2 modules (i.e. more than one module are purchased at a time).[386]

4.353 TTG, in response to whether the SFI2s should be within the scope of this charge control review, said that "[c]*ertain parts of SFI are clearly absolutely necessary and within the market since they relate to repairing part of BT's own network to allow broadband to function. Even for those elements of SFI which are not on BT's network, CPs do not, in reality, have the 'discretion' whether to purchase from BT. Therefore, it is appropriate to regulate them*".[387]

4.354 Both TTG and Sky also disagreed that SFI2s should remain outside the scope of the charge control itself. Sky and TTG proposed that we charge control SFIs in a new basket (together with TRCs). In doing so, both Sky[388] and TTG[389] argued that SFIs charge controlled (in a basket) would be better than our proposals because:

- Sky and TTG's spend on SFI2s often exceeds spend for most ancillary services, and so is proportionate to charge control SFIs;

- SFIs are mostly SMP services, cannot be purchased elsewhere, and it would be relatively simple to identify SFI2s subject to SMP from SFIs not subject to SMP;

- Cost-orientation obligations (instead of charge controls) would be insufficient, as it would allow Openreach to price SFI2s above efficient cost and not incentivise Openreach to be efficient. Separately, TTG argued that Openreach are currently charging excessively for SFI2s, but in case our proposals should also be based on potential for abuse, that cost orientation obligations do not provide the certainty that a charge control provides, and that setting a charge control would be more administratively efficient for Ofcom than enforcing cost orientation obligations); and

- A charge control would prevent over-allocation costs to SFIs (and mean over-allocation elsewhere for other services) so that the "*overall amount consumers*

[384] GC response to the March 2011 Consultation, page 7.
[385] EE response to the March 2011 Consultation, page 20.
[386] C&WW response to the March 2011 Consultation, page 25.
[387] TTG response (July 2011) to the March 2011 Consultation (October 2011 submission), paragraph 63.
[388] Sky response to the March 2011 Consultation, paragraphs 10 to 21, pages 2 to 4.
[389] TTG response (July 2011) to the March 2011 Consultation, paragraphs 4.70 to 4.84.

pay is broadly unchanged" which would reduce Openreach's incentives to game the charges.

4.355 TTG also argued that the forthcoming review on cost-orientation guidance may not be helpful because the review may not actually take place, and if it does take place the guidance from the review may not be sufficiently useful and prescriptive to determine whether Openreach is charging excessively and provide TTG with a sufficient basis to allow it to raise a potential dispute.[390]

4.356 TTG also argued that SFI2s service charges for MPF, SMPF and WLR should be aligned (but that this measure on its own would not be sufficient).

4.357 Finally, TTG said a basket (with TRCs) would provide Openreach with flexibility to restructure and re-balance prices.

4.358 Openreach also disagreed with our approach, but instead argued that SFIs should not be subject to any regulation. Openreach said that SFIs can be outside the demarcation of the WLA market and are outside the specification of a standard LLU service (e.g. SFI2 work can be carried out on customer premise and supports lines over 100Mhz). Openreach also said these products are value-added, and Openreach does not charge the CP for SFI where the fault is found on its network.[391]

Our response and conclusion

4.359 We discuss our response below.

Scope of charge control

4.360 We note stakeholder's comments that we should charge control SFI2 services. However, we do not consider that the implementation of a charge control (by way of a basket or other means) is appropriate or a proportionate approach for LLU SFI2 services.

4.361 In reaching to this decision, we consider that the general remedies which apply will allow Openreach flexibility to trial demand for a relatively nascent set of restructured product modules, but still provide a reasonable level of protection for consumers. We discuss this further in paragraph 4.362 below.

4.362 We consider that a charge control (by way of a basket or other means) may not be a sufficiently targeted intervention given the recent developments to SFI service and price structures (i.e. for SFI2 services). We note that prices for the new SFI2s have reduced by £10 since April 2011, on an aggregate basis across all the modules, but have increased and decreased for certain modules.[392] This indicates that Openreach may be trialling prices given the nascency of the new modular structure, which came into effect last year and was agreed with industry.

4.363 We recognise that LLU SFI2s can represent a significant item of spend for CPs, and as C&WW notes out SFI2s can be important services for consumers. However, we note it is only a relative small proportion of total reported faults that are investigated using SFI2s. This is because SFI2s are ordered as a *further* investigation product,

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[390] TTG response (July 2011) to the March 2011 Consultation, paragraph 4.77.
[391] Openreach response to the March 2011 Consultation, paragraphs 402 to 404.
[392] http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPrices.do?data=%2Bs55xT91%2FPruY0Pxlyi4HVnqs1m6OcKz301sgolk8P2FdiaKKPEfrCsJCb3sZkzJ at 31/01/12.

where faults have not been previously resolved. We consider that the general remedies, imposed in the WLA Market review, are a more proportionate means of regulating these services than a charge control.

4.364 As discussed in the March 2011 Consultation,[393] we intend to publish a Cost Orientation and Regulatory Reporting Review, in 2012.

Scope of regulation

4.365 We note Openreach's comments that SFI2s should not be subject to any regulation. As discussed in paragraph 4.345 above, we consider that where SFI2s are reasonably necessary for the use of LLU services, the SFI2 charges should be subject to the general remedies imposed in the WLA market review.

4.366 We do not consider that it is appropriate or instructive to further specify which specific SFI2 modules are 'reasonably necessary'. Such analysis would need to be considered on a case by basis, in light of the specific circumstances.

Alignment

4.367 With respect to our March 2011 Consultation proposal[394] to maintain the alignment of MPF and SMPF SFI2 service charges, we have taken note of stakeholder's comments that there could be competitive distortions where the underlying costs are not the same between MPF and SMPF. We note that that SFI2s involve Openreach engineers investigating and resolving the source of broadband problems. The cost of SFI2 work are largely based on direct and indirect labour engineering time charged on an hourly incremental basis, and end-user or exchange visit costs where applicable. On the evidence provided,[395] we consider that the time spent investigating and remedying the source of broadband problems for SFI2s is likely to be broadly similar between MPF and SMPF services. We, therefore, consider that the underlying costs are likely to be broadly similar for MPF and SMPF SFI2 services, and so it is appropriate to maintain alignment of MPF and SMPF SFI2 service charges.

Conclusion

4.368 As proposed in our March 2011 Consultation, we consider that where SFI2[396] services are reasonably necessary for the provision of LLU services, SFI2 services should be subject to general remedies as set out in the WLA 2010 Market Review.[397]

4.369 In light of stakeholder comments received in response to the March 2011 Consultation and our response as outlined above, we have decided that it is appropriate to maintain alignment of MPF and SMPF SFI2 service charges (i.e. to keep service charges equal).

[393] March 2011 Consultation, paragraphs 4.136 to 4.137.
[394] March 2011 Consultation, paragraph 4.130.
[395] Openreach response to Ofcom's 12th section 135 request, 4 November 2011.
[396] We note that the SFI services that were replaced by SFI2 no longer exist and are therefore not subject to regulation.
[397] March 2011 Consultation, paragraph 4.127.

Electricity

4.370 CPs buy electricity from Openreach to provide power to their equipment used to provide LLU services to consumers. These are currently subject to general remedies imposed in the WLA 2010 Market Review. LLU electricity prices largely depend on the wholesale price that Openreach itself is charged, as a large proportion of the price is a pass-through of the raw wholesale costs of electricity.

March 2011 Consultation proposals

4.371 In the March 2011 Consultation we proposed that electricity should remain outside the scope of the charge control but remain subject to general remedies set in the WLA 2010 Market Review.[398] In particular, we said that it would be difficult to set a price control for electricity charges, given that the price at which Openreach purchases electricity, can be variable.[399]

4.372 We went on to note in the March 2011 Consultation that an alternative approach could be to price control the proportion of the Openreach electricity charge which is not a pass through of the raw wholesale electricity costs. However, we explained that we did not consider that this approach would be appropriate, given that this comparatively small element of the overall charge is low revenue and a charge control on it could prove to be over-prescriptive and inflexible.[400]

4.373 However, in the March 2011 Consultation, we said we would investigate whether Openreach could provide more transparency on these charges.[401] We also noted that further guidance on the application of cost-orientation due to take place in our Cost Orientation and Regulatory Financial Reporting Review may be helpful to CPs.[402]

4.374 We asked stakeholders the following question in the March 2011 Consultation:

Question 4.17: *Do you agree that electricity charges should remain out of the scope of the charge control but subject general remedies set in the WLA market review?*

March 2011 Consultation responses

4.375 Both TTG and Sky said that they spend a material amount on electricity, and that they need pricing protection that goes beyond general remedies.

4.376 TTG proposed that we price control the element which is not the raw electricity cost. TTG said that BT has an incentive to charge excessively given that it does not use this itself and there is little transparency. TTG acknowledged that controlling the raw cost of electricity would be difficult given the price volatility, but said we could charge control the remaining portion of the charge. TTG said we should require Openreach to report the raw cost of electricity in the RFS.[403]

4.377 Sky, on the other hand, went further and said that we should regulate the whole electricity charge, and argued that other key costs (e.g. copper cabling) that BT has little control of, and are subject to price variability, are included in charge controlled

[398] March 2011 Consultation, paragraph 4.135.
[399] March 2011 Consultation, paragraph 4.133.
[400] March 2011 Consultation, paragraph 4.134.
[401] March 2011 Consultation, paragraph 4.135.
[402] March 2011 Consultation, paragraph 4.137.
[403] TTG response (July 2011) to the March 2011 Consultation, paragraphs 4.87 to 4.91.

LLU and WLR services, and noted that electricity costs feed into other charge controlled services.[404]

4.378 C&WW, while agreeing with our proposals, considered that the speed of pass through of increases and decreases in electricity charges was not even handed, with increases passed through quicker than decreases.[405]

4.379 EE said that further consideration of this service in Cost Orientation and Regulatory Financial Reporting Review would be appropriate.[406]

<u>Our response and conclusions</u>

4.380 As proposed in the March 2011 Consultation,[407] we have decided that electricity should remain outside the scope of the charge control, but subject to general remedies set in the 2010 WLA market review.

4.381 We note stakeholder's comments that we should price control the whole electricity charge or the element of the charge which is not a pass through of the raw electricity cost.

4.382 As set out in the March 2011 Consultation, we consider a charge control on electricity charges would not be appropriate, largely because of the volatile nature of the raw electricity pass through costs.[408] We note Sky's comments in defence of a charge control that electricity comprises a cost input into other LLU services that we propose to charge control, as can other cost inputs which are subject to volatility, more generally (e.g. copper cabling). We recognise this, however, it is important to note that such costs do not form a large proportion of the overall cost stacks for these other charge controlled services, unlike a charge controlled electricity charge (where the vast majority of the cost stack would be raw electricity pass through costs).

4.383 With respect to stakeholder's suggestions that we impose a charge control on the remaining element of the electricity charges (i.e. the proportion which is not raw electricity pass through costs), we note that, as set out in our March 2011 Consultation, we consider that a charge control on this element would be over prescriptive and disproportionate.

4.384 As also noted in the March 2011 Consultation[409] we are currently reviewing BT's regulatory financial reporting and audit requirements, and in 2012 we intend to publish a review of Cost Orientation and Regulatory Reporting Review.

4.385 Accordingly, we have decided that electricity charges should remain out of the scope of the charge control but should be subject to the general remedies set in the WLA 2010 Market Review.

LLU Enhanced Care services

4.386 LLU Enhanced Care services offer consumers higher levels of care (in response to reported faults) than are available to customers of the LLU rental services. Openreach has recently harmonised Enhanced Care services across its portfolio of

[404] Sky response to the March 2011 Consultation , paragraphs 15 to 17.
[405] C&WW response to the March 2011 Consultation, page 25.
[406] EE response to the March 2011 Consultation, page 20.
[407] March 2011 Consultation, paragraphs 4.31 to 4.37.
[408] March 2011 Consultation, paragraph 4.133.
[409] March 2011 Consultation, paragraphs 4.136 to 4.137.

products. BT Wholesale is the biggest user of Enhanced Care services, and there are relatively few other users of the service. Instead of using LLU Enhanced Care services, customers can also use Expedited Repair Service levels[410] (used on a one-off basis).

Figure 4.11: Current prices of Enhanced Care services (£ per month)

Product	Service Maintenance Level 1	Service Maintenance Level 2	Service Maintenance Level 3	Service Maintenance Level 4
Description of service	**Next working day + 1, fix Monday to Friday**	**Next working day, fix Monday to Saturday**	**Report am fix pm, Report pm fix next am. Monday to Sunday**	**6 hour repair anytime**
MPF	N/A	Included in rental	37.20	48.00
SMPF	N/A	Included in rental	37.20	48.00
WLR – Basic	Included in rental	6.32	43.52	54.32
WLR – Premium	N/A	Included in rental	37.20	48.00
ISDN 2	N/A	Included in rental	37.20	48.00
ISDN 30 (per channel)	N/A	Included in rental	25.20	27.20

4.387 In the 2009 WLR Implementation Statement[411] we decided to remove cost orientation requirements from WLR Enhanced Care services, largely as we considered there was a market driven constraint from the WLR rental charge that prevented Openreach from pricing WLR Enhanced Care services excessively.

March 2011 Consultation proposals

4.388 We preferred to impose an obligation on Openreach to align LLU Enhanced Care service charges with WLR Enhanced Care service charges (i.e., Option 4 in the March 2011 Consultation). We said that LLU Enhanced Care service charges then would be constrained by the WLR rental prices. We explained that this would then allow us to remove cost orientation obligations for LLU Enhanced Care services.[412]

4.389 We also discussed other alternative options in the March 2011 Consultation. In particular, we considered retaining cost orientation obligations on LLU Enhanced Care services (Option 1 in the March 2011 Consultation), but noted that a cost orientation requirement may not be very well targeted given the difficulty of identifying costs and because a wide range of prices may satisfy the first order tests for cost orientation set out in the WLA 2010 Market Review (i.e. that in order for charges to be compliant with the cost orientation SMP condition the charges be between DLRIC and DSAC).[413]

[410] http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=o1GUUZA4oSGmoXU5lc%2BgZQD265It6W32TNnfEUU7w1FZ6rNZujnCs99NbIKJZPD9hXYmiijxH6wr%0ACQm97GZMyQ%3D%3D as at date 2/2/12.
[411] See paragraphs 4.41 to 4.47.
[412] March 2011 Consultation, paragraph 4.163.
[413] March 2011 Consultation, paragraph 4.150.

4.390 In the March 2011 Consultation, we discussed only removing the cost orientation obligation on LLU Enhanced Care services (Option 2 in the March 2011 Consultation) but considered that, on balance, there is insufficient evidence of LLU Enhanced Care services being constrained by the LLU rental prices.[414]

4.391 We also considered whether LLU Enhanced Care services should be charge controlled in baskets or using a safeguard cap (Option 3 in the March 2011 Consultation). However, we felt that this approach could result in inflexibility and/or stifle innovation.[415]

4.392 On the balance of the evidence available to us we set out our preferred option (Option 4). We noted that a market driven constraint currently exists between WLR core rental and WLR Enhanced Care services, and that by keeping the charges for WLR Enhanced Care services and LLU Enhanced Care services aligned, the WLR rental price would constrain excessive price rises for LLU Enhanced Care services. We also noted that this would allow pricing flexibility and be consistent with the Openreach Service Harmonisation[416] Openreach has initiated. However, we noted that the success of Option 4 would largely depend on the price of WLR rental acting as a sufficient constraint, and that this constraint may not be perfect (for example, Openreach may be able to excessively raise prices for care levels which are not heavily utilised by WLR customers (e.g. levels 3 and 4) but that are essential for LLU users). We said that, if Option 4 were to be implemented, we would bear this in mind where there were any significant price increases in the future.[417]

4.393 We asked stakeholders the following question in the March 2011 Consultation:

> ***Question 4.19****: Please indicate which of the Options 1 – 4 you think would be the most effective method of regulation of LLU enhanced care services. Please indicate whether you think Option 4 (removal of the cost orientation requirement and creation of a new requirement that the charges for LLU enhanced care should not be misaligned from those for equivalent WLR enhanced care services) would be an effective remedy.*

March 2011 Consultation responses

4.394 TTG's preferred option was a basket charge control for LLU Enhanced Care services. TTG argued that Option 4 would not prevent Openreach from pricing excessively to raise profits and raising prices excessively to prevent cannibalisation of BTs Leased Lines Enhanced Care services, which TTG says can be used instead of LLU Enhanced Care services to supply business products.[418]

4.395 TTG also said that the constraint imposed by the WLR rental product is weak because enhanced care levels are not so critical for WLR users, compared to LLU users, and that the chain of substitution between LLU Enhanced Care services and the LLU rental products is weak.

4.396 C&WW was also in favour of, at a minimum, retaining cost orientation obligations, but also considered that a charge control would be consistent with our proposals for LLU

[414] March 2011 Consultation, paragraphs 4.151 to 4.156.
[415] March 2011 Consultation, paragraph 4.158.
[416] Under Openreach's Service Harmonisation Initiative, the Enhanced Care service arrangements between LLU and WLR have been made more comparable than was previously the case.
[417] March 2011 Consultation, paragraphs 4.160 to 4.165.
[418] TTG response (July 2011) to the March 2011 Consultation, paragraphs 4.92 to 4.99, and TTG response (October 2011) to the March 2011 Consultation, pages 12 and 13.

Enhanced Care services set out in the 2011 ISDN 30 Consultation. C&WW argued that LLU Enhanced Care services are essential to supply its downstream business services. C&WW was concerned that Option 4 would not be workable given the differences in downstream usage for LLU compared to WLR. C&WW went on to say that including LLU volumes could weaken the current constraint for WLR Enhanced Care users.[419]

4.397 Openreach was in favour of Option 2 (removal of cost orientation obligations) but supported our preferred Option 4, largely because Option 4 is in line with its commercial objectives with respect to innovation and alignment of WLR Enhanced Care service levels and LLU Enhanced Care service levels. Openreach also considered there is substitutability between the LLU Enhanced Care service levels.[420]

Our response and conclusions

4.398 We have decided to implement Option 4 from the March 2011 Consultation. Accordingly, we require that LLU Enhanced Care service charges are aligned to WLR Enhanced Care service charges over the duration of the LLU / WLR charge control period. Consequently, we have removed cost orientation obligations from LLU Enhanced Care services.

4.399 In reaching our decision, we consider that there are competition benefits from aligning LLU Enhanced Care service charges with WLR Enhanced Care service charges (i.e. Option 4 in the March 2011 Consultation), and as well as protecting customers the approach will allow Openreach some pricing flexibility. We note that the framework applied to WLR Enhanced Care services (as part of the 2009 WLR Statement has been effective to date, and consider that including LLU Enhanced Care services is likely to strengthen the currently aligned WLR framework.

4.400 We note stakeholder concerns and recognise that it is key that WLR Enhanced Care services and LLU Enhanced Care services are sufficiently constrained by the WLR rental charge, in order for consumers to be sufficiently protected. However, we consider that while there is a risk that Openreach may be able to unfairly enhance its profitability within this framework by increasing charges for enhanced care levels which are not heavily utilised by WLR customers (e.g. levels 3 and 4) but are an essential service for some MPF and SMPF customers,[421] this risk is low. We set out why in the paragraph below.

4.401 Firstly, this is because we consider that there is likely to still be a sufficient proportion of customers (i.e. WLR Enhanced Care service and LLU Enhanced Care service customers combined) that will be willing to switch, in order to act as a constraint on the levels of charges for all Enhanced Care service packages. Secondly, we note that customers also have the option to purchase support services on a piecemeal basis when needed (e.g. using 'expedite repair') if they do not wish to have an ongoing Enhanced Care service support arrangement (i.e. customers can use once off repairs instead of ongoing Enhanced Care services). Finally, we note that that the vast majority of Enhanced Care users are SMPF customers, and that BT is a significant consumer of these services. We therefore consider that Openreach's incentives to price LLU Enhanced Care services excessively is likely to be weakened

[419] C&WW response to the March 2011 Consultation, pages 26 to 27 and further C&WW responses to the March 2011 Consultation, dated 28/12/2011 and 18/01/2012 respectively.
[420] Openreach response to the March 2011 Consultation, paragraphs 4.13 to 4.19.
[421] March 2011 Consultation, paragraph 4.162.

if the charges for LLU Enhanced Care services are aligned to the charges for WLR Enhanced Care services.

4.402 On this basis, we do not consider that there is a material risk of Openreach raising prices excessively to prevent cannibalisation of BT's Leased Lines Enhanced Care services.

4.403 However, in light of the low risk discussed in paragraph 4.401 above (and also identified in the March 2011 Consultation) we will also continue to monitor the charges for LLU Enhanced Care services, and would look carefully at any significant increases, over the course of the charge control.

Low volume Co-Mingling ancillary services

March 2011 Consultation proposals

4.404 In the March 2011 Consultation, we noted that there were around 70 low volume products within the Co-Mingling ancillary services basket, and we discussed whether not imposing a charge control on these services would lower the administrative burden to Ofcom and Openreach (i.e. because no basket charge control would be set and monitored). However, we also noted that if we did not impose a charge control on these services an administrative burden of assessing whether the prices of the services are cost oriented (as this is part BT's SMP condition) would still apply.[422]

4.405 Accordingly, in the March 2011 Consultation we proposed to continue to charge control these services in the Co-Mingling ancillary services basket[423] and asked stakeholders the following question:

> ***Question 4.13**: Do you agree that the 70 low volume products in the co-mingling basket should continue to be charge controlled within the co-mingling basket?*

March 2011 Consultation responses

4.406 All stakeholders, excluding Openreach, agreed with our proposal.

4.407 Openreach considered that the number of products in the Co-mingling basket is too high, and asked that we relax the formal reporting requirements for these services.[424]

Our response and conclusions

4.408 We have taken note that stakeholders were generally in support of our proposal. We have decided that the low volume products should remain in the Co-mingling basket.

4.409 We have addressed Openreach's point in paragraphs 3.150 to 3.152 of this Statement.

[422] March 2011 Consultation response, paragraphs 4.117.
[423] March 2011 Consultation response, paragraphs 4.117 to 4.125.
[424] Openreach response to the March 2011 Consultation, paragraph 399.

Overlapping regulation

Overlapping Regulation of Co-Mingling prices

4.410 The Co-Mingling basket includes services which are used by CPs for Leased Line products as well as LLU. Accordingly, we set controls on these services in the LLCC.

4.411 While the LLCC control was aligned with the LLU control when it was set, we are now proposing a different control for LLU. Accordingly, we need to consider whether and how we should deal with a possible conflict between the controls.

4.412 In response to our March 2011 Consultation proposals on the Co-Mingling ancillary services basket, Openreach noted that over 50 products which we were proposing to charge control in that basket are also currently regulated as part of the LLCC in the AI Accommodation Basket.[425]

4.413 Openreach was concerned that it would not be able to comply with both the LLCC and the obligations imposed in this LLU charge control, as the timing and the level of price changes required would be different. Openreach said that products should be regulated under one charge control only.[426]

Our response and conclusions

4.414 We recognise the concern that Openreach has identified. The LLU charge controls as part of this review will be set from 1 April 2012, whereas LLCC (and specifically the AI Accommodation Basket set under SMP services condition HH4 which comprises the overlapping obligation) is due to expire on 30 September 2012. There will therefore be an overlap of approximately 6 months where certain products will be subject to two different charge controls.

4.415 It is clearly not desirable for the same services to have different charge control obligations and clearly we would want to avoid a situation where BT must breach one set of SMP conditions in order to comply with the other set of SMP conditions.

4.416 We recognise that there is also likely to be an equivalent overlap between the LLU charge control imposed on the Co-Mingling ancillary services basket and the forthcoming LLCC. We will also consider in the LLCC what steps are appropriate to ensure that consistent charge controls are applied to the same services supplied in both markets.

4.417 While we consider that it is unlikely that BT will need to breach either condition to comply with the other, there is a risk that the overlap will lead to higher than desirable charges for these services. We are investigating how we may address the overlap between this LLU charge control and the existing LLCC. In particular we are considering whether we can amend the existing LLCC control in respect of the relevant basket.

[425] Openreach response to the March 2011 Consultation, paragraph 400.
[426] Openreach response to the March 2011 Consultation, paragraphs 2.53 to 2.54.

Treatment of new services (which partially or fully replace regulation)

March 2011 Consultation proposals

4.418 In the March 2011 Consultation[427] we considered how we would treat 'new' services, which partially or fully replace existing services, introduced during the charge control period.

4.419 In particular, we proposed a mechanism to deal with any material changes (other than to a charge) made by Openreach to any product or service subject to the charge controls. In this case, a "material change" would include the introduction of a new product or service wholly or substantially in substitution for that existing product or service.

4.420 In such a case, we proposed that the charge controls would have effect subject to such reasonable adjustment to take account of the change as Ofcom may direct to be appropriate in the circumstances under SMP condition FAA4(A).13. Before giving such a direction, Ofcom would consult on its proposal in accordance with the process set out in section 49 of the Act. On giving such a direction, BT would be required to comply with it under Condition FAA4(A).17.

4.421 In order to ensure that the baskets remain fully transparent going forward as to their products and/or services, should any changes be required from time to time, we would propose to exercise our power of direction under SMP condition FAA4(A).13 by amending the list of services covered by the basket in question as set out in Parts 1 to 3 of the Annex to Condition FAA4(A).

4.422 We also said we would nonetheless expect Openreach to retain in each basket the full functionality presently contained within the basket defined in the Annex to Condition FAA4(A). We also noted that, in any event, such 'new' services may fall within the relevant market and hence be covered by general remedies.

4.423 We asked stakeholders the following question in the March 2011 Consultation:

> ***Question 4.20***: *Do you agree that new services which partially or fully replace existing services should be included in the charge controls?*

March 2011 Consultation responses

4.424 The vast majority of stakeholders supported our proposal. However, certain stakeholders asked for further clarity, including TTG who was unclear as to how effective our proposal would be.

4.425 In particular, TTG[428] noted the following:

- "*If a service falls within a market in which BT has SMP but it does not replace an existing service (e.g. a new repair service, additional care level) will the Direction not apply?*";[429]

[427] March 2011 Consultation, paragraphs 4.166 to 4.170.
[428] March 2011 Consultation, paragraphs 523 to 525.
[429] TTG response (July 2011) to the March 2011 Consultation, paragraph 5.23.

- *"Ofcom talks about the new service being part of the appropriate basket. What would happen if, for whatever reason, the new product should have a separate charge control and not be part of a basket?*";[430] and

- *"Would the Direction include the setting of an initial starting price (which is obviously necessary if it were part of a basket)? On what basis would a starting price be set*".[431]

4.426 TTG instead proposed that we *"retain* [our] *discretion and powers to (say) 'regulate as appropriate new services in line with Ofcom's duties'"*.[432]

4.427 C&WW was concerned that Openreach could recover costs twice where it introduces a new charge and asked for us to provide clarity on this concern.

Our response and conclusions

4.428 We note that stakeholders have asked for further clarity on our proposal. We address these comments below.

4.429 We note that SMP Condition FAA4(A).13 applies "*where the dominant Provider makes a material change…..to any Charge Controlled Service…*" (as set out in SMP Condition FAA4(A).13). Therefore, this condition is not necessarily limited to those existing services in MPF, SMPF or Co-Mingling ancillary services baskets. We also confirm that the condition SMP Condition FAA4(A).13 only applies to existing services which are charge controlled by SMP Condition FAA4(A). Finally, before making such a direction, Ofcom is required to consult on its proposal in accordance with the process set out in section 49 of the Act (except where the proposal would not have a significant impact on the market). The specifics as to how we continue to charge control the new service in question (e.g. the charge control and issues of cost recovery, where necessary), would be considered as part of such consultation.

4.430 In the light of the comments received from stakeholders in response to the March 2011 Consultation and our responses above, we have decided to implement SMP condition FAA4(A).13.

[430] TTG response (July 2011) to the March 2011 Consultation, paragraph 5.23.
[431] TTG response (July 2011) to the March 2011 Consultation, paragraph 5.23.
[432] TTG response (July 2011) to the March 2011 Consultation, paragraph 5.24.

Section 5

WLR charge control structure

Introduction

5.1 In this Section we set out our conclusions on the charge controls for WLR rental and related ancillary services. In particular, we consider:

- the form of charge control on WLR rental;
- the form of charge control on WLR transfer;
- the form of charge control on WLR New Provide;[433] and
- whether the scope of the charge control should be expanded to include other WLR services.

5.2 This Section does not deal with specific decisions on the service cost stacks or cost allocations which are considered in Section 6 and Annex 4 of this Statement.

Summary of our decisions

5.3 Our conclusions on the WLR charge control structure are that:

- WLR rental, WLR transfer[434] and WLR New Provide will each be subject to separate charge controls; and
- MPF to WLR transfer, calling and network features, pre-validation charges, ISDN to WLR conversion charges, cancellation charges, time-related charges and WLR cease charges will remain outside the scope of the charge controls.

WLR rental

March 2011 Consultation proposals

5.4 In the March 2011 Consultation, we proposed to continue to set an individual charge control for the WLR rental service.[435]

5.5 We considered whether to include the rental service in a basket with other WLR services (such as WLR New Provide and WLR transfer). However, we noted our concern that if we adopted such an approach (with rentals and connections in the same basket) this would given Openreach scope to lower WLR charges relative to LLU charges. We also noted that such an approach would increase uncertainty about the future pricing of the WLR rental service. Furthermore, we considered that the current framework had worked well and there was no evidence to suggest any change was required.

[433] Openreach refer to this product as "supply of new line". In 2009 WLR Statement this product was referred to as "WLR new line connection". In this Statement we refer to the product throughout as "WLR New Provide".
[434] WLR to WLR Transfer.
[435] March 2011 Consultation, paragraphs 5.10 to 5.15.

5.6 Consistent with the principles set out in Section 3 of the March 2011 Consultation, we proposed to set the price of the WLR rental on a glide path to ensure it recovers CCA FAC costs by the end of the charge control period.[436]

5.7 We also proposed to amend the SMP conditions to make it clear that the obligation to provide WLR, when requested by a third party, includes such ancillary services as may be reasonably necessary for the use of WLR. This was to clarify the status of WLR ancillary services and to make the SMP conditions for LLU and WLR consistent.

5.8 We asked stakeholders the following question in the March 2011 Consultation:

> ***Question 5.1****: Do you agree that the core rental should be subject to a charge control which sets the price of the WLR core rental on a glide path to ensure it recovers CCA FAC costs by the end of the charge control period?*

March 2011 Consultation responses

5.9 C&WW,[437] EE,[438], FCS,[439] GC[440] and SSE[441] agreed with our proposal to retain a separate charge control for WLR rental.

5.10 EE said that "*without a strong and compelling reason for changing the current approach in this regard, there is benefit in continuing with a framework which has worked in the past*".[442]

5.11 Openreach said that in general its "*preference is to have broad baskets to give greater flexibility in setting prices to reflect market demand and so as to align prices with costs over the control period*" but noted that if "*the WLR core rental services are to have a separate charge control, then the corresponding X needs to be set in such a way such that price aligns with the underlying cost over the period of the charge control*".[443] Also, in answer to Question 5.2 (discussed further below), Openreach said that in the case of WLR transfer Openreach "*considers a separate charge control is appropriate*".[444]

5.12 On our proposal to amend the SMP conditions in relation to ancillary services, Openreach commented that changes to "*SMP Conditions should only be made once Ofcom has carried out the necessary analysis of the market in question as per section 85 of the Communications Act 2003*".[445] Openreach also observed that the SoR process already requires Openreach to supply ancillary services upon reasonable request.

Our response and conclusions

5.13 We agree with the majority of stakeholders that there does not appear to be a case for moving away from the current specific charge control for WLR rental.

[436] See March 2011 Consultation, paragraphs 3.90 to 3.98.
[437] C&WW response to the November 2011 Consultation, page 27, response to question 5.1.
[438] EE response to the November 2011 Consultation, page 21, response to question 5.1.
[439] FCS response to the November 2011 Consultation, page 6, response to question 5.1.
[440] GC response to the November 2011 Consultation, page 8, response to question 5.1.
[441] SSE response to the November 2011 Consultation, response to question 5.1.
[442] EE response, page 21, response to question 5.1.
[443] Openreach response to the November 2011 Consultation, paragraphs 422 and 423.
[444] Openreach response to the November 2011 Consultation, paragraph 424.
[445] Openreach response to March 2011 Consultation, paragraph 283.

5.14 While we note Openreach's stated preference for a broad basket of services, we do not consider that there is a case for such a framework. As there are only a small number of services (WLR rental, WLR transfer and WLR New Provide) subject to charge controls, we could not create a viable basket with appropriate safeguards that would not be dominated by WLR rental service given its far higher revenues and volumes – i.e. the basket control would be in effect the WLR rental control and the other services in the basket would be required to more in line with the WLR rental cost changes.

5.15 In addition, we note the strong stakeholder preference for separate charges. Given that we consider only three WLR services should be subject to charge controls (unlike LLU), this suggests that a basket control would not be appropriate. Openreach, itself agrees that a separate charge control for WLR transfer is appropriate, which suggests that WLR rental would be in a basket of only two services.

5.16 The purpose of a basket structure is to provide an undertaking that has been found to have SMP, and in relation to which we have imposed a charge control condition, with flexibility to adjust charges for services which use a common set of resources while ensuring that the condition is appropriate for the purposes of promoting efficiency, sustainable competition and conferring the greatest possible benefits on end-users of the services. In this case there is a very limited overlap in resources used by the WLR services and there is also a single dominant service (i.e. WLR rental) in terms of revenue.

5.17 As such, as we proposed in the March 2011 Consultation, we will set a single WLR rental charge control with glide path to ensure it recovers CCA FAC (subject to the adjustment for WLR transfer discussed below) by the end of the charge control period.

5.18 On our proposed change to the SMP conditions to make it clear that the obligation to provide WLR, when requested by a third party, includes such ancillary services as may be reasonably necessary for the use of WLR, we are satisfied that it is appropriate to make this change. Section 86 of the Act provides that Ofcom may modify SMP conditions where there has not been a material change in the market identified or otherwise used for the purposes of the market power determination by reference to which the condition was set or last modified. We set out in our November 2011 Consultation our provisional view that there has been no material change in either the WLA market or the WFAEL market since Ofcom's market power determinations in relation to those markets. We confirm this view in this Statement (Annex 11). As we explained in our March 2011 Consultation, this does not constitute a policy change, but merely clarifies the status of WLR ancillary services and, as now drafted, would make the SMP conditions for LLU and WLR consistent.

WLR transfer

5.19 WLR transfer is a service which CPs purchase when an existing WLR retail customer transfers its services to another WLR provider. In 2010/11, CPs spent approximately £10 million on this service.

March 2011 Consultation proposals

5.20 In the March 2011 Consultation we proposed to continue to set an individual charge control for WLR transfer.[446]

5.21 We believed it was important to ensure that the level of wholesale charges did not distort downstream and retail markets – for example by encouraging the creation of new MCPs which raise barriers to retail switching and reduce the level of choice for consumers. We said that Ofcom would like to see no-MCP options continue to be available in retail fixed voice markets.[447]

5.22 In the March 2011 Consultation, we noted that our general approach to price regulation where cost orientation applies is that a first order test of cost orientation is whether a charge lies between its distributed long run incremental costs (DLRIC) and its distributed stand-alone costs (DSAC). Openreach's reported long-run incremental costs (LRIC) and stand-alone costs (SAC)[448] of the transfer charge in 2009/10 was £10.09 and £24.28 respectively.[449] We noted the 2010/11 level of charges (£3.09) was significantly below the reported estimated LRIC. Therefore, unless charges are raised to at least the level of LRIC, it may be appropriate to remove the basis of charges (cost orientation) obligation that currently applies to this service. We considered it unlikely that removal of cost orientation in this case would result in a risk of excessive pricing, since WLR transfer will continue to be subject to an individual charge control.

5.23 However, we said in the March 2011 Consultation that it may be appropriate and proportionate to align the charges more closely with reported costs in the next LLU / WLR charge control. The charge control model forecasted the CCA FAC for WLR transfer at around £16 in 2014. Reconciliation of charges with this estimate of costs by the end of the charge control period would clearly require significant increases to charges in each year of the control.

5.24 Therefore, if we followed this approach we would need to consider whether increases to transfer charges would have a disruptive or damaging impact in downstream voice markets. In particular, we would be concerned if increases to the WLR transfer charge resulted in a reduction in the availability of residential telephone services without MCPs, or a general lengthening of MCPs.

5.25 We also considered how our approach to the WLR transfer charge contrasted with other charge controlled transfer and connection services subject to a charge control (i.e. MPF and SMPF transfer charges). It was clear that the treatment of the WLR transfer charge was markedly different to that of the other migration charges. As such, we considered whether there was a need to apply a consistent approach, i.e. aligning WLR transfer to CCA FAC. However, we noted that if we were to adopt the approach of aligning the WLR transfer charge to CCA FAC, a significant degree of price adjustment would be required (see Figure 5.1 below).

[446] March 2011 Consultation, paragraphs 5.16 to 5.27.
[447] March 2011 Consultation, paragraph 5.19.
[448] We consider that Openreach's estimate of LRIC to be a reasonable proxy for DLIRC in this case and SAC gives a lower bound estimate of the stand alone cost. Charges between LRIC and SAC would, therefore, also meet the criteria of be between DLRIC and DSAC.
[449] See Section 7.3 of Current Cost Financial Statements for 2010.

Figure 5.1: Percentage adjustments to align migration service charges to CCA FAC (Figure 5.1 in the March 2011 Consultation)

Service (all prices in nominal terms)	Charge at 31/3/2011	Forecast 2013/14 CCA FAC	% adjustment to align
MPF transfer	£38.64	£37.03	- 4.2
SMPF connection	£38.64	£30.24	- 21.7
MPF new provide	£62.11	£48.53	- 21.9
WLR transfer	£3.09	£16.30	+ 427.5

5.26 Figure 5.1 above illustrates that the adjustment required to align WLR transfer to CCA FAC is far greater than that required to align the LLU migration service charges. In the March 2011 Consultation, we said that we considered that such a large price adjustment over a 2.5 year period would carry a risk of disruption in the market and downstream at the retail level. In the March 2011 Consultation, we said that if we were to adopt an approach of aligning charges for WLR transfer more closely to cost, we believed a more gradual transition would be appropriate – for example, an alignment of the WLR transfer charge to an estimate of DLRIC over the life of the next controls (i.e. to the end of 2016/17) would result in a shallower glide path to CCA FAC alignment.

5.27 In light of the above, in the March 2011 Consultation we consulted on the following options:

- Option 1: maintain the current approach of maintaining a low WLR transfer charge (below reported LRIC), applying an indexation of RPI to allow charges to rise in line with inflation.

- Option 2: allow charges to rise over the life of the charge control to a level consistent with DLRIC. Our model did not forecast DLRIC values, but BT's published LRIC floor for WLR transfer could be a reasonable point of reference. The LRIC floor in the 2009/10 RFS is £10.09. Indexation at 3% over 3 years results in a forecast LRIC for 2013/14 of £11.00. Enabling charges to rise to this level would require very significant increases in each year of the charge control.

5.28 Since neither of these options would result in an immediate alignment of charges to reported costs, we also consulted on whether the current cost orientation obligation should be removed from WLR transfer.

5.29 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 5.2*: Do you agree that WLR transfer should be subject to a separate charge control? Please give reasons for your answer.*

Question 5.3*: Do you think that Ofcom should adopt Option 1 or 2 above as its approach to the pricing of WLR transfer during the next charge control? Please give reasons for your answer.*

Question 5.4: *Do you think that the cost orientation obligation should be removed from WLR transfer services? Please give reasons for your answer.*

March 2011 Consultation responseQuestion 5.2: whether there should be a separate charge control for WLR transfer

5.30 Openreach,[450] C&WW,[451] EE[452] and FCS[453] agreed that WLR transfer should be subject to a separate charge control. EE told us that "[t]*he WLR to WLR transfer service is a vital bottleneck switching service that any WLR or WLR+SMPF based competing operator must acquire from Openreach in order to gain an existing WLR or WLR+SMPF based customer from BT Retail or any other WLR or WLR+SMPF based provider. With the increasing prevalence of voice and broadband packages in the UK retail broadband market, the cost of the WLR to WLR transfer service is thus a critical input cost to enabling both voice and broadband retail competition in the UK. For as long as BT retains SMP in the Wholesale Fixed Analogue Exchange Line (WFAEL) market, we therefore firmly believe that the price of this service should be subject to a separate charge control to prevent Openreach from imposing excessive price rises, and increasing switching costs, that could distort or prevent competition in downstream markets*".[454]

5.31 GC, however, said that it did not "*think* [WLR transfer] *should necessarily be subject to charge control, provided Ofcom is fully satisfied that the proposed charges are fully justified on a cost orientation basis and that provision is duly made for bulk transfers at a lower pro-rata charge*".[455]

5.32 C&WW said that "[m]*argins for WLR are very low. Increases to the existing transfer charge will have significant impact on the viability of WLR without a considerable term (circa 18/24 months) minimum contract period in order to recover costs*".[456]

Question 5.3: Approach to the pricing of WLR transfer

5.33 C&WW,[457] EE,[458] FCS[459] and GC[460] said that we should adopt Option 1 (see paragraph 5.27 above) as our approach to the pricing of WLR transfer during the next charge control.

5.34 SSE said that its "*favoured options in order of preference are* [i] *Remove the charge completely* [i.e. place a cap of zero on charges made to CPs for the service of transferring customers between suppliers] *and recover the costs through line rental* [ii] *Reduce the charge from its current level* [and/or, iii] *Keep the charge at its current relatively low level*".[461] SSE also noted that "*Option 1 is worse than any of these* [preferences]*, in that* [Option 1] *proposes increasing the charge by applying*

[450] Openreach response to the November 2011 Consultation, paragraph 424.
[451] C&WW response to the November 2011 Consultation, page 28, response to question 5.2.
[452] EE response to the November 2011 Consultation, page 21, response to question 5.2.
[453] FCS response to the November 2011 Consultation, page 6, response to question 5.2.
[454] EE response to the November 2011 Consultation, page 21, response to question 5.2.
[455] GC response to the November 2011 Consultation, response to question 5.2.
[456] C&WW response to the November 2011 Consultation, page 28, response to question 5.2.
[457] C&WW response to the November 2011 Consultation page 28, response to question 5.3.
[458] EE response to the November 2011 Consultation pages 21 to 22, response to question 5.3.
[459] FCS response to the November 2011 Consultation, page 6, response to question 5.3.
[460] GC response to the November 2011 Consultation, response to question 5.3.
[461] SSE response to the November 2011 Consultation, Appendix, page 1 response to questions 5.2 and 5.3.

indexation of RPI to the current charge" but that Option 1 was nevertheless preferable to Option 2.[462]

5.35 Openreach said that WLR transfer should be set on a glidepath to recover its CCA FAC over the charge control period, as this would be consistent with the approach currently applied to WLR to MPF and MPF to MPF transfers.[463]

5.36 TTG said that "*ideally the WLR - WLR transfer should recover FAC*", but if this causes undue disruption then "*the right approach is to increase the price as quickly as reasonably possible*" and that "*a £2-3 increase in price each year*" should be manageable and the "*under-recovery verses FAC* [...] *should be recovered from WLR line rental*".[464]

Question 5.4: removal of cost orientation obligation

5.37 All stakeholders that addressed this question in response to the March 2011 Consultation (Openreach[465], C&WW[466], FCS[467], GC[468] and SSE[469]) broadly agreed that the cost orientation obligation should be removed from WLR transfer services.

Our response and conclusions

5.38 In light of the comments received from stakeholders, we do not consider that there is a case for changes to be made to the existing pricing approach set out in the 2006 WLR Statement which set a charge for WLR transfer below DLRIC to ensure that transfer charges did not act as a barrier to switching.[470]

5.39 We have not seen evidence from stakeholders that a closer alignment of the charge to DLRIC would lead to a significant beneficial change in consumer behaviour.

5.40 In addition, Openreach's position regarding the alignment of the WLR transfer charge with CCA FAC appears to be based on taking a consistent approach rather than any economic argument or a consideration of consequences of the adjustment. Other stakeholders have agreed with us that there are risks to competition (i.e. an increase in MCP) if there were to be substantial price increases for WLR transfer.

5.41 We have also considered whether we should place a zero price cap for WLR transfer (as proposed by SSE), however there is no evidence to suggest that the current relatively low charge is acting as a barrier to transfers or is responsible for the introduction of MCPs. On the other hand it would lead to further CCA FAC to be recovered by the WLR rental service and ultimately, therefore, the monthly retail line rental charges. In such circumstances we cannot see a case for the full removal of the charge.

5.42 Accordingly, we have decided to maintain the current approach of a low (below reported LRIC) WLR transfer charge together with RPI indexation to allow charges to

[462] SSE response to the November 2011 Consultation, Appendix, page 1, response to questions 5.2 and 5.3.
[463] Openreach response to the November 2011 Consultation, paragraphs 279 to 281 and 425.
[464] TTG response to the November 2011 Consultation, paragraph 444.
[465] Openreach response to the November 2011 Consultation, paragraphs 426 to 427.
[466] C&WW response to the November 2011 Consultation, page 28, response to question 5.4.
[467] FCS response to the November 2011 Consultation, page 7, response to question 5.4.
[468] GC response to the November 2011 Consultation, page 8, response to question 5.4.
[469] SSE response to the November 2011 Consultation, Appendix, page 2, response to question 5.4.
[470] See 2006 WLR Statement, paragraphs 3.64 to 3.66.

rise in line with inflation over the period of the charge control. We will also remove the cost orientation obligation for WLR transfer.

WLR New Provide

5.43 WLR New Provide is a service provided to customers switching to a WLR service who do not have an existing BT copper line. In 2010/11, CPs spent approximately £82 million on this service.

March 2011 Consultation proposals

5.44 In the March 2011 Consultation, we proposed to continue to charge control WLR New Provide to prevent Openreach from imposing excessive price rises and increasing switching costs, which could distort competition in downstream markets.[471] In the March 2011 Consultation, we noted that this would bring the price into line with CCA FAC by the end of the charge control period.

5.45 In the 2009 WLR Statement we considered evidence that the price of WLR New Provide was significantly in excess of CCA FAC.[472] We therefore, in the 2009 WLR Statement proposed a one-off adjustment which reflected half the difference between cost and price and a separate control to bring the charge for WLR New Provide into line with cost.

5.46 In the March 2011 Consultation we set out our review of the current WLR New Provide charge and underlying costs to ensure that the charge for WLR New Provide matches CCA FAC by the end of the charge control period. Given the 2010/11 charge for WLR New Provide is reasonably close to CCA FAC we did not consider that there is a requirement for a further one off adjustment.

5.47 In the March 2011 Consultation we asked stakeholders the following question:

> ***Question 5.5****: Do you agree that the price for WLR new provide should be subject to a separate control which ensures that the price is aligned with FAC by the end of the charge control period?*

March 2011 Consultation responses

5.48 Openreach,[473] C&WW,[474] EE[475], FCS,[476] GC[477] and SSE[478] agreed that the price for WLR New Provide should be subject to a separate control which ensures that the price is aligned with CCA FAC by the end of the charge control period.

5.49 Openreach also noted that "[a]*s a matter of principle, Openreach's preference is to have broad baskets to give greater flexibility in setting prices to reflect market demand and so as to align prices with costs over the control period*".[479]

[471] March 2011 Consultation, paragraphs 5.28 to 5.31.
[472] 2009 WLR Statement, paragraph 6.43 to 6.58.
[473] Openreach response to the March 2011 Consultation, paragraphs 428 to 429.
[474] C&WW response to the March 2011 Consultation, page 28, response to question 5.5.
[475] EE response to the March 2011 Consultation, page 22, response to question 5.5.
[476] FCS response to the March 2011 Consultation, page 7, response to question 5.5.
[477] GC response to the March 2011 Consultation, page 8, response to question 5.5.
[478] SSE response to the March 2011 Consultation, Appendix, page 2, response to question 5.5.
[479] Openreach response to the March 2011 Consultation, paragraphs 428 and 429.

Our response and conclusions

5.50 In the light of the comments received from stakeholders in relation to this issue, we have decided that, in line with the March 2011 Consultation proposal, the price for WLR New Provide will be subject to a separate charge control which ensures that the price is aligned with CCA FAC by the end of the charge control period.

5.51 With regard to Openreach's comments, as we explain in paragraphs 5.14 to 5.17, it is not practical to have a basket structure for the WLR charges given the limited number of services and the risk of distortion by the significantly larger (by revenue) WRL rental service. A basket control without WLR rental would only include two services, one of which is WLR transfer with which we have a specific competition policy interest in keeping below CCA FAC and therefore, it would not be appropriate to include this service in a basket, a point endorsed by Openreach.[480]

5.52 However, we do agree with Openreach, and the stakeholders who commented on this issue, that the corresponding X for WLR New Provide needs to be set in such a way that price aligns with the underlying cost over the period of the charge control. As such, in line with the March 2011 Consultation proposal, we have set the WLR New Provide charge control to align with CCA FAC by the end of the charge control period.

Services outside the scope of the charge control

5.53 In the March 2011 Consultation, we set out our provisional view that there are certain WLR services[481] in respect of which it is appropriate and proportionate to continue to rely on existing general remedies applied in the WFAEL 2010 Market Review.[482] We therefore proposed not to apply any new charge controls to these services.

MPF to WLR transfer

March 2011 Consultation proposals

5.54 The MPF to WLR transfer charge is incurred by the gaining WLR provider when a customer switches from an MPF provider.

5.55 In the March 2011 Consultation, we stated that we would be concerned if the current differential between the charges for conversion from MPF to WLR and WLR to MPF led to competitive distortions, for example, if the price of switching services tended to favour BT's downstream operations rather than other MPF competitors.[483]

5.56 We set out the charges (see Figure 5.2) that CPs pay when consumers switch between WLR and MPF in different circumstances.

Figure 5.2: Migration charges (at 1 April 2011) (Table 5.3 in the March 2011 Consultation)

	Voice only customers	Voice and broadband customers
MPF to WLR (+ SMPF)	£34.86	£39.79 + £34.86 = £74.47

[480] Openreach response to the March 2011 Consultation, paragraph 424.
[481] MPF to WLR transfer, calling and network features, pre-validation charges, ISDN to WLR transfer, cancellation charges and TRCs.
[482] March 2011 Consultation, paragraphs 5.31 to 5.53 and Annex 1 of the WFAEL 2010 Market Review.
[483] March 2011 Consultation, paragraphs 5.32 to 5.37.

WLR (+ SMPF) to MPF	£39.79	£39.79

5.57 We said that although the price of MPF to WLR (voice only) is lower than the symmetric charge for WLR (voice only) to MPF, we did not consider there is a strong case to align the prices.[484] This is because, first, although the services are similar they are not exactly the same[485] and therefore, some differential between the prices may be appropriate. Second, in the March 2011 Consultation we did not consider that the differential caused a significant competitive distortion in favour of BT's downstream operations. We argued that this was because, on the one hand, a WLR based operator faces lower switching costs attracting a voice only subscriber from an MPF competitor than MPF operators face attracting a WLR customer.

5.58 In relation to voice and broadband, a WLR +SMPF operator faces higher switching costs when attracting a broadband customer from an MPF competitor than MPF operators face attracting a WLR + SMPF broadband customer. However, we stated that given the low volume of MPF to WLR conversions[486] and as there did not appear to be a significant competitive distortion caused by current prices, in the March 2011 Consultation we proposed that MPF to WLR transfer should not be charge controlled.

5.59 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 5.6*: Do you agree that a charge control would not be practical for MPF to WLR conversion given the low volume of services?*

Question 5.7*: Do you agree that charges for MPF to WLR conversion should not be aligned precisely to the charge for WLR to MPF?*

March 2011 Consultation responses

Question 5.6: Whether MPF to WLR conversion should be charge controlled

5.60 Openreach,[487] C&WW[488] and GC[489] agreed with our proposal.

5.61 EE "*strongly disagree*[d]*"* with our proposal, noting the "*highly competitively significant £34.86 cost disadvantage when* [a WLR + SMPF based provider] *want to acquire a customer from an MPF based provider, as compared to when an MPF based provider wishes to acquire an SMPF or WLR based provider*". EE considered that "*asymmetry in migration charges is one of the most important regulatory hindrances to EE's ability to compete effectively and actively for MPF based retail broadband customers*".[490]

5.62 EE also noted that the relatively low volume of MPF to WLR conversions was because "*it is simply not generally financially viable for WLR+SMPF providers to compete for MPF based customers when faced with this cost disadvantage arising*

[484] March 2011 Consultation, paragraph 5.36.
[485] They involve similar but not identical engineering inputs. See the March 2011 Consultation, paragraph 5.33.
[486] Openreach estimates that there were around 85,000 MPF to WLR conversions in 2009/10. Openreach response of 24 December 2010 to question 4i of Ofcom's request for information of 10 December 2010.
[487] Openreach response to the March 2011 Consultation, paragraphs 430 to 432.
[488] C&WW response to the March 2011 Consultation, page 28, response to question 5.6.
[489] GC response to the March 2011 Consultation, page 8, response to question 5.6.
[490] EE response to the March 2011 Consultation, page 22, response to question 5.6.

directly from the (non) regulated charges". EE considered that "*these low numbers of conversions* [...] *provide direct evidence of the competitive distortion and harm being caused by Ofcom's failure to regulate to align MPF to WLR+SMPF migration costs with WLR+SMPF to MPF migration costs*".[491]

5.63 EE considered that an "*immediate charge control on the price for MPF to WLR transfers so as to ensure that the price that is required to be paid to Openreach to migrate a voice and broadband retail customer from MPF to WLR+SMPF is no more than the price to migrate a voice and broadband retail customer from WLR+SMPF to MPF (i.e. currently £39.79)*" was required.[492]

5.64 FCS noted that "*the low volume of transfers is due to the current level of the charge" and said that "Ofcom should impose a separate charge control to reduce the MPF to WLR charge to a level closer to the WLR to WLR charge*".[493]

5.65 SSE in response to questions 5.6 and 5.7 (see paragraphs 5.66 to 5.68 below) of the March 2011 Consultation said that "*we would advocate that there is no charge for conversions between MPF and WLR. Ofcom mentions* [...] *that there is a low volume of MPF to WLR conversions – the fact that there is a significant charge for the transfer might actually be having an effect on the volumes. To some extent, a competitive distortion does still exist in this market if customers are going to be charged from moving off or onto BT Openreach infrastructure. Other aspects of a customer's experience in moving between these two segments of what – from a customer's perspective – is a single retail market are being considered in Ofcom's strategic review of consumer switching. We urge Ofcom to take the opportunity of market reviews to consider what measures can be taken to promote consumer benefit or address customer detriment as identified by these other pieces of work*".[494]

Question 5.7: MPF to WLR conversion charge alignment

5.66 C&WW[495] and Openreach[496] agreed that the charge for MPF to WLR conversion should not be aligned precisely to the charge for WLR to MPF Transfer.

5.67 FCS said that "[a]*s a matter of principle, we believe that transfer charges should be kept at a low level and Openreach costs from activity associated with the transfer should be recovered via the monthly rental*".[497]

5.68 EE, making reference to the comments it had made in respect of question 5.6 (noted at paragraph 5.63 above) strongly objected to the proposal in the March 2011 Consultation not to align MPF to WLR conversion to the charge for WLR to MPF.

Our response

5.69 It is clear from the responses that the focus of stakeholders concerns with respect to the MPF to WLR transfer charge, where they exist, is linked to the charge when it is used in relation to broadband, as part of a broader concern with respect to the

[491] EE response to the March 2011 Consultation, page 22, response to question 5.6.
[492] EE response to the March 2011 Consultation, page 23, response to question 5.6.
[493] FCS response to the March 2011 Consultation, page 7, response to question 5.6.
[494] SSE response to the March 2011 Consultation, Appendix, page 2, response to questions 5.6 and 5.7.
[495] C&WW response to the March 2011 Consultation, page 29, response to question 5.7.
[496] Openreach response to the March 2011 Consultation, paragraphs 433 to 434.
[497] FCS response to the March 2011 Consultation, page 7, response to question 5.7.

relative competitive position of providers of voice and broadband who use WLR+SMPF and those whose use MPF.

5.70 This is understandable as we note that as there is no voice-only MPF provision at present, therefore the focus is on the impact of this service when considered in the context of voice and broadband provision. We note that as NGA develops there may be a market for MPF voice-only service provision (when combined with a FTTC broadband service) and, therefore, we are open to reviewing this decision in future reviews if the competitive impact of price differential was evidenced to be more significant.

5.71 However, it is worth considering separately the impact of the charges on voice only competition and voice and broadband competition.

Voice competition

5.72 MPF is inherently less efficient than WLR for the provision of voice only services. As we noted in the 2009 WLR Statement[498] the differential between MPF and WLR rentals would be an important consideration if the size of the differential appeared likely to create significant productive inefficiencies. However, we said that in practice it was unlikely that any productive inefficiency would occur if the difference in the charges for WLR and MPF did not reflect LRIC because it was not clear that it would be economic for an LLU operator to provide voice-only services given the economies of scale involved relative to the value of the service.

5.73 This similarly applies to supporting services in the context of a voice only market.

5.74 We observe that despite the lower migration charge from MPF to WLR, volumes for this transfer are far lower than that for WLR to MPF. This suggests that this differential is not alone key to any migration decision. This is undoubtedly a consequence of the fact that at present there is no significant level of voice only MPF provision.

5.75 Accordingly, we consider that there are no current competition issues with respect to voice only competition that an adjustment of the MPF to WLR service would address.

Voice and broadband competition

5.76 Both EE and FCS are seeking changes that would lead to a closer alignment of the costs of migration of services from MPF to WLR+SMPF with migration in the opposite direction.

5.77 We consider that there is scope to simplify and reduce the charge control and simplify the processes for the MPF to WLR (+ SMPF) conversion. Currently migration requires two separate processes (one process to migrate the customer to WLR and second to migrate the customer to SMPF). The question is what is appropriate and proportionate to achieve this end.

5.78 EE and FCS are seeking to address this concern over relative charges through adjustment of the individual MPF to WLR transfer and SMPF Connection charges.

5.79 We would be concerned about such an adjustment as seeking to equalise (or at least more closely align) the sum of these charge to the MPF transfer charge would distort

[498] 2009 WLR Statement, paragraph 5.16.

the individual charge levels, which would be inconsistent with our approach of aligning charge with CCA FAC and inconsistent with the principle that charge differentials should be consistent with LRIC differentials. This is important as the services are bought individually as well as collectively, particularly the SMPF Connection charge and were we to equalise (or more closely align) the charges, this would be likely to result in a significant distortion

5.80 We are, however, of the view that there is scope to create a single migration service that allows a CP to migrate customers to WLR + SMPF from MPF simultaneously. This would reduce the overall cost of migration to MPF and WLR services and provide a more seamless consumer experience – as there will be no gap between the re-establishment of WLR and the connection of SMPF.

5.81 However, given that this would require the creation of a new service by Openreach, we are not able to resolve this issue in the context of this charge control review. We cannot set a charge for a service that does not exist as we do not have any detailed cost or activity information on which to base a charge. In September 2011, BT Retail submitted a SoR which identified that Openreach was charging two connection charges for transfers from MPF to WLR+SMPF, but only one connection charge for transfers from WLR+SMPF to MPF. BT Retail said that this had resulted in SMPF providers being disadvantaged compared to MPF providers and that this was increasingly becoming an issue as MPF becomes more prevalent.

5.82 In the SoR, BT Retail requested that Openreach either a) amends the price to take account of potential savings as only one engineer visit is required to connect the SMPF and WLR or b) provides a new product to take account of the savings.

5.83 We require the SoR to be undertaken before we are in a position to reach a view on the appropriateness of a charge for this service. The SoR will consider the cost savings, new system requirements and also expected volumes for the service, all of which are necessary to develop a charge.

5.84 We consider the new service would also address EE concerns and, at least in part, the concerns expressed by FCS as it should lead to a rebalancing of the MPF / WLR+SMPF competitive positions. However, we would note that FCS' preference for an alignment of the MPF to WLR transfer to the WLR to WLR transfer ignores the significant LRIC differential between the services and the risk of distortion of economic incentives and (assuming there is a continuing need for a charge control) we would have to consider carefully whether there was a case for setting a charge below LRIC given the wider competition benefits.

Our conclusions

5.85 In the light of comments received from stakeholders, and our response to those to the points raised by EE and FCS, we have decided that a charge control and/or alignment with WLR to MPF conversion is not required at this time for MPF to WLR transfer.

5.86 We accept that the existing services available to WLR based CPs may put them at a disadvantage compared to MPF based providers. However, as discussed above adjusting this charge alone would not address the broader concern over WLR+SMPF versus MPF competition and to adjust the charge as suggested by FCS would risk substantial economic incentive distortion.

5.87 Going forward, we consider that the SoR process will lead to an identification of the cost elements of the combined transfer services and result in a better consumer experience (to the advantage of WLR+SMPF based competitors). Furthermore, we would anticipate that the new service would be considered in the next WFAEL and WLA market reviews.

Calling and network features

March 2011 Consultation proposals

5.88 Calling and network features are add-on services provided alongside core WLR rentals.[499] In the March 2011 Consultation,[500] we said that there are around 50 network features and around 30 call features that Openreach and BT Wholesale charge CPs for, when such services are offered to their retail customers. We also said in the March 2011 Consultation that during 2009 Openreach conducted a trial of lower prices for these services which resulted in the price falling in most cases except for call waiting, caller display and three-way calling, which remained at their pre-trial pricing.

5.89 During the 2009 trial, while some features showed a modest increase in demand at the lower pricing levels (and indeed volumes for some features actually decreased), call waiting, caller display and three-way calling showed a stronger increase in demand in response to the price change. Openreach reverted its pricing for these services back to the pre-trial levels. Openreach advised Ofcom in their response to the 2009 WLR review[501] that incremental capital expenditure would be required to support the additional demand for these services at the lower (trial level) price points, which would be difficult to justify given this is a legacy system.

5.90 In the 2009 WLR Statement, we said that in light of this information provided by BT, and taking account of Openreach's price reductions for many calling and network features, we considered these services would, therefore, not be subject to charge control.[502]

5.91 In the March 2011 Consultation we noted that it appeared to us that the continued historically low prices for most network and calling features implied a prescriptive charge control is not necessary.[503] Furthermore, we considered that in practice it would be difficult to set a robust charge control on these services, given the challenge of identifying the specific costs associated with the provision of these services.

5.92 Therefore, on balance, we considered it was appropriate and proportionate to continue to rely on existing general remedies applied in the WFAEL 2010 Market Review than to apply any new charge control.

5.93 In the March 2011 Consultation, we asked stakeholders the following question:

[499] Call features include: call diversion, call barring, bypass number, call waiting, call sign, caller display, reminder call and ringback. Network features include: call diversion by admin control, change of divert to number, outgoing calls barred, incoming calls barred.
[500] March 2011 Consultation, paragraph 5.38.
[501] Openreach response to 2009 first consultation on WLR charge controls, answer to question 5.4: http://stakeholders.ofcom.org.uk/binaries/consultations/wlrcc/responses/bt_response.pdf .
[502] 2009 WLR Statement, paragraph 6.76.
[503] March 2011 Consultation, paragraphs 5.38 to 5.43

***Question 5.8**: Do you agree that charges for calling and network features should not be charge controlled? Please give reasons for your answers*

March 2011 Consultation responses

5.94 Openreach,[504] C&WW,[505] FCS[506] and GC[507] broadly agreed that charges for calling and network features should not be subject to a charge control. However, FCS said that "*it may be prudent to apply some form of "safeguard cap" to prevent any unreasonable increases beyond current levels*". [508]

5.95 EE told us that "*it is very important for Ofcom to charge control caller display and voicemail as the information available to it suggested BT was extracting monopoly profits from the supply of these features. It said prices are causing serious competitive harm to WLR+SMPF based voice and broadband bundle providers such as EE, who have no effective choice but to buy these services from BT*".[509]

5.96 SSE noted "*some concerns*" with the approach we proposed in the March 2011 Consultation as "[n]*etwork and calling features are an integral part of the service a customer expects to receive in this retail market and an unfettered ability for the only provider of those services to increase wholesale charges is not desirable. We accept that it may be difficult to set a robust control on the services due to the fact that use of the features does not incur incremental activity. However, to provide reassurance to the many wholesale customers that charges will not be allowed to increase unreasonably over the life of a control, then perhaps "safeguard caps" at the current price levels could be implemented. We do not see how such a move would limit the ability of Openreach to efficiently recover costs as these have been stated as difficult to identify robustly. Openreach could make the case at each successive market review for amending these wholesale charges if it could demonstrate good reasons for wishing to do this*".[510]

Our response and conclusions

5.97 We understand the concerns expressed by stakeholders but consider that there is not sufficient evidence that a charge control is appropriate.

5.98 EE identifies two distinct sets of services (i) messaging services supplied by BT Wholesale (which includes 1571 and Callminder) and (ii) number identification, call barring and re-routing services supplied by Openreach.

5.99 With respect to the BT Wholesale services, these have been developed in response to WLR customer interest in providing voice handling services to compete with third party services directly available to consumers in units in their homes. It is clear that such services are competing directly with such alternatives and as such, the retail and wholesale pricing for such services are constrained by the alternative cost of provision. We also recognise that there are a number of commercial providers of voice mail and call handling services which offer off site (i.e. remote) call handling

[504] Openreach response to the March 2011 Consultation, paragraphs 435 to 438.
[505] C&WW response to the March 2011 Consultation, page 29, response to question 5.8.
[506] FCS response to the March 2011 Consultation page 7, response to question 5.8.
[507] GC response to the March 2011 Consultation, page 9, response to question 5.8.
[508] FCS response to the March 2011 Consultation, page 7, response to question 5.8.
[509] EE response to the March 2011 Consultation, page 3.
[510] SSE response to the March 2011 Consultation, Appendix, page 2, response to question 5.8.

services including voice mail, largely to commercial entities. We consider that there is sufficient commercial constraint on the wholesale charges BT Wholesale can set.

5.100 For the remaining Openreach provided services, as previously identified (paragraphs 5.89 to 5.90), there have been a number of price reductions in 2009.

5.101 However, as discussed above (see paragraphs 5.88 to 5.89), Openreach has informed us that a significant level of price reductions in the call waiting, caller display and three way caller services will lead to a level of demand not manageable by the current system, and which would require further investment in the legacy system by Openreach. As such it is difficult to set charge controls as the new investment will lead to an increase costs which will in turn lead to an increase in charges. Equally, we do not consider that it is justifiable to encourage investment in legacy systems at a time of technological change, when it is likely the legacy system provision of such service will not be required in the future as the services are moved to IP based systems.

5.102 However, we note that Openreach has committed to a further review of the wholesale charges for the calling and network services that only Openreach is able to provide[511] in order to determine more precisely an equilibrium price point that will allow reduced charges to customers without the need for substantial new investment. Openreach has committed to engaging with Ofcom throughout this review and expect in to complete the review in the first half of 2012/13.

5.103 We have considered also the need for a safeguard cap on the service charges. Given that the charges have not increased since the last review and that Openreach has committed to a review of the charges to determine whether further reductions can be offered, we do not consider that a safeguard cap is appropriate or proportionate at this time.

5.104 Accordingly, we have decided that not to apply a charge control to these services at this time. We will consider the outcome of Openreach's review of its calling and network features and consider whether further intervention is required in the future.

Pre-validation charges

March 2011 Consultation proposals

5.105 The pre-validation charge applies to all WLR lines and enables a CP to confirm, prior to a 'like for like' order being placed, how the end user's line is configured and whether there are products connected that are incompatible with the WLR offering. In the March 2011 Consultation, we proposed not to include this charge within the scope of the charge control. We noted that the £2.00 charge had remained unchanged since 2006 and in the circumstances we considered it was appropriate and proportionate to continue to rely on existing general remedies applied in the WFAEL 2010 Market Review than to apply any new charge control.

5.106 In the March 2011 Consultation we asked stakeholders the following question:

Question 5.9*: Do you agree with that pre-validation charges should not be charge controlled? Please give reasons for your answers.*

[511] Email from BT dated 18 January 2012.

March 2011 Consultation responses

5.107 Openreach,[512] C&WW,[513] FCS[514] and GC[515] broadly agreed that pre-validation charges should not be charge controlled. Openreach noted that: "[p]*re-validation services, which provide information to a CP about the features on an existing line, are only used by WLR2 CPs as such data is available to WLR3 CPs via the Equivalence Management Platform. The WLR2 platform was scheduled to be closed on 30 June 2011, and therefore the pre-validation service was withdrawn with the WLR2 contract at that time*".[516]

5.108 SSE argued that a pre-validation charge is similar to a transfer charge as it is a cost which impacts on migration incentives and it should be set to zero, with the actual costs recovered through the rental charge.[517]

Our response and conclusions

5.109 As Openreach note in their response, this service was withdrawn after the March 2011 Consultation and there is no equivalent replacement service, as its function is now delivered within the rental service ordering platform for which no separate charge is made and hence consistent with the approach proposed by SSE. Therefore, since this service no longer exists, we clearly do not need to consider the need for a charge control.

ISDN to WLR conversion charge

March 2011 Consultation proposals

5.110 The ISDN to WLR conversion charge applies when customers who currently have an ISDN line wish to convert to a single WLR analogue line. The current ISDN to analogue conversion charge is £70.00. In the March 2011 Consultation, we noted that the level of conversions from ISDN to WLR is very low and given the difficulty of identifying robust cost data it appeared to us to be disproportionate to impose new charge control regulation for ISDN to WLR conversion in addition to the general cost orientation obligation.

5.111 In the March 2011 Consultation we asked stakeholders the following question:

> ***Question 5.10****: Do you agree that ISDN to WLR conversion charge should be subject to cost orientation obligation but should not be charge controlled? Please give reasons for your answers.*

March 2011 Consultation responses

5.112 Openreach[518] and C&WW[519] agreed with our proposal. GC said that "[*w*]*hile we acknowledge the low volumes and generally support the proposed approach, we are*

[512] Openreach response to the March 2011 Consultation, paragraphs 439 to 440.
[513] C&WW response to the March 2011 Consultation, page 29, response to question 5.9.
[514] FCS response to the March 2011 Consultation, page 7, response to question 5.9.
[515] GC response to the March 2011 Consultation, page 8, response to question 5.9.
[516] Openreach response to the March 2011 Consultation, paragraph 439.
[517] SSE response to the March 2011 Consultation, Appendix, page 2, response to question 5.9.
[518] Openreach response to the March 2011 Consultation, paragraphs 441 to 443.
[519] C&WW response to the March 2011 Consultation, page 29, response to question 5.10.

also concerned that the current £70 conversion charge is intuitively high and may be worthy of a slightly deeper investigation".[520]

Our response and conclusions

5.113 We do not consider that there is any evidence of a competitive distortion caused by the current charge, nor evidence of significant market impact which would justify a charge control rather than relying on the general cost orientation remedy. The comments received from stakeholders in response to our March 2011 Consultation appear to broadly agree.

5.114 Our conclusion in the WFAEL 2010 Market Review was that the ISDN and WLR services were in separate markets. Accordingly, the ISDN to WLR conversion service is relevant to a substantial change in line use rather than being instrumental in competitive service provision within the WFAEL market. Any provider offering a WFAEL service would have to undertake a similar conversion.

5.115 As noted above, the level of conversions from ISDN to WLR is very low. Low volume services are inherently more costly and more difficult to set charges for which deliver a consistent level of return. We consider that the risk of error in setting the charge is greater than any likely market or commercial impact of leaving it subject to cost orientation alone.

Cancellation charges

March 2011 Consultation proposals

5.116 In the March 2011 Consultation, we explained that with regard to charges for the cancellation of orders[521] where Openreach has incurred costs involved in preparing to deliver a service, we considered it to be reasonable for Openreach to recover those costs through reasonable cancellation charges.[522]

5.117 We said that Openreach had two tiers of cancellation services as set out in their price list:

- Orders cancelled before 4pm on the day prior to the date when the customer requires the service are charged at £3.50; and
- Orders after 4pm of the day prior to the date when the customer requires the service are charged at full order price (for example in the case of a WLR New Provide this could be £48.22).[523]

5.118 We noted in the March 2011 Consultation that Openreach had informally told Ofcom that the price of cancellations prior to 4pm of the day before service initiation reflected the fact that the service centre and resourcing costs required to initiate the

[520] GC response to the March 2011 Consultation, page 8, response to question 5.10.
[521] See: http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=PgMT6eI2nnlo4hhO70Yda27EtHRtVUAuOBA%2F5MusDN1UNeIS4WkJBRh6z%2FRUAIt8maxtgrEro1A7%0Aw5V8nzAZpQ%3D%3D as at 13 January 2012.
[522] March 2011 Consultation, paragraphs 5.46 to 5.49.
[523] See the Openreach price list, http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=PgMT6eI2nnlo4hhO70Yda27EtHRtVUAuOBA%2F5MusDN1UNeIS4WkJBRh6z%2FRUAIt8maxtgrEro1A7%0Aw5V8nzAZpQ%3D%3D as at 13 January 2012.

order had already been incurred.[524] Openreach argued that staff cannot be redeployed after 4pm on the day prior to the order and, in some cases, cancellation at this point may entail further incremental work as Openreach has to 'reverse' work already completed as part of the initial order.

5.119 We said in the March 2011 Consultation that we did not consider that it was appropriate to impose a new charge control for cancellation charges and stated our preference to continue to rely on the existing general remedies applied in the WFAEL 2010 Market Review. Furthermore, we noted in the March 2011 Consultation[525] that we would interpret the cost orientation obligation as meaning that we would not expect the cancellation charge to exceed the charge of the original order. As such, we did not consider that there was a need to charge control the cancellation charge as it is constrained to some extent by the level of the regulated price for the initial order.

5.120 In the March 2011 Consultation we asked stakeholders the following question:

Question 5.11*: Do you agree that cancellation charges should not be charge controlled? Please give reasons for your answer.*

March 2011 Consultation responses

5.121 Openreach [526] and C&WW[527] agreed that cancellation charges should not be charge controlled. Openreach said that such a control would provide incorrect incentives to Openreach to become more efficient.

5.122 FCS agreed that specific charge controls may not be appropriate but stated that some form of safeguard cap and/or monitoring by Ofcom to prevent unreasonable increases would be welcome.[528]

5.123 GC told us that "[w]*hile we generally support the exclusion of cancellation charges from controls, we are nevertheless concerned that in recent months, Openreach has displayed an appetite to seek additional technician-related charges (eg when the end user denies access). We therefore urge that vigilance and caution is applied in Ofcom's approach to this issue*".[529]

5.124 SSE said that"[cancellation charges and TRCs[530]] *are two further categories of charges that suppliers face in using Openreach infrastructure to deliver retail communications services. We do not believe it is satisfactory for Ofcom to leave market participants relying only on "general remedies*" *from the market review to constrain the pricing policies of Openreach. Suppliers should not be paying over the odds for these services and there is not a great deal of transparency about how charges are set in these areas. We note that Ofcom is considering providing cost orientation guidance for the time-related charges and think that this would be helpful. We believe it would also be helpful for Openreach to be required to set out its methodology for establishing these charges as a public document to aid*

[524] March 2011 Consultation, paragraph 5.48.
[525] March 2011 Consultation, paragraph 5.49.
[526] Openreach response to the March 2011 Consultation, paragraphs 444 to 447.
[527] C&WW response to the March 2011 Consultation, page 29, response to question 5.11.
[528] FCS response to the March 2011 Consultation, page 8, response to question 5.11.
[529] GC response to the March 2011 Consultation, page 9, response to question 5.11.
[530] See also paragraphs 5.131 to 5.152 below.

transparency and to justify any changes to the charges – these to be signalled well in advance of implementation".[531]

Our response and conclusions

5.125 We have noted the comments made by stakeholders, in response to our proposal in the March 2011 Consultation.

5.126 We discussed in the WFAEL 2010 Market Review that where Openreach has incurred costs involved in preparing to deliver a service, we did not consider that it was unwarranted for Openreach to recover these costs through reasonable cancellation charges. As the vast majority of a cancellation charge is likely to include costs related to engineering work which potentially Openreach will need to 'reverse' to cancel an order, we did not consider that the scale of charges seemed unwarranted. We maintain this position.

5.127 Further, it is clear that the charges are intended to provide the appropriate incentive for early notification of a cancellation. The 'before 4pm' £3.50 charge is clearly comparable with other SMC non-engineering action charges (for example MPF Cease). To lower the late notification charge also risks removing the disincentive to cancel late in the day, something which clearly does not contribute to the efficient use of Openreach resources.

5.128 Accordingly, we consider that cancellation charges should not be subject to a specific charge control at this time but should continue to be subject to the cost orientation condition.

5.129 We also note SSE's concerns about transparency. As discussed previously, we are currently undertaking the Cost Orientation and Regulatory Reporting Review. We consider that stakeholder concerns with respect to transparency will be addressed in the context of this review.

TRCs

5.130 TRCs are related to the provision of additional services where the work is not covered within Openreach service level agreements.[532] TRCs are provided across Openreach's portfolio of products and not just for WLR services. These are charged on a per visit or per hour cost of an engineer's visit. TRC charges can vary depending on when the work takes place – i.e. weekday, business hours, outside normal business.

March 2011 Consultation proposals

5.131 We proposed in the March 2011 Consultation that WLR TRCs should remain outside the scope of the charge control, and be subject to general remedies set out in the WFAEL 2010 Market Review. We noted that while WLR TRCs may to some extent be contestable, it is debatable how far some CPs are practically able to substitute to alternatives to Openreach.[533]

[531] SSE response to the March 2011 Consultation, Appendix, page 3, response to questions 5.11 and 5.12.
[532] http://www.openreach.co.uk/orpg/home/products/serviceproducts/timerelatedcharges/timerelatedcharges/downloads/TRCs.pdf.
[533] March 2011 Consultation, paragraph 5.51.

5.132 We also considered that separate reporting arrangements for TRCs in Openreach's regulatory accounts would not be appropriate or proportionate. This is because it would be difficult from a practical perspective to identify whether each instance of TRC would be subject to the WLR market. We also considered that the structure of the charges (which are based on per visit or per hour cost of engineer time) provides enough information for CPs to assess whether charges are reasonable and cost orientated.[534]

5.133 Finally, we recognised that further guidance on the application of cost-orientation due to take place in our forthcoming Cost Orientation and Regulatory Reporting Review may be helpful to CPs.[535]

5.134 We asked Stakeholders the following question in the March 2011 Consultation:

> ***Question 5.12:*** *Do you agree that time related charges should remain out of the scope of the charge control and subject to general remedies applied in the WAEL market review?*

March 2011 Consultation responses

5.135 Openreach agreed that TRCs should not be charge controlled. Openreach explained that these services are provided across different markets (e.g. Leased Lines), and so would be complex to control, are contestable, and "*are used for activities outside-of-the-normal*".[536]

5.136 EE supported further consideration of TRCs in the forthcoming cost orientation review.[537]

5.137 However, both TTG and Sky disagreed that TRCs should remain outside the scope of the LLU charge control. Both Sky and TTG proposed that we charge control TRCs in a new basket (together with SFIs). Sky[538] and TTG[539] argued that TRCs charge controlled in a basket would be better than our proposals because:

- Sky and TTG's spend on TRCs can often exceed spend for certain ancillary services and so is proportionate to charge control TRCs. TTG said industry spend was likely to be around £100 million in 2009/10, and these charges are above efficient cost;

- TRCs are mostly SMP services, cannot be purchased elsewhere, and it would be relatively simple to distinguish and identify TRCs which are subject to SMP from TRCs which are not subject to SMP;

- Cost orientation obligations, instead of charge controls, would be insufficient, as it would allow Openreach to price TRCs above efficient cost and not incentivise Openreach to be efficient. Separately, TTG also argued that Openreach are currently charging excessively for TRCs, but that, in any case, our proposals should also be based on potential for abuse, that cost orientation obligations do

[534] March 2011 Consultation, paragraph 5.52.
[535] March 2011 Consultation, paragraph 5.53.
[536] Openreach response to the March 2011 Consultation, paragraph 4.01.
[537] EE response to the March 2011 Consultation, page 19.
[538] Sky response to the March 2011 Consultation, paragraphs 11 to 21.
[539] TTG response (July 2011) to the March 2011 Consultation, paragraphs 470 to 484.

not provide the certainty that a charge control provides, and that enforcing a charge control would be more administratively efficient for Ofcom to enforce cost orientation obligations; and

- A charge control would prevent over-allocation of costs to TRCs (and mean under-allocation elsewhere for other services) so that the "*overall amount consumers pay is broadly unchanged*"[540] which would reduce Openreach's incentives to game the charges.

5.138 TTG also argued that the forthcoming review on cost-orientation guidance may not be helpful because the review may not actually take place, and if it does take place the guidance from the review may not be sufficiently useful and prescriptive to determine whether Openreach is charging excessively and provide TTG with a sufficient basis to allow it to raise a potential dispute.[541]

5.139 TTG also argued that TRCs service charges for MPF, SMPF and WLR should be aligned (but that this measure on its own would not be sufficient).

5.140 Finally, TTG said a basket (with SFIs) would provide Openreach with flexibility to restructure and re-balance prices.[542]

Our response and conclusions

5.141 We do not consider that implementation of a charge control (by way of a basket or other means) is appropriate or a proportionate approach for WLR TRCs.

5.142 We note that the cross-market nature of TRCs and the nature of the service itself means that a charge control (by way of a basket or other means) may not be a sufficiently targeted intervention. For example, TRCs can be provided in the Leased Lines and WLA markets (in addition to the WLR market), making it difficult to identify robustly all WLR TRC costs (which are reasonably necessary for the use of LLU services). As noted in the March 2011 Consultation,[543] we do not consider that separate reporting arrangements in Openreach's regulatory accounts would be appropriate or proportionate. Further, the structure of the charges, given the nature of the service, also means that charges can be variable. For example, TRC charges can vary depending on when the work takes place (i.e., on a weekday or during business hours or outside normal business hours).

5.143 We note that Openreach does not currently charge on a separate basis for TRCs for MPF or SMPF or WLR products (unlike SFI, for example, where there is an MPF SFI and an SMPF SFI). We consider that any potential risk in Openreach discriminating between types of product user to distort competition between users, is therefore likely to be extremely low. We note that TRCs are currently the same price regardless of what product the work is carried out on and we do not consider that any service charge alignment obligation (i.e. that a TRC carried out for MPF, SMPF and WLR should be set equal) is necessary or practical given the nature of the product (including for the reasons above - see paragraph 5.142).

5.144 We recognise that WLR (and LLU) TRCs can represent a significant item of spend for CPs (although we note that 2009/10 industry spend on LLU and WLR TRCs is

[540] TTG response (July 2011) to the March 2011 Consultation, paragraph 483.
[541] TTG response (July 2011) to the March 2011 Consultation, paragraph 4.77.
[542] TTG response (July 2011) to the March 2011 Consultation, paragraphs 4.85 to 4.86.
[543] March 2011 Consultation, paragraphs 4.123 to 4.125.

likely to be approximately at least 30% less than what TTG stated in its March 2011 Consultation response[544] for 2009/10).

5.145 However, we have reviewed Openreach's overall returns (which are commercially confidential) for TRCs. We consider that these are in line with our normal expectations for Openreach services, suggesting that they are not overcharging for TRCs by Openreach.

5.146 In response to TTG's comment in relation to the prospect of abuse by Openreach, we consider that Openreach is aware that were Openreach to begin to make above normal levels of returns against TRCs we would both consider a re-allocation of more common costs to TRCs (given they draw largely on a common cost pool which also supports the charge controlled services) in setting future charge controls and possible options for more direct intervention.

5.147 We consider that the cross market and flexible nature of TRCs means that regulation through cost orientation rather than an explicit charge control is more appropriate.

5.148 However, we recognise stakeholder's concerns with respect to transparency around setting charges for services subject to cost orientation obligations. In response to this, as noted above, we are undertaking a Cost Orientation and Regulatory Reporting Review. Stakeholder concerns regarding cost orientation obligations imposed on BT (Openreach) and the reporting and monitoring requirements associated with regulated services will be considered in the context of this review.

5.149 We conclude that where TRCs are reasonably necessary for the provision of WLR services, they should be subject to the general remedies as set out in WFAEL 2010 Market Review.

5.150 For consistency, we have taken the same approach with respect to WLR TRCs. This approach is set out in Section 4 of this Statement (paragraph 4.322 to 4.342).

WLR cease charges

5.151 In the March 2011 Consultation, we did not consult on any proposals with regard to WLR cease charges. However, TTG in its response "*noted that there is no cease charge for WLR"* and said that it *"seems likely that there are significant costs associated with WLR ceases. Ofcom must investigate where/how these costs are recovered*".[545]

5.152 TTG further commented on cease charges in its response to the November 2011 Consultation, where it proposed an estimate of £7 million across all WLR lines and questioned whether these costs were being inappropriately recovered by LLU services as well as WLR services.[546]

Our response and conclusions

5.153 We note that there was traditionally no charge for WLR cease, as there is no physical activity that occurs when Openreach ceases a WLR service.

[544] TTG response (July 2011) to the March 2011 Consultation, paragraph 2.71.
[545] TTG response (July 2011) to the March 2011 Consultation, paragraph 465.
[546] TTG response to the November 2011 Consultation, paragraph 42.

5.154 However, we would note that there are record activities of a similar nature as LLU soft ceases with the CCA FAC cost being related to the SMC and principally composed of fixed system costs and a low level of incremental costs (see discussion in Section 4, paragraphs 4.88 to 4.119 relating to MPF and SMPF cease charges).

5.155 In the past such costs have been recovered through the WLR rental charge alone. The SMC costs for LLU services were always separately identified. As we now have decided to recover the MPF and SMPF cease in a similar manner (see Section 4, paragraphs 4.88 to 4.119) there is no basis for altering the position in relation to WLR cease charges.

Section 6

Calculation of charge controls

Introduction

6.1 In this Section, we set out the basis of our calculation of the charge controls. In particular, we:

- set out our final estimates of the cost of providing the services that fall within the scope of this charge control review;
- explain the basis for estimating those costs, including the general approach taken and the assumptions used;
- demonstrate how we have adjusted the cost estimates for the purpose of setting the charges; and
- set out how we have taken account of the adjusted cost estimates to derive the final charge controls.

6.2 For each issue under consideration, this Section sets out:

- a summary of our proposals as set out in the March 2011 Consultation and the November 2011 Consultation (where applicable);
- a summary of the comments received from stakeholders on those proposals set out in the March 2011 Consultation and the November 2011 Consultation (where applicable); and
- our response to those comments and our decision, in light of stakeholder comments, together with the arguments in support of our conclusions.

Summary of our decisions

6.3 Figure 6.1 sets out the base case 2013/14 cost estimate as presented in the March 2011 Consultation.

Figure 6.1: Ofcom base case charges estimates for the Core Rental Services (2013/14), as set out in the March 2011 Consultation

	MPF rental	WLR rental	SMPF rental
	£	£	£
Base case cost estimate	90.89	98.25	9.14
Reallocation of TAMs costs	(2.31)		1.68
Inclusion of costs relating to LLU ceases	0.51		0.28
Inclusion of costs relating to transfers		2.37	
Restated cost stacks for charging purposes	**89.09**	**100.62**	**11.10**

6.4 As explained in the November 2011 Consultation, we subsequently revised our base case estimate downwards to reflect the removal of certain Information System (IS) costs.[547] As set out in this Section, we have now reviewed all of our assumptions and updated our final estimate accordingly. Our final estimate is set out in Figure 6.2 below.

Figure 6.2: Final estimate of unit costs (2013/14) for the Core Rental Services

	MPF rental	WLR rental	SMPF rental
	£	**£**	**£**
Base case cost estimate	86.85	92.65	8.42
Reallocation of TAMs costs	(2.27)		1.65
Inclusion of costs relating to ceases	0.31		0.31
Inclusion of costs relating to transfers		1.87	
Restated cost stacks for charging purposes	**84.89**	**94.52**	**10.38**

6.5 The main reasons for the difference between the estimates in the March 2011 Consultation and final estimates are set out in Figure 6.3 below.

Figure 6.3: Summary of key differences between March 2011 Consultation base case and final estimate in this Statement on restated cost stacks for pricing purposes (2013/14)

	MPF rental	WLR rental	SMPF rental
	£	**£**	**£**
Restated cost stack in March	**89.09**	**100.62**	**11.10**
Duct and RAV and Holding Gains (see Annex 7)	(1.54)	(1.53)	-
IS Costs (exclusion of costs of £125million)	(2.08)	(2.10)	(0.47)
c2% Higher Copper Volumes	(1.47)	(1.64)	(0.11)
Line Length (WLR 1.6% longer than MPF)	(0.52)	0.22	-
Higher Care (5.6% differential)	0.36	(0.37)	0.05
EvoTAM (Allocate 0.6:1.0 WLR:SMPF)	-	(0.21)	0.44
WACC (was 8.6%, now 8.8%)	0.61	0.60	0.01
SMC Reallocation (Allocate 5.6:1.0 MPF:SMPF)	0.96	-	(0.71)
Allocation of repayment income (by asset rather than current labour)	(0.31)	(0.34)	0.04
Others	(0.21)	(0.73)	0.03
Restated cost stacks, final view	**84.89**	**94.52**	**10.38**

6.6 As explained in Section 4 of this Statement, we are also implementing individual controls for a number of ancillary services. The unit cost of providing these ancillary services in 2013/14 is set out in table 6.4 below, shown alongside the current (the voluntary) prices and the March 2011 Consultation base cases for comparison:

[547] November 2011 Consultation, paragraphs 2.06-2.08.

Figure 6.4: March 2011 Consultation and final unit cost estimates for 2013/14 for LLU and WLR Ancillary services

	MPF New provide £	WLR New Connection £	SMPF New Provide £	MPF Single migration £	SMPF Single migration £
Cost estimate in March 2011 Consultation (2013/14)	48.53	51.53	29.87	37.03	34.55
Final Cost for 2013/14	45.43	47.00	28.75	35.30	33.30

6.7 With respect to SMPF New Provide, MPF Single Migration and SMPF Single Migration, we have calculated the blended cost to be £30.67 in 2013/14 to determine a single charge control (see paragraphs 4.25 to 4.87).

6.8 In developing our charge control proposals, we have undertaken modelling which establishes the capital base for the calculation of the charge controls by adjusting the valuation of some of the costs of infrastructure included in the cost stacks for LLU and WLR in the RFS to create the RAV Model;

6.8.1 forecasts Openreach's operational costs over the period of the control (the Cost Forecast model); and

6.8.2 allocates these costs to products provided by Openreach (the Cost Allocation model).

6.9 As part of our March 2011 Consultation this charge control modelling was made available to stakeholders.

6.10 In order to provide further transparency of our final decisions, we will make available revised versions of the RAV model, the non-confidential Cost Forecast models and the non-confidential Cost Allocation models (both empty and non-confidential data filled) to stakeholders on request.

Final Cost Estimates – General Approach

March 2011 Consultation proposals

6.11 As explained in Section 3 of the Statement, we have set the LLU / WLR charge controls for the period to 31 March 2014 on the basis of CCA FAC with a RAV adjustment to establish the cost base. The cost base is consistent with our anchor pricing approach discussed in Section 3.

6.12 As set out in the March 2011 Consultation,[548] in order to set this charge control, we have estimated the CCA FAC of providing the in-scope services in the year to 31 March 2014 (2013/14).

6.13 In the March 2011 Consultation,[549] we provided estimates of these costs based on a series of assumptions relating to Openreach's costs and how these costs will change over time and sought stakeholder comments on these assumptions. We have taken those views into account as well as carrying out further work into Openreach's costs

548 March 2011 Consultation, paragraph 7.4.
549 March 2011 Consultation, Section 7.

and allocations. Following on from this, where necessary and appropriate, we have amended our assumptions to arrive at the final CCA FACs for the purposes of setting the LLU / WLR charge controls.

6.14 We set out in detail our modelling approach in the March 2011 Consultation. In summary, this involved using the Cost Forecast model to determine Openreach's aggregate revenue, operating costs and capital expenditure, the RAV model to determine Openreach's copper and duct asset base and the Cost Allocation model to allocate costs and assets to individual services to derive unit cost estimates for the period to 2013/14.

6.15 Additionally, our Cost Forecast Model has been subject to certain independent test procedures [550] and together with the March 2011 Consultation, it was available to stakeholders (subject to confidentiality constraints) for their comment.

6.16 In the March 2011 Consultation, we asked stakeholders the following question in connection with our general modelling approach:

Question 7.1*: Do you agree with our general approach to estimating costs?*

March 2011 Consultation responses

6.17 Stakeholders who specifically commented on the models generally supported the approach to the modelling of costs set out in the March 2011 Consultation, although some Stakeholders interpreted this question in terms of specific concerns on individual assumptions (in particular C&WW[551] and EE[552]). Some stakeholders also raised concerns over the transparency of the modelling. We have considered these comments in Section 3 of this Statement.

Our response and conclusions

6.18 We deal with the specific points on individual assumptions raised by Stakeholders as appropriate through this Statement.

6.19 However, the overall approach appears to have been understood and accepted by stakeholders. We had adopted a similar approach for the 2009 LLU Statement, although during this review we have sought to provide a greater level of transparency around the modelling in response to stakeholder concerns arising out of the 2009 charge control review we conducted in 2009 (i.e. the 2009 LLU Statement and the 2009 WLR Statement).

6.20 This approach was also subject to significant scrutiny during the 2009 LLU Appeal.

6.21 Therefore, we consider that it is appropriate to follow a similar approach for the prices determined for this charge control.

[550] Performed by E&Y in accordance with an engagement agreement for professional services and on the basis that E&Y accepts responsibility only to Ofcom for their work
[551] C&WW response to the March 2011 Consultation, page 30.
[552] EE response to the March 2011 Consultation, page 27.

Reconciliation with RFS

6.22 As explained in the March 2011 Consultation, [553] we compared our cost estimates with cost estimates calculated by BT using the same data in its own cost modelling. BT also reconciled its cost estimates to the 2009/10 RFS. BT also provided a comparison of the unadjusted unit cost estimates to the figures in the 2009/10 RFS.[554]

6.23 As explained in the March 2011 Consultation, the reconciliation provided further assurance that the data provided by BT's for our cost modelling was robust. However, in the March 2011 Consultation,[555] we noted that we would obtain further information on the reconciliation, in particular where the reconciliation did not appear to add up, to provide additional confidence that the base year data was consistent with the RFS.

6.24 We have undertaken this further reconciliation, the results of which are set out in Annex 5 of this Statement. We consider that this analysis provides further assurance that our approach provides a sound basis for estimating costs.

6.25 The Cost Forecast model has been modified in response to the stakeholder comments, as set out elsewhere in this Statement. We commissioned further independent review[556] by Ernst and Young of the operation of the modified Cost Forecast model (and the supporting Cost Allocation and RAV models) and the consistency of these models between themselves and with certain input data sources. The review did not identify any issue of concern. The results of Ernst and Young's review will be published when we make the models available to stakeholders.

Comparison of Ofcom model to BT's March 2011 Management Accounts

6.26 In September 2011, BT's March 2011 RFS were published. As such, we considered whether we should fully refresh the model; i.e. replace the March 2011 actual/forecast data with actual data including new cost relationships. However, we considered that there were benefits associated with updating the 2010/11 forecast derived from 2009/10 data (not least of which were the need for a timely conclusion to the charge control review and the fact that basis of forecasting the costs from 2009/10 actual costs had already been subject to discussion in the March 2011 Consultation).

6.27 As a explained in further detail in Annex 5 of this Statement, we asked Openreach to assist us in reconciling the outputs of the Cost Forecast model for 2010/11 used in the March 2011 Consultation and their March 2011 Management Accounts. Our analysis indicated our 2011 forecast costs were consistent with the 2011 Management Accounts.

6.28 In conclusion, in light of the above, we are satisfied that our Cost Forecast model produces consistent results with Openreach's March 2011 Management accounts and we have decided in the context of this LLU/WLR charge control project that it would not be appropriate or proportionate to undertake a full model refresh.

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[553] Paragraph 7.33.
[554] Openreach response to Ofcom's 11th section 135 request, 4 October 2011.
[555] Section 2, paragraph 2.43
[556] Performed by E&Y in accordance with an engagement agreement for professional services and on the basis that E&Y accepts responsibility only to Ofcom for their work.

6.29 Our final key assumptions in our cost modelling are summarised in Figure 6.5 below. We have highlighted where these assumptions have changed since the March 2011 Consultation and November 2011 Consultation.

Figure 6.5: Ofcom key assumptions

Parameter	Final Assumption	March 2011 Consultation
Volumes and mix – Annex 2	Demand for fixed lines falls by 0.6 million lines over three years, demand for MPF to increase by 1.5 million lines, with 1 million decline in demand for SMPF	Demand for fixed lines falls by 0.7 million lines over three years, demand for MPF to increase by 1.4 million lines, with 1 million decline in demand for SMPF
Efficiency, including fault rates - Annex 3	5.0% gross annual saving across most cash payments, equivalent to 4.5% net	5.0% gross annual saving across cash payments, equivalent to 4.5% net
Inflation (non-pay) – Section 5	2.5% annual increase in most cash costs.	2.5% annual increase in cash costs
Inflation (pay) – Section 5	3% annual increase in pay costs	No change
Pension costs	Annual charges to meet future liabilities are included in our assessment of recoverable costs, but regulated charges should not include any contribution to the funding of the pension deficit	No change
LUS	None of the cost of the LUS has been included in regulated products	No change
Fault Rates – Section 5	Allocated on the incidence of actual faults rather than reported or estimated faults taking account of the higher levels of care for MPF and WLR Premium	Allocated on the incidence of actual faults rather than reported or estimated faults
TAMs- Section 5	For cost purposes, allocated on cost causality basis, with a pricing adjustment to spread TAMs to SMPF	No change
Cost allocation - Annex 4	Changes to IS costs, NGA IS costs, Allocation of costs to Northern Ireland.	Allocation of costs to Northern Ireland.
Asset prices - Annex 7	Have used 10/11 RFS data	No change in principle but used 09/10 RFS data
Cost of Capital - Annex 8	Pre-tax nominal rate of 8.8%	Pre-tax nominal rate of 8.6%
Holding gains - Annex 7	Updated Forecast RPI	Forecast Average RPI

Basis of Assumptions

6.30 In arriving at our cost forecast, it was necessary to make assumptions about:

- the services that will be provided;

- the activities required to deliver those services;
- the extent to which the time taken and costs incurred will change over time (due to, for example, increased efficiency and the extent to which it will be offset by increased input costs);
- the assets that will be used by these services, their value and the way the value of these assets is reflected in the cost calculations (through depreciation and a reasonable rate of return on those assets);
- the extent to which these costs should be adjusted or excluded for the purposes of setting prices to determine total Openreach costs; and
- how these costs are allocated to individual services.

6.31 Set out below is our consideration of these issues.

The services that will be provided

6.32 Our estimates of the volumes of the services that will be provided and the basis for those estimates are set out in Annex 2 of this Statement.

The activities required to deliver those services

March 2011 Consultation proposals

6.33 In the March 2011 Consultation we noted that the Cost Forecast model builds up the costs of providing the services included in the scope of this charge control by multiplying (i) the number of tasks that would need to be undertaken to deliver the forecast volumes by (ii) the expected time it would take to complete each task and (iii) the costs that would be incurred. [557]

6.34 For the year 2009/10, the Cost Forecast model reflected the actual volumes delivered and the actual costs incurred, the actual tasks performed and the actual time spent on each task.

6.35 The Cost Forecast model utilises this data to derive the cost relationships that can be applied to forecast volumes to generate cost forecasts (which are added to forecast overheads and asset-related costs to generate cost forecasts for Openreach).

6.36 Figure 6.8 below sets out a range for the estimated duration (i.e. task time) of the key tasks associated with the key services within the scope of the LLU / WLR charge control review in 2009/10 that we published in the March 2011 Consultation. We noted that these were supplied by Openreach under formal powers[558] and that we had used them in our modelling.

[557] March 2011 Consultation, paragraph 7.14.
[558] Openreach response to Ofcom's 1st section 135 request, 31 August 2010.

Figure 6.8: Task Time assumptions

Activity	2009/10 Task time (minutes)
WLR Provide	25-30
WLR Cease	15-20
LLU Provide	25-30
LLU Cease	20-25
LLU Migration	30-35
Field Provision	150-180
Non Network Fault, Exchange Fault, End User Fault, Network Fault[559]	150-180

6.37 We also noted in the March 2011 Consultation that in our Cost Forecast model, the task times for all services are reduced in line with the annual efficiency assumption.[560]

6.38 We asked Stakeholders in the March 2011 Consultation the following question:

> ***Question 7.2****: Do you consider the task times to be reasonable? If not, please provide your reasons and alternative view, together with supporting evidence where possible.*

March 2011 Consultation responses

6.39 Both GC[561] and Openreach[562] considered the task times set out in the March 2011 Consultation to be reasonable. We did not receive any other comments from other Stakeholders in response to this question.

Our response and conclusions

6.40 Given the comments from stakeholders, the task times as set out in the March 2011 Consultation have been used to determine the costs in the price controls.

How might costs change over time?

6.41 As explained above, the Cost Forecast model projects costs by multiplying the number of tasks that would be undertaken to deliver the forecast volumes by the cost of completing those tasks. It is therefore necessary to consider how the number and cost of those tasks might change in the future due to the effects of efficiency and inflation.

Efficiency gains

6.42 In the March 2011 Consultation, we set our base case cost estimate on an assumption of net annual efficiency of 4.5% within a range of 3.5% to 5.5%. We have now concluded that the appropriate gross efficiency rate should be 5.0%, equivalent to a net annual efficiency rate of 4.5%.

[559] This task time is a weighted average of the following activities: Non Network Faults, Exchange Fault, End-user Fault and Network Fault.
[560] March 2011 Consultation, paragraph 7.48.
[561] GC response to the March 2011 Consultation, page 9.
[562] Openreach response to the March 2011 Consultation, paragraphs 454 to 457.

6.43 The details of our analysis, including stakeholder responses to our proposals are set out in Annex 3 of this Statement.

Cost of capital

6.44 We have set out our analysis on the cost of capital in Annex 8 of this Statement. This includes details of Stakeholder responses to our proposals set out in the March 2011 Consultation. We have concluded that the cost of capital to be used in setting LLU/WLR charge controls should remain the same as used in the setting of the WBA charge controls, that is, 8.8% for Openreach.

Inflation

March 2011 Consultation proposals

6.45 In the March 2011 Consultation we explained that RPI provides a reasonable proxy of general inflation in the long term, but in the short term observed volatile movements did not reflect the movement of Openreach costs. [563] The March 2011 Consultation therefore assumed that Openreach's costs would increase at a rate below forecast RPI. Based on HM Treasury forecasts set out in the March 2011 Consultation, we proposed an average RPI of around 3% per annum for the period to 2013/14. On this basis, we assumed an underlying non pay inflation rate of 2.5% in our base case estimate of Openreach's costs.

6.46 In our Cost Forecast model as set out in the March 2011 Consultation, we applied this rate to most costs, except pay costs, which we considered would increase at a higher rate, and rent, which would inflate at a contractual rate of 3%. Historically, pay costs have tended to be more closely related to RPI (even if they are not explicitly linked). For our Cost Forecast model, we used an average annual rate of 3% for pay costs.

6.47 In the March 2011 Consultation we asked stakeholders the following question:

> ***Question 7.4****: Do you have any views on our proposed assumptions regarding the impact of inflation on Openreach's costs through efficiency gains.*

March 2011 Consultation responses

6.48 Stakeholders seemed generally supportive of our approach to deriving an underlying rate of inflation but commented on the appropriate rates to be used and the costs that should be subject to those rates.

6.49 Openreach agreed that it is appropriate to reduce RPI to estimate non-pay inflation. [564] TTG suggested that our underlying rate of inflation should be based on an RPI assumption of 2.5% to 3.0%, with an appropriate underlying rate of inflation of between 2.0% and 2.5%. [565]

6.50 In respect of pay costs, Openreach argued that national statistics and recent regulatory determinations supported a pay inflation rate of 1% above the assumed RPI. To support its case, it noted that real wage inflation of 1.4% per annum is

[563] March 2011 Consultation, paragraph 7.54.
[564] Openreach response to the March 2011 Consultation, paragraph 159.
[565] TTG response (July 2011) to the March 2011 Consultation, paragraph 324.

consistent with the long term historical trend and asserted that over the course of the charge control period it is appropriate to assume that real wage inflation will trend back to the observed long term historical average.[566] On the basis of the proposals set out in the March 2011 Consultation this would support a pay inflation assumption of 4%.

6.51 However, TTG argued that an annual pay inflation assumption of 2% was more realistic.[567] To support this view, TTG argued that: most organisations have implemented pay freezes and have only now started to pay increases which are typically in the range 1% to 2%; the change in the basis for calculating pension payments from RPI to CPI reduces the pension cost to BT; and any cost increase due to grade inflation should be disallowed.[568]

6.52 In respect of other specific cost categories, Openreach stated that we had not applied inflation to a number of cost categories,[569] while TTG stated that we should not apply the rate from the Telereal contract across all accommodation costs.[570]

Our response and our conclusions

6.53 The proposals in the March 2011 Consultation took account of HM Treasury forecasts at the time. We have reviewed our estimate of future inflation based on more recent forecasts.

6.54 Forecasting inflation remains difficult. Based on HM Treasury forecasts, we consider that an assumption that RPI inflation might average around 3% in 2012/13 and 2013/14 is reasonable. After stripping out an estimate of the impact of expected changes in interest rates, we estimate that BT's underlying rate of inflation will be around 2.5% (on the assumption that Openreach's costs would increase at a rate below forecast RPI).

6.55 The range of stakeholder views around the likely level of pay inflation (from 1% less than RPI to 1% more than RPI) illustrates the difficulty in arriving at a robust estimate of what might happen to pay levels in the next few years. We note that pay has historically been linked (if only indirectly) to RPI and in light of the ongoing economic uncertainty, we consider that it reasonable to assume that pay inflation will be similar to RPI inflation rather than trying to predict increases will be slightly above or below this level. On this basis we have assumed pay will increase at a rate of 3%.

6.56 Informed by stakeholder responses, we have checked the application of our inflation assumptions in our cost modelling and have now applied our inflation assumption to some cost categories which had not been subject to inflation in our cost modelling. These include the overhead element of Cost of Sales, LUS, Phone Books, and Corporate Overheads. We have applied the underlying rate of inflation to the accommodation costs that are not subject to contractual increases. We consider accommodation costs in more detail in Annex 4 of this Statement.

[566] Openreach response to the March 2011 Consultation, paragraph 160.
[567] TTG response (July 2011) to the March 2011 Consultation, paragraph 332.
[568] TTG response (July 2011) to the March 2011 Consultation, paragraphs 326 and 329.
[569] Openreach response to the March 2011 Consultation, paragraph 162.
[570] TTG response (July 2011) to the March 2011 Consultation, paragraph 333.

The assets that will be used to deliver these services

Duct valuation

6.57 In Section 3 of this Statement (and in further detail in Annex 1) we set out our conclusion in relation to our approach to duct valuation in particular:

- the continued application of the RAV adjustment to pre-August 1997 duct assets; and

- the use of RPI to index the value the post-1997 duct.

6.58 In doing so we set out our March 2011 Consultation proposals, comments received from stakeholders in response to these proposals and our response and conclusion. We set out our approach in relation to non-duct capital assets below.

Non-duct Capital Assets

March 2011 Consultation proposals

6.59 In the March 2011 Consultation[571], we identified the key non-duct capital asset issues as:

- the approach to the opening valuation copper;

- projected capital expenditure;

- and changes in asset values over the control period.

Copper

6.60 In the March 2011 Consultation we considered the use of the RAV model. This valued the post-1997 copper assets on a CCA FAC basis and the pre-1997 copper assets after a RAV adjustment. As set out in the March 2011 Consultation [572] we considered the most appropriate valuation point to be the most recent balance sheet, which we expected to be March 2011. The base case assumption in the March 2011 Consultation was based on a January 2011 valuation of the post-1997 copper assets.

6.61 The valuation used in the March 2011 Consultation suggested that copper prices had increased by 12% from April 2010, which equated to an expected 5.2% holding gain for copper assets in 2010/11. The actual holding gain for 2010/11 was slightly higher than this but this was more than offset by a major downward valuation of its copper asset base as set out in Annex 7 of this Statement.

Projected capital expenditure

6.62 In the March 2011 Consultation,[573] we explained how we used the Cost Forecast model to project Openreach's future capital expenditure ("Capex").

6.63 As set out in the March 2011 Consultation,[574] we converted the current BT programme of Capex costs into fixed asset categories to forecast asset and

[571] March 2011 Consultation, paragraph 7.60.
[572] March 2011 Consultation, paragraph 7.65.
[573] March 2011 Consultation, paragraphs 7.28 to 7.36.

depreciation costs using the allocation mapping in the 2009/10 RFS. We used BT's actual 2010/11 Capex to update the RAV model.

Figure 6.10: Total Capex driven by Operations 2011/12 to 2013/14

	2011/12 £'m	2012/13 £'m	2013/14 £'m
Dropwire	131	126	118
Other volume driven copper	120	63	60
Network Health and resilience	137	137	132
Local Loop Unbundling	60	21	20
Other	24	24	24
Fibre	[✂]	[✂]	[✂]
Total Capex driven by ops – Ofcom Forecast	[✂]	[✂]	[✂]
IT Capex	[✂]	[✂]	[✂]
EvoTAMs	[✂]	[✂]	[✂]
Total Capex not driven by ops – Openreach Forecast	175	118	100
Total Programme Capex	[✂]	[✂]	[✂]

6.64 Our capital expenditure forecasts and asset valuations are considered in more detail in Annex 6 of this Statement.

Change in asset values over the charge control period

6.65 Under a CCA approach to setting prices, assets are valued by reference to the cost of replacing the asset at today's prices – their current cost – rather than their original, or historic, cost. If prices go up, the asset value is higher than it otherwise would have been (and vice versa). As a result, the annual depreciation charge would increase as it is based on a higher asset value. However, over the lifetime of the asset, this increase in the annual depreciation charge – which would cause costs to increase – is offset exactly by the holding gain (the gain made by holding the asset while it increases in value).

6.66 Asset inflation also affects the calculation of the mean capital employed and increasing asset prices causes the assessment of the reasonable return on those assets to increase.

March 2011 Consultation proposals

6.67 In the March 2011 Consultation, we noted that we are required to estimate holding gains, i.e. how asset values might change during the period of the charge control. We said we considered that it remains appropriate to use the RAV approach to valuing pre-1997 copper and duct assets that we adopted. In accordance with that the indexed HCA value of the pre-1997 assets were projected forwards in line with RPI.

[574] March 2011 Consultation, paragraphs 7.66 to 7.78.

We noted that were using a forecast RPI of 3% for this purpose consistent with the 2005 Cost of Copper Review.[575]

6.68 Similarly, for post-1997 assets, as explained in the March 2011 Consultation, we set out our estimates of holding gains based on assets value increasing in line with RPI forecast. We assumed this to be at an annual rate of 3% from 2011/12, with copper in year holding gains smoothed at 2.5%.[576]

6.69 In our final calculations set out in this Statement, we used annual forecasts of RPI in the RAV model (see Annex 7 of this Statement for further details). For non-RAV assets, holding gains were set using our long term RPI assumption of 3%.

6.70 In the March 2011 Consultation, we asked stakeholders the following questions:

Question 7.5: *Do you have any comments on our proposed approach to dealing with the changes in the cost of replacing the copper assets?*

Question 7.6*: Do you have any comments on Ofcom's approach to projecting costs relating to Openreach's assets.*

March 2011 Consultation responses

6.71 GC[577] suggested that we base our analysis on using fibre assets, as in practice this would be the replacement asset (while accepting that copper price increases lead to holding gains in regulated prices). EE[578] argued that applying a holding gain to assets which were not readily disposable was not realistic. EE proposed that copper holding gains should only apply to new assets (i.e. post 1997) whilst old assets should be uplifted by RPI.

6.72 TTG[579] suggested that our cost estimates should exclude the cost of DACS equipment, consistent with the proposed treatment on the Line Length adjustment.

Our response and conclusions

6.73 For the duration of this charge control, particularly in the case of the distribution side network,[580] copper cable will remain the dominant technology for delivering residential voice and data services. Whilst a valuation methodology for using fibre could be used as part of an MEA approach, we set out the reasons in Section 3 of this Statement why this approach is not appropriate. In relation to EE's response, we agree that the valuation of replacement of assets is difficult, but consider that adopting EE's proposed approach would fail to recognise the increased cost of replacing existing copper assets and therefore not provide the correct investment incentives to Openreach. However, we also note that our RAV approach currently includes an element of EE's suggestion, as we value pre-1997 copper assets using the RPI indexation.

[575] March 2011 Consultation, paragraphs 7.73 to 7.76.
[576] March 2011 Consultation, paragraphs 7.77 to 7.78.
[577] GC response to the March 2011 Consultation, page 10.
[578] EE response to the March 2011 Consultation, pages 29 to 30.
[579] TTG response (July 2011) to the March 2011 Consultation, paragraphs 159 to 162.
[580] The Distribution or D side network is the copper cabling and duct between the DPs and cabinets (see Network Diagram).

6.74 DACS equipment is the electronics sited at the Distribution Point that allows two end users to access voice services over a single copper pair. DACS do not support the use of broadband. BT did have an active programme of reducing them, but that programme has ended as it is no longer economic and Openreach now removes them on request (usually where a broadband service is required). DACS costs are actual costs representing the depreciation of equipment. This actual cost is then reflected in a slightly lower line usage factor for WLR to account for line sharing. The Line Length adjustment on the other hand is a not an actual cost but the application of an estimated adjustment to the line usage factor for LLU and WLR products to move costs from one product to another to account for estimated line length differentials. Accordingly, we do not consider there is any requirement to treat both costs in the same manner. We consider our approach to the line length adjustment in more detail in Annex 4 of this Statement.

Pension treatment

March 2011 Consultation proposals

6.75 As described in the March 2011 Consultation,[581] we considered the treatment of contributions to BT's pension scheme in two parts; ongoing pension costs and additional annual payments required to address a funding shortfall in BT's pension scheme (Pension deficit repair payments or 'PDRs').

6.76 For ongoing pension costs, we proposed in the March 2011 Consultation that we should include an estimate of ongoing contributions to meet future liabilities; based on the statutory reported accounting costs.

6.77 For PDRs we explained that our approach was consistent with the conclusions of the Pensions Review.

6.78 In the Pension Review, we concluded that when setting BT charge controls, pension deficit payments should be disallowed (and any pension holidays should be ignored).

6.79 On this basis, we proposed that cost forecasts should include the cost of ongoing contributions only (at a rate of 19.5% of pensionable pay, with 6% met by the employees) with no amount included in respect of pension deficit payments.

March 2011 Consultation responses

6.80 Openreach noted that "*Ofcom has made no allowance in its costs model for any of the annual pensions deficit repair payments that BT is currently required to make in relation to the period of the proposed charge control. These are a cost of BT doing business going forward and, in so far as they result from pensions costs that were efficiently incurred, it is reasonable and consistent with Ofcom's regulatory duties and stated objectives for this charge control that they be included when calculating the cost base for regulated charges for Openreach's LLU and WLR services going forward.*"[582]

6.81 TTG noted that "*BT have a very high pension contribution. BT's overall company pension contribution (defined contribution and defined benefits) is around 10% of salary whilst for a representation sample of other FTSE 100 it is about 7%*". TTG

[581] See paras 7.80 – 7.84 of http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/summary/wlr-cc-2011.pdf
[582] Openreach response to the March 2011 Consultation, paragraph 244.

further noted that "*BT is also unusual in that it operates a defined benefits pension scheme that is open to new contributions from existing members. As well as leading to high pension contributions, this has a negative effect on efficiency since it creates particularly high disincentives to leave BT (since later in a career the effective pension contribution is very high). It also increases leaver costs (since large pension settlements need to be made on top of redundancy costs) and so deters efficiency programmes that result in redundancies. Unusually, though the scheme is closed to new entrants, pension members who leave BT and then rejoin have (we understand) the right to rejoin the defined benefits scheme.*" [583] Sky also commented on the high cost of BT pensions.

Our response and conclusions

6.82 We have not included costs related to the repair of BT's pension deficit in the cost stack for the purposes of the WLR/LLU charge controls. In excluding such costs, we have been consistent with the Pensions Review which we published in December 2010. The Pensions Review contained our pensions cost guidelines[584] ('the Pension Guidelines') which set out our general policy as to the approach we normally expect to take in relation to the treatment of BT's pension costs when assessing the efficiently incurred costs of providing relevant regulated products or services.

6.83 In the Pensions Review we explained that, while we expect the Pension Guidelines to form an important consideration in relevant cases, we intend to apply the Pension Guidelines on a case-by-case and will always act consistently with our duties and applicable legal tests under the Act. Although the Pension Guidelines set out the approach that we would normally expect to take, each case will be considered on its own merits.

6.84 As specified in the Pensions Review, if we decide to depart from the Pension Guidelines in a particular case, we will set out our reasons for doing so. As a general rule, unless we consider that there has been a material change in the circumstances and background considered as part of our review, we are not expecting to depart from the Pension Guidelines.

6.85 As BT acknowledges, the arguments it raised in response to the WLR/LLU charge control are not new. We consider that these arguments have been dealt with in the Pensions Review.

6.86 We do not consider that there are any factors relating to the WLR/LLU charge control in particular which would support the adoption of an approach other than expressed in our Pension Guidelines. In addition, BT has not provided any new evidence to demonstrate that there has been a material change in the circumstances since the Pensions Review concluded in December 2010.

6.87 We also summarised our view on the points reiterated by BT in the WBA Statement.[585] However, we refer readers to the appropriate sections of the Pensions Review for our detailed analysis.

[583] TTG response (July 2011) to the March 2011 Consultation, paragraphs 304 to305.
[584] See annex 1, of the BT Pensions statement at:
http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/statement/statement.pdf
[585] See annex 3 of the Pensions Review at:
http://stakeholders.ofcom.org.uk/binaries/consultations/823069/statement/statement.pdf

6.88 We note that BT has appealed the WBA Statement and has challenged in that appeal Ofcom's decision not to allow recovery of PDRs. That appeal is currently being heard by the CAT and CC. [586]

EvoTAMs

March 2011 Consultation proposals

6.89 EvoTAMs are test equipment that enables the testing of the broadband frequencies over SMPF. Without an evoTAM, broadband services that are delivered using SMPF can only be tested via the WLR test equipment that tests only the voice frequencies.

6.90 In the March 2011 Consultation, we explained that our cost projections for Openreach included the projected costs associated with BT's proposed roll-out of evoTAMs. As set out in the March 2011 Consultation, we allocated these costs between WLR, SMPF, ISDN2 and ISDN30.[587] However, we noted that there may be grounds for excluding these costs from the cost stacks used to inform the price control applied to the SMPF service.

6.91 In the March 2011 Consultation, we asked stakeholders the following question:

> ***Question 7.8:*** *What issues should we consider when deciding whether to exclude costs relating to evoTAMs from the regulated cost stacks? If you consider that the costs should be excluded, please provide your reasons. If you consider that they should be included, how should they be allocated across services?*

March 2011 Consultation Responses

6.92 Openreach stated that EvoTAM technology is being used for line testing 21CN enabled DSL lines in those exchanges where this is available argued that it was available to all CPs and as such should be treated as DSL set up costs. It argued that the costs should remain 100% allocated to SMPF in the cost stacks but proposed that there should be a pricing adjustment that spreads these costs across DSL lines.[588]

6.93 TTG suggested that more context was required to be able to answer this question, but noted that, generally, there was benefit in the approach to deployment and charging of evoTAMs being similar to that for other testing equipment and also Openreach charging for equipment that is deployed to test its assets.[589]

6.94 C&WW argued that the costs of the evoTAMs should only fall on the parties that make use of the facility while GC stated that evoTAM costs should apply only to those services for which their use is appropriate.[590]

Our response and conclusions

6.95 In general, we consider that it is appropriate to allow Openreach to charge for equipment used to test its assets. In the absence of compelling arguments to the contrary, we do not consider it appropriate to exclude these costs in this case.

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[586] CAT case ref 1187/3/3/11 *BT v Ofcom (Wholesale Broadband Access Charge Control)*.
[587] March 2011 Consultation, paragraph A9.41.
[588] Openreach response to the March 2011 Consultation, paragraph 488.
[589] TTG response (July 2011) to the March 2011 Consultation, paragraph 192.
[590] C&WW response to the March 2011 Consultation, page 31.

6.96 We have therefore considered how these costs might be recovered through regulated charges. We consider that it is appropriate to recover the costs from the services that might benefit from them. As explained in Annex 4 of this Statement, we have therefore spread the costs across SMPF and WLR services, such that each WLR picks up a reduced share to reflect the fact that not all WLR lines are used with SMPF.

Other adjustments

March 2011 Consultation proposals

6.97 In the March 2011 Consultation we considered some of the existing regulatory cost adjustments relating to the following issues:

- Dropwire adjustment; and
- Line length adjustment;

6.98 Stakeholders also raised other costs areas which we have also addressed below:

- SLAs/ SLGs; and
- Directories.

Dropwire [591]

6.99 In the March 2011 Consultation, we noted that the biggest element of the cost relates to the depreciation of the copper pair and NTE that link the end user premises to the DP.

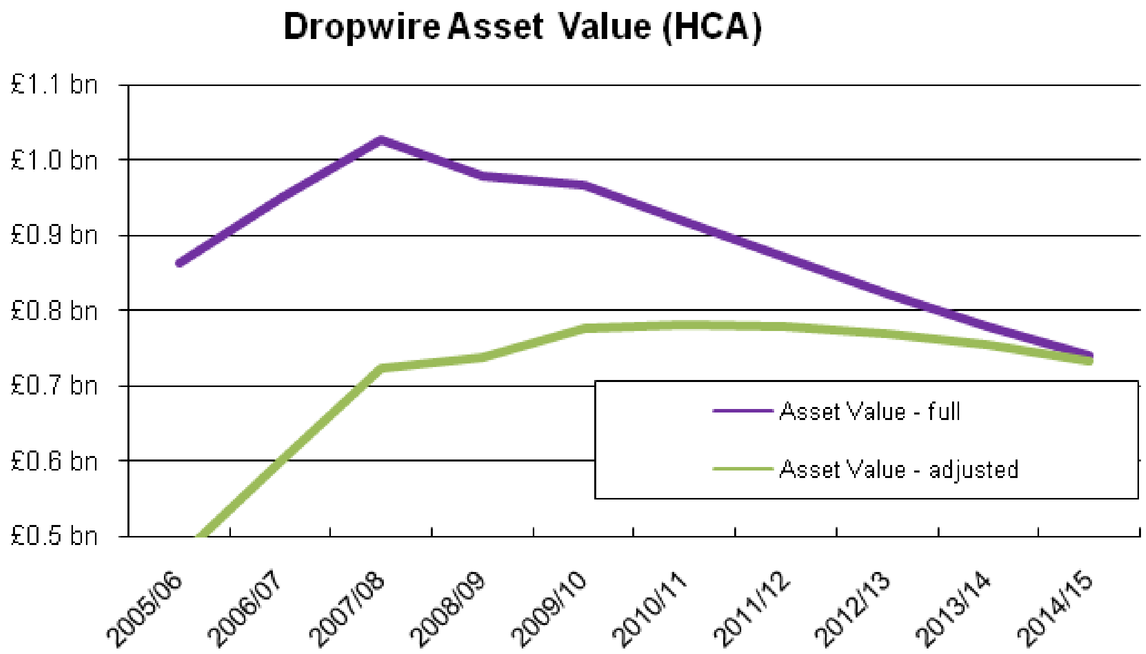
6.100 We noted that up until 2001 the full cost of Dropwires, including the Capex element were accounted for as they were installed. In 2001 the BT changed its policy so that the Capex element was capitalised and depreciated over a period of 10 years.

6.101 In the March 2011 Consultation, we confirmed that in previous charge controls BT has recovered Dropwire capital costs through rental charges rather than connection charges. Prior to March 2006, rental charges were controlled at the both the retail level (through the Retail price charge control) and the wholesale level. In March 2006, following publication of the 2006 WLR Statement[592] we removed the retail price control and set new wholesale charge controls.

6.102 We noted that in the 2006 WLR Statement we concluded that residential Dropwires in use at December 2005 had already been recovered once through the Retail Price Controls and as such decided that those capital costs should be disallowed to prevent double recovery when setting the charge controls in the 2006 WLR Statement. The dropwire adjustment is the adjustment that removes the residential dropwires installed up to December 2005 from the asset base. As can be seen in Figure 6.11 below, the difference between the full and the adjusted value (used for setting rental prices) falls until all pre-2006 dropwire costs are written off in 20014/15.

[591] March 2011 Consultation, paragraphs 7.85 to 7.90.
[592] http://stakeholders.ofcom.org.uk/binaries/consultations/wlrcharge/statement/statement.pdf

Figure 6.11: HCA Dropwire Asset Value



6.103 We further noted that in the 2009 Openreach Financial Framework Statement, the per line MPF Dropwire adjustment was set out 85% of the WLR Residential adjustment. This was because at the time MPF prices were originally set it, was assumed on a higher proportion of the WLR lines were pre-2006 as MPF was a nascent product. The number of MPF lines has increased from 0.2million in 2005[593] to 2.5million in 2009/10 and are forecast to rise to 6.8m by 2013/14. By 2013/14 MPF is expected to represent 29% of total copper lines. Given that dropwires have a ten year life span, we have concluded that the impact of any differential between pre 2006 WLR and LLU dropwires, if there is one at all, will be small. As proposed in the March 2011 Consultation we have changed the basis for allocating this adjustment to be the same for MPF and WLR lines.

6.104 In the March 2011 Consultation, we proposed to exclude a proportion of the residential dropwires installed prior to 2006 in line with previous charge controls.

Line Length

6.105 In the March 2011 Consultation[594] we explained that when the price of MPF was set we excluded 16% of the D-side copper costs to reflect the fact that, at that time, the length of lines used to support broadband were shorter than the average line length. We went on to explain that this line length adjustment was reduced to 6% when we set the MPF price in 2009. Finally, for the purpose of this charge control, we set out our view in the March 2011 Consultation that there is no longer any meaningful difference between the average MPF line length and the average line length and on this basis we proposed to no longer have a line length adjustment.

[593] http://media.ofcom.org.uk/files/2011/04/Ofcom_telecoms_analyst_briefing_19_April_2011.pdf
[594] March 2011 Consultation, paragraphs A8.134 to A8.137,

SLA/SLGs

6.106 In the base case cost estimate in the March 2011 Consultation,[595] we proposed to include the Openreach costs of compensation payments under the terms of SLAs and SLGs.

Directories

6.107 In the base case cost estimate in the March 2011 Consultation,[596] we allocated the wholesale costs of directories to WLR services.

6.108 We asked stakeholders the following question:

> ***Question 7.7****: Do you have any comments on the proposed regulatory adjustments to be made in determining the recoverable costs?*

March 2011 Consultation responses

Dropwire

6.109 Stakeholders did not comment on the dropwire adjustment we proposed in the March 2011 Consultation.

Line Length

6.110 Sky[597] and TTG[598] questioned the removal of the line length adjustment and provided data to support their view that there remains a meaningful difference between the average MPF line length and the average line length. In particular they relied on the Analysys Mason report on Line length which concluded that there is a 33% to 35% length difference between the typical MPF and WLR rental products.

6.111 Openreach[599] argued that Analysys Mason's central assumption in its report on line length was significantly in error and if corrected then the difference between the average MPF line length and the average line length is likely to lie in the range 0.4% to 1.6% depending on the precise assumptions used.

SLA/SLGs

6.112 Openreach[600] noted that "*In April 2011, Ofcom asked the OTA2 to review the SLA and SLG arrangements for WLR, MPF and ISDN2 provisions which require an engineering appointment. In this process, CPs have requested that a target lead time for appointments be introduced and backed by SLG payments. Any change in the SLA/SLG regimes, which results in Openreach incurring higher costs must be reflected in a commensurate change in the cost base. Ofcom and the OTA2 have indicated to Openreach that if there is a cost recovery issue, it should be addressed via these charge controls in an increase to the costs allowed in charges. Ofcom's final LLU/WLR decision must therefore consider and reflect as appropriate any*

[595] March 2011 Consultation, paragraphs A8.134 to A8.138.
[596] March 2011 Consultation, paragraphs A9.50 to A9.52.
[597] Sky response to the March 2011 Consultation, paragraph 90.
[598] TTG response (July 2011) to the March 2011 Consultation, paragraph 12.
[599] Openreach response to the March 2011 Consultation, paragraph 487.
[600] Openreach response to the March 2011 Consultation, paragraph 166,

*changes to SLAs/SLGs or leave open the possibility to do so if changes are not agreed by the time of Ofcom's final Statemen*t".

Directories

6.113 EE[601] argued that the cost of telephone book provision should be excluded from the WLR cost base. EE argued that the BT local directory is an independent commercial operation which appears to be self-funding through classified advertising and provides commercial brand advantage to BT.

6.114 EE noted that there is a risk that funding support for the standard directory risks distorting the market for those providing classified directories.

6.115 EE also highlighted the fact that while BT chooses for its own commercial reasons to deliver the phonebook to all households, only WLR lines have a charge and that this cost is not borne by MPF providers or VM.

Our response and conclusions

Dropwire adjustment

6.116 We have applied the approach proposed in the March 2011 Consultation to calculating the dropwire adjustment.

Line Length adjustment

6.117 We have set out our reasoning on the line length adjustment in detail in Annex 4 of this Statement.

6.118 For the reasons given in Annex 4 of this Statement, we have concluded that:

- it remains appropriate for the line length adjustment to be made for the purpose of this control; and
- the adjustment should reflect our assessment that, on average, MPF lines are 1.6% shorter than non-MPF lines.

SLA/SLGs

6.119 We have set out our reasoning on the treatment of SLAs and SLGs in Annex 4.

6.120 For the reasons given in Annex 4, while we accept in principle it may in due course become appropriate to include any net additional costs, however, we consider that it is not feasible to do so for this control.

Directories

6.121 We note that all CPs have an obligation under General Condition 8 to provide a telephone directory on request to their subscribers. BT distributes a telephone directory to all households which satisfies this obligation on behalf of all CPs (irrespective of whether requested by the subscriber). The WLR rental service includes an obligation on BT to distribute the telephone directory on behalf of CPs

[601] EE response to the March 2011 Consultation, pages 32 to 36.

purchasing that service; conversely, the MPF rental (and SMPF rental) service does not include the distribution of the telephone directory.

6.122 When the first WLR rental charge was set, we allocated the full cost of directories to the cost stack of WLR rental. This was in response to our understanding that there was no significant cost saving in seeking to provide phone books to only customers supplied through the use of the WLR rental service. Rather the economics of publication and distribution mean that there was no material savings associated with delivery to just those households supplied through the use of the WLR rental service. Accordingly, while the cost covers the provision of the phone book to all households, this cost broadly equates to the cost of providing the phone book only to households supplied through the use of the WLR rental service.[602] BT, therefore, continues to transfer the cost of the basic directory provision to Openreach to be recovered from WLR lines.

6.123 The additional costs attributable to the classified directory are not recovered from WLR lines.

6.124 As a consequence, the cost for the phone book provision is not linked to either the number of WLR lines or fixed lines. Rather it is linked to the total number of households in the UK outside of the Hull area (where KCOM provides a printed directory). A breakdown of the relevant cost categories for printed directories is set out in Figure 6.12.

Figure 6.12: Directory cost categories

Cost category	**Cost (£k)**	**%**
External Cost of Sales		
Production	[✂]	[✂]
Paper/Board	[✂]	[✂]
Delivery	[✂]	[✂]
Cost of Sale Pay	[✂]	[✂]
Other	[✂]	[✂]
Internal Cost of Sales	[✂]	[✂]
Data	[✂]	[✂]
Data Charges (BT Directories)	[✂]	[✂]
Internal and External General Admin	[✂]	[✂]
Pay	[✂]	[✂]
IT/Computing	[✂]	[✂]
Secondary Delivery	[✂]	[✂]
Other	[✂]	[✂]
Sub total	[✂]	[✂]
Regulatory Adjustment	[✂]	[✂]
TOTAL	**39,129**	**100.0%**

Source: BT response to Ofcom's 11th S135 Request of 20 September 2011

[602] We discussed briefly the economies of the printed directory in our last consultation on the Wholesale Directory Market (see http://stakeholders.ofcom.org.uk/binaries/consultations/dirinfo/summary/dirinfo.pdf).

6.125 General Condition 8 also applies to MPF providers and VM, however, when the MPF rental service was defined it was envisaged that MPF providers and VM would independently satisfy this obligation.

6.126 In our last review of the Directories market in 2008[603] we noted that the commercial market conditions relating to the provision of a printed local directory appeared sufficient to ensure the continued free provision and maintenance of printed directories, which included the contribution of WLR.

6.127 Accordingly, we do not consider that we are in a position to remove the cost from the WLR rental charge while there remains a contractual obligation for BT to provide a directory with the WLR rental service.

6.128 We invite BT, EE and other WLR users to consider whether this remains an appropriate mechanism for meeting their General Condition 8 obligation which may be undertaken through a request for a modified WLR rental service which excludes directory costs.

How should these costs be allocated to services?

6.129 Based on the approach and assumptions described above, our forecast aggregate costs for Openreach as set out in Figure 6.13.

Figure 6.13: Ofcom forecast of Openreach costs

	2009/10	2010/11	2011/12	2012/13	2013/14
	£'m	£'m	£'m	£'m	£'m
Current Pay	885	819	799	773	742
Other Operating Costs	184	197	171	166	155
Transfer Charges	1,280	1,002	975	951	926
Internal Cost of Sales	1,054	962	925	897	857
Other Operating Income	(143)	(125)	(93)	(86)	(86)
Operating Cost	**3,260**	**2,855**	**2,777**	**2,701**	**2,594**
Depreciation	1,672	1,144	984	1,100	1,128
Holding Gains	(959)	(701)	(411)	(391)	(374)
Operating Cost inc Depreciation	**3,973**	**3,298**	**3,350**	**3,410**	**3,348**

6.130 Having estimated the costs for Openreach, it is necessary to allocate these costs to products. The basis for allocating costs to products was described in detail in Annex 8 of the March 2011 Consultation, while the product costs were considered in Annex 9 of the March 2011 Consultation.

6.131 In Annex 4 of this Statement we set out our analysis of cost allocation, including stakeholder responses. Key issues raised by stakeholders were:

- NGA Costs;
- Fault Rates and Repair Costs;

[603] The review was not concluded due to consideration of a related dispute on BT Wholesale directory charges. A copy of the review consultation is available at http://stakeholders.ofcom.org.uk/consultations/dirinfo/.

- Computing Costs;
- Product Management Costs;
- Northern Ireland;
- Non Core cost Allocation;
- Marketing and the Olympics;
- Line Length adjustment; and
- Service level differentials between MPF and WLR.

Results of cost modelling

6.132 Our final estimate of the costs for each of the Core Rental Services in 2012/13 using the revised assumptions as set out above, are summarised below in Figure 6.14, alongside the current prices. The same information has been produced for ancillary services in Figure 6.15.

Figure 6.14: Ofcom estimate of the costs for the Core Rental Services and current prices

	MPF rental	WLR rental	SMPF rental
	£	£	£
Cost estimate for 2013/14	86.85	92.65	8.42

Figure 6.15: Ofcom estimate of the costs for LLU and WLR ancillary services and current prices

	MPF New provide	WLR Basic New Connection	SMPF New Provide	MPF Single migration	SMPF Single migration
	£	£	£	£	£
Cost estimate for 2013/14	45.43	47.00	28.75	35.30	33.30

6.133 Our summary basket costs are as follows:

Figure 6.16: Ofcom MPF basket costs

MPF Basket	2009/10	2010/11	2011/12	2012/13	2013/14
	£'m	£'m	£'m	£'m	£'m
Current Pay	10	3	4	2	2
Other Operating Costs	1	1	1	1	0
Transfer Charges	6	2	2	1	1
Internal Cost of Sales	0	0	0	0	0
Other Operating Income	0	0	0	0	0

Internal Capitalisation	0	0	0	0	0
Depreciation inc holding gains	1	0	0	0	0
ROCE (@8.8%)	0	0	0	0	0
Total cost	**18**	**6**	**7**	**4**	**3**

Figure 6.17: Ofcom SMPF basket costs

SMPF Basket	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
	£'m	**£'m**	**£'m**	**£'m**	**£'m**
Current Pay	24	24	25	19	14
Other Operating Costs	3	6	6	4	3
Transfer Charges	15	13	14	11	9
Internal Cost of Sales	0	0	0	0	0
Other Operating Income	0	0	0	0	0
Internal Capitalisation	0	0	0	0	0
Depreciation inc holding gains	2	2	3	2	2
ROCE (@8.8%)	1	1	1	0	0
Total cost	**45**	**46**	**49**	**36**	**28**

Figure 6.18: Ofcom comingling basket costs

Comingling Basket	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
	£'m	**£'m**	**£'m**	**£'m**	**£'m**
Current Pay	3	2	2	2	2
Other Operating Costs	1	1	0	0	0
Transfer Charges	18	13	13	12	12
Internal Cost of Sales	35	44	39	44	45
Other Operating Income	0	0	0	0	0
Internal Capitalisation	0	0	0	0	0
Depreciation inc holding gains	10	11	12	14	14
ROCE (@8.8%)	13	13	13	12	12
Total cost	**80**	**84**	**79**	**84**	**85**

Figure 6.19: Ofcom LLU migration Services costs

Migration Services	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
	£'m	**£'m**	**£'m**	**£'m**	**£'m**
Current Pay	83	81	71	64	60
Other Operating Costs	10	19	16	14	13
Transfer Charges	46	39	35	33	33
Internal Cost of Sales	0	0	0	0	0
Other Operating Income	0	0	0	0	0
Internal Capitalisation	0	0	0	0	0
Depreciation inc holding gains	7	6	6	7	6
ROCE (@8.8%)	2	2	2	1	1

Total cost	**148**	**147**	**130**	**119**	**113**

Adjusted cost stacks for pricing purposes

6.134 The unit costs in Figure 6.14 above represent our final estimate of the cost of providing the Core Rental Services. However, for the purpose of setting prices, we have made the following adjustments to these cost estimates to reflect our conclusions on cost reallocation elsewhere in this Statement:

- Reallocation of TAMs for the purpose of setting charges. We spread the TAM costs across all DSL lines (see paragraphs 6.132 to 6.142 below);
- Recovery of costs of WLR transfer. As set out in Section 5 of this Statement, we are setting WLR transfer with a control below CCA FAC. Accordingly, the remaining CCA FAC costs for this service will be recovered from the WLR Rental charge;
- Recovery of costs of MPF Cease and SMPF Cease. As set out in Section 4, we are setting the MPF Cease and SMPF Cease charges to zero. Accordingly, the CCA FAC costs for these MPF Cease and SMPF Cease services will be recovered equally from the respective MPF and SMPF rental charges;

Reallocation of TAMs costs

March 2011 Consultation proposals

6.135 TAMs are testing equipment used by MPF lines.

6.136 As explained in Annex 4 of this Statement, for the purpose of our cost modelling we have allocated all of the cost of TAMs across all MPF lines, on the basis that it is only MPF lines that use this equipment.

6.137 However, as set out in the March 2011 Consultation, in our 2005 LLU Statement, we explained that some of the costs might be considered to represent system set up costs. These represented the costs incurred by BT to develop and implement the systems and software necessary to provide LLU services of a reasonable quality. We considered that the cost of developing and rolling out an automated testing system (i.e. the TAMs), fell within this category of costs.[604]

6.138 When considering the six principles of cost recovery to these costs, we concluded that, where possible, system set up costs, such as the cost of TAMs, should be recovered across all local loops used to provide DSL services.

March 2011 Consultation responses

6.139 In its response, Openreach argued that, if Ofcom did not pool EvoTAM costs with the LLU system set up costs and allocated these cost across all DSL lines, there should be no reallocation of TAM costs to SMPF.

6.140 TTG agreed with Ofcom's approach of spreading TAM costs across MPF and SMPF lines. TTG noted that the approach was first implemented in 2004 and stated that it

[604] March 2011 Consultation, paragraph 7.125.

will avoid distortions. GC noted that they generally supported our approach to price adjustments.

Our response and conclusions

6.141 The case for the treating TAMs costs as set up costs was established in 2004 and as stated we consider that this remains an appropriate adjustment for this control. However, we consider that the logic does not apply to EvoTAMs, which have been introduced as an enhancement to WLR+SMPF, and, therefore, are not essential costs for establishing the entry of these services into the market.

6.142 For the purpose of setting charges, we have therefore spread the TAM costs across all DSL lines. Our approach to the allocation of EvoTAM costs is described above and in more detail in Annex 4 of this Statement.

6.143 After including the above adjustments, our final adjusted cost estimates for the charge controls illustrated in Figure 6.20 below.

Figure 6.20: Ofcom cost estimates for pricing for the Core Rental Services

	MPF £	WLR £	SMPF £
Final cost estimate	86.85	92.65	8.42
Reallocation of TAMs costs	(2.27)		1.65
Inclusion of costs relating to ceases	0.31		0.31
Inclusion of costs relating to transfers		1.87	
Restated cost stacks for pricing purposes	**84.89**	**94.52**	**10.38**

Deriving Xs from the cost estimates

March 2011 Consultation proposals

6.144 In the March 2011 Consultation, we proposed that we would set prices with reference to the price controlled prices in 2010/11 and not the more recent voluntary arrangements.

6.145 In the March 2011 Consultation, we asked stakeholders the following question:

Question 7.12: *Do you agree with our approach for deriving the glide paths?*

March 2011 Consultation Responses

6.146 A number of stakeholders commented on our proposals as they related to the glide paths. We consider these responses in Section 3 of this Statement.

November 2011 Consultation proposals

6.147 In the November 2011 Consultation we noted that the charges controls were likely to apply from the start of 2012/13 and that the prices set under the charge controls were likely to be similar to those that would have been set in the second and third years of a three year glide path starting in 2010/11. We also noted that we may decide to express the 2012/13 charges as absolute amount (i.e. as a specified price) rather than in an RPI -X format.[605]

Our response and conclusions

6.148 As set out in Section 3, we consider that it is important to set a smooth control for the LLU and WLR services. We also consider that it would not be appropriate to allow Openreach to benefit from a glide path that was linked to the current voluntary prices. We therefore consider it appropriate to set prices with reference to the price controlled prices in 2010/11 and not the more recent voluntary arrangements.

6.149 The controls for 2012/13 and 203/14 set out below are therefore calculated to be similar to those that would have applied in the second and third years of a three year glide path starting in 2010/11.

6.150 For the purpose of the charge control, we will use the RPI taken from the October in the preceding year. The RPI figure from October 2010 was 4.5% and October 2011 was 5.4%.

6.151 Consistent with our underlying inflation forecasts (which are linked, but not equal, to RPI), we have assumed that RPI will be 3% in October 2012. On this basis, a charge control linked to RPI would deliver an increase of around 13% over three years before adjusting for the X, equivalent to an average annual increase of around 4.3%.

6.152 The calculation of the X required to deliver a glide path that should move the prices for the Core Rental Services into line with our base case cost estimates over the next three years (rounded to the nearest 0.1%) is summarised in Figure 6.21 below:

Figure 6.21: Ofcom calculation of Xs for Core Rental Services

		MPF	WLR	SMPF
Regulated price in 2010/11		£89.10	£103.68	£15.04
Restated Cost Stack for pricing purposes		£84.89	£94.52	£10.38
Change in price required		-4.7%	-8.8%	-31.0%
Annual rate required to deliver change		-1.6%	-3.0%	-11.6%
RPI as at October 2010	4.5%			
RPI as at October 2011	5.4%			
Estimated RPI at October 2012	3.0%			
Average annual rate of RPI 2010 - 2012	4.3%			
X required to deliver target price		**5.9%**	**7.3%**	**15.9%**
Implied[606] 2011/12 price		£87.85	£100.75	£13.32
Required 2012/13 price		**£87.41**	**£98.81**	**£11.92**
Expected 2013/14 price		£84.89	£94.52	£10.38

6.153 Figure 6.22 below provides similar calculations for the ancillary services.

[605] November 2011 Consultation, paragraphs 2.10 to 2.12.
[606] This assumes a linear real terms 3 year glide path. If we had been required to set a 2011/12 charge then other glide path considerations may have influenced this charge.

Figure 6.22: Ofcom calculations of Xs for MPF new provide and WLR new connection

		MPF new provides	WLR new connection
Regulated price in 2010/11		£62.11	£55.74
Restated Cost Stack for pricing purposes		£45.43	£47.00
Change in price required		-26.9%	-15.7%
Annual rate required to deliver change		-9.9%	-5.5%
RPI as at October 2010	4.5%		
RPI as at October 2011	5.4%		
Estimated RPI at October 2012	3.0%		
Average annual rate of RPI 2010 - 2012	4.3%		
X required to deliver target price		**14.2%**	**9.8%**
Implied 2011/12 price		£56.09	£52.77
Required 2012/13 price		**£51.16**	**£50.44**
Expected 2013/14 price		£45.43	£47.00

6.154 We note that the charge control for WLR New Connection is different to that presented in the Draft Statement. This is due to the discovery of an arithmetic error in the calculation whereby we had not included in the costs the ROCE. This has now been corrected leading to an increase in the first year charge to £50.44 from £50.06 and an increase in the X from -10.2 to -9.8

6.155 Table 6.23 below shows the calculation of the X's for the LLU basket ancillary services.

Figure 6.23: Ofcom calculations of Xs for LLU basket ancillary services

		MPF £m	SMPF £m	Co-Mingling £m
Regulated revenue in 2010/11		£4.90	£37.32	£83.70
Restated Costs for pricing purposes		£4.24	£28.41	£85.35
Change in price required		-13.5%	-23.9%	2.0%
Annual rate required to deliver change		-4.7%	-8.7%	0.7%
RPI as at October 2010	4.5%			
RPI as at October 2011	5.4%			
Estimated RPI at October 2012	3.0%			
Average annual rate of RPI 2010 - 2012	4.3%			
X required to deliver target price		**9.0%**	**13.0%**	**3.6%**

6.156 Figure 6.24 below shows the calculation of the LLU migration charge based on the blended weighted revenues and costs for MPF Single Migration, SMPF New Provide and SMPF Single Migration (Option 1 in the November Consultation).

Figure 6.24: Ofcom calculations of Xs for LLU migrations

			LLU migration £m
Regulated revenue in 2010/11	£'m		£141.81
Restated Costs for pricing purposes	£'m		£113.88
Change in price required			-19.7%
Annual rate required to deliver change			-7.1%
RPI as at October 2010		4.5%	
RPI as at October 2011		5.4%	
Estimated RPI at October 2012		3.0%	
Average annual rate of RPI 2010 - 2012		4.3%	
X required to deliver target revenue			**11.3%**

6.157 For WLR transfer, the implied 2011/12 price is £3.20, the charge control ceiling for 2012/13 will be £3.29 with the Controlling percent set at RPI+0%, which results in an expected charge control ceiling of £3.39 in 2013/14.

Section 7

LRIC differentials

Introduction

7.1 In Section 3 of this Statement, we conclude that there are advantages to setting charges on the basis of CCA FAC. However, as we explained in the March 2011 Consultation,[607] CCA FAC may not necessarily lead to the most efficient outcome in all cases. This is particularly the case for setting relative prices within a group of services. Relative prices can be important for efficiency.

7.2 In this Section, we therefore consider whether the CCA FAC-derived rental charges derived in the earlier sections of this Statement are likely to lead to inefficiencies, through a distortion of relative prices. In particular, we:

- consider efficiency considerations;
- estimate the LRIC differentials for MPF vs. WLR/WLR+SMPF, which involves looking at differences in cost for the following:
  - line card costs;
  - exchange wiring and line test equipment;
  - directories;
  - fault repair and standard of care; and
  - product management and other costs.
- summarise Ofcom's assessment of LRIC differentials.

7.3 For each issue under consideration, we set out:

- a summary of our proposals as set out in the March 2011 Consultation;
- a summary of the comments received from stakeholders on our proposals set out in the March 2011 Consultation; and
- our response to those comments and in light of this response, our decision, together with arguments in support of our conclusions.

Summary of our decisions

7.4 We conclude that the price differentials between MPF and WLR/WLR+SMPF resulting from CCA FAC are appropriate for the purposes of promoting efficiency for the LLU / WLR charge control. In particular, the price differentials are likely to be greater than the absolute LRIC difference and are declining towards the LRIC difference over time. In the longer term, we expect to continue reducing the price differentials to the differences in absolute LRICs.

[607] March 2011 Consultation, paragraph 8.2.

Efficiency considerations

7.5 In Section 3 of this Statement we set out why we have set prices using CCA FAC.[608] In this section, we focus solely on the 'cross-check' of the resulting prices for the Core Rental Services, to ensure that the price differentials are appropriate for the purposes of promoting efficiency.

March 2011 Consultation proposals

7.6 In paragraphs 8.6 to 8.19 of the March 2011 Consultation, we proposed that the differentials between the core rental charges should not be less than the likely differences in LRIC and also not significantly greater than the likely differences in LRIC.

7.7 Figure 7.1 below reproduces Figure 8.1 from the March 2011 Consultation (all figures are expressed in outturn prices). Figure 7.1 shows the differentials between the base case for the charges we proposed to set in the March 2011 Consultation, together with our estimates, at that time, of the likely LRIC differentials.

Figure 7.1: Differentials for MPF vs. WLR/WLR+SMPF in March 2011 Consultation

2013/14, £ per line per annum	MPF vs. WLR	MPF vs. WLR+SMPF
Proposed differences in charges	£9	£20
Estimated LRIC differences	£0 to £8	£8 to £15

7.8 As the differentials for the proposed charges for MPF vs. WLR/WLR+SMPF were unlikely to be less than the LRIC differentials, our preliminary conclusion in the March 2011 Consultation was that there were not strong economic efficiency reasons for moving away from the charges we proposed based on CCA FAC.[609]

7.9 In reaching this view, we considered different aspects of economic efficiency:

- 'Allocative efficiency' is achieved when prices are close to cost. Allocative efficiency ensures that all consumers who value a product at more than its cost are able to purchase it;
- 'Productive efficiency' means that the costs of production are minimised;
- 'Dynamic efficiency' means that firms have the correct incentives to invest (e.g. in new infrastructure) and to innovate (e.g. to generate new products). Greater reliability and other quality improvements, and the creation of new products and services, are critically-linked to investment and innovation.

7.10 In the March 2011 Consultation, we considered that the MPF vs. WLR/WLR+SMPF rental services are alternative wholesale inputs for the same broadband and voice retail markets. Because of this, we considered that the main efficiency consideration is to induce an efficient choice of wholesale inputs, so as to minimise overall costs. We considered that these productive efficiency considerations point to differentials between products that reflect the absolute differences in LRIC.

[608] Paragraphs 3.4 to 3.21.

[609] In paragraph 8.17 of the March 2011 Consultation we described some adjustments incorporated into these figures. In paragraphs 8.18 and 8.19 we explained why we considered that our proposals were consistent with the 2009 WLR Determination.

7.11 We considered that allocative efficiency considerations at the retail level are far less relevant because the Core Rental Services are used to supply the same downstream retail markets. Attempting to recover more common costs from one set of wholesale inputs over the other would, to a considerable extent, be undermined by arbitrage, especially in the longer term.

7.12 In the March 2011 Consultation, we recognised that the Core Rental Services may not be perfect substitutes at the wholesale level, especially in the short term. In theory, an optimal set of prices may put some weight on allocative efficiency, in the sense of recovering common costs in the way that least distorts retail choices.[610] However, we explained in the March 2011 Consultation that we did not consider it would be feasible to attempt to optimise economic efficiency in a very precise way because of the extent of the information required to undertake such an exercise and the difficulty of measuring some of the parameters with any degree of accuracy.[611]

7.13 Dynamic efficiency can be enhanced by increased competition. During the 2009 WLR Appeal, TTG argued that we should deliberately promote MPF-based competition by setting a very large differential between MPF and WLR charges. In general, we consider that promoting competition by assisting a particular type of competitor (such as a new entrant) can sometimes be justified. For example, while costs may rise in the short term, it may be in consumers' interests if it results in lower prices and more choice in the longer term. However, promoting competition in this way needs to be considered on a case by case basis.

7.14 As noted in the March 2011 Consultation, in the current LLU / WLR charge control review, we did not see a strong argument for setting the MPF charge lower than we otherwise would so as to stimulate deeper competition in voice or broadband services at this time. We therefore did not see a need to adjust charges to create stronger investment signals. This is consistent with the conclusion we reached in the 2009 WLR Statement. In the March 2011 Consultation, we explained that, if anything, the case for setting charges to favour MPF-based competition is now weaker than it was in May 2009, because of increasing investment in and momentum for FTTP and FTTC. In the longer term, these investments may make MPF-based competition less relevant.

7.15 In the March 2011 Consultation, we also noted that using CCA FAC to set particular charges may be beneficial for dynamic efficiency to the extent that it is consistent with decisions in previous LLU / WLR charge control reviews. Consistency with previous decisions promotes regulatory certainty and provides stakeholders with confidence in the stability and predictability of the regulatory framework.

7.16 In the March 2011 Consultation we noted that given the measurement difficulties and informational constraints of trying to set optimal prices, we considered the best that can realistically be achieved to promote efficiency is to review the pricing differentials resulting from the way we have set prices based on CCA FAC estimates to ensure that the differences in charges should not be less than the differences in the respective LRICs. If the differential were less than LRIC, then MPF-based competition may be disadvantaged in a way that would be productively inefficient.

[610] By this, we mean optimal prices assuming that common costs need to be recovered, so as to ensure investment incentives. Without this requirement, optimal prices would be equal to marginal cost.

[611] A full optimisation would include estimating, amongst other things, elasticities of demand for broadband and voice and the degree of substitutability between MPF and WLR. It would also need to consider how these factors changed over time.

Similarly, we did not consider the differential should be significantly greater than LRIC.

7.17 In the March 2011 Consultation, we asked stakeholders the following question:

***Question 8.1**: Do you agree with Ofcom's proposal to base charges on CCA FAC provided that this results in differentials between the core rental charges that are not less than the likely differences in LRIC and not significantly greater than the likely differences in LRIC?*

March 2011 Consultation responses

7.18 Openreach[612] and GC[613] said they generally agreed with our proposed approach.

7.19 TTG agreed with basing costs on CCA FAC and cross-checking that the resulting price difference is greater that the LRIC cost difference. However, TTG considered the cross-check should be done using LRIC+EPMU rather than LRIC. TTG also considered Ofcom's calculation of CCA FAC and LRIC costs was flawed.[614]

7.20 TTG argued[615] that the differential should include some mark-up over a pure LRIC difference for the following reasons:

- The identified LRIC is often less than the true LRIC, due to inherent estimation errors; and
- Though productive efficiency may be maximised with a price differential equal to LRIC, allocative efficiency and dynamic efficiency might imply a greater mark-up.

7.21 We have expanded further on TTG's arguments below.

7.22 Like TTG, VM also considered that charges should be set on the basis of LRIC+EPMU. This was because VM considered that LRIC+EPMU would "*deliver tangible benefits in transparency and monitorability and would, for example, allow Ofcom and others to more easily ascertain whether accounting treatment accords with cost orientation obligations*".[616]

7.23 EE had significant concerns about Ofcom's approach in the March 2011 Consultation. EE considered that the current price differential between MPF rental and WLR+SMPF rental costs is well above the LRIC differential in the cost of providing these services. As such, EE considered it is distorting competition in favour of MPF based service provision.[617]

7.24 EE considered that the focus of Ofcom's analysis in the March 2011 Consultation was on "*ensuring that the differences in core rental charges were not less than the likely differences in LRIC*" and that we had not considered the implications of price differentials significantly greater than the likely differences in LRIC. EE also said that we had not provided any indication of what we would consider constituted a 'significantly greater' differential.

[612] Openreach response to the March 2011 Consultation, paragraph 512.
[613] GC response to the March 2011 Consultation, last page.
[614] TTG response (July 2011) to the March 2011 Consultation, paragraph 346.
[615] TTG response (July 2011) to the March 2011 Consultation, paragraphs 387 to 394.
[616] VM response to the March 2011 Consultation, page 3.
[617] EE response to the March 2011 Consultation, pages 40 to 42.

7.25 We expand on EE's arguments below when we consider them.

7.26 Sky considered the test for checking the price differentials were at efficient levels was "*rendered meaningless*" because it considered the CCA FAC estimates to be incorrect.[618]

7.27 C&WW "*recognise*[d] *the difficulty that Ofcom faces but also consider*[d] *that it is important that services are not artificially promoted due to the manner in which CCA FAC charges have been built up rather than the actual differences in costs of providing each of the services*".[619]

Our response

Revised estimates of LRIC differential and CCA FAC differentials

7.28 We respond to the comments received from stakeholders below, but we first compare our final CCA FAC figures set out in this Statement with our revised estimates of the likely LRIC differences. In doing so, we focus on the Core Rental Charges, because these represent the most important charges in the context of this charge control review. Ultimately, however, the relevant comparison for avoiding a distortion in the choice of wholesale inputs is between WLR-related charges (and SMPF-related charge) and MPF-related charges.

7.29 As described at paragraph 6.131 of this Statement, we have decided to make a number of adjustments within each product family. We are setting the WLR transfer charge lower than the amount implied by CCA FAC and recovering the difference with a corresponding increase in the WLR rental charge. We are also removing the LLU Cease charges with a corresponding increase in the MPF rental and SMPF rental charges. However, these changes do not change the WLR-related costs or the LLU-related costs overall.

7.30 As far as possible, we want to compare the LRIC differentials with prices on a like-for-like basis. We have therefore compared the LRIC differentials with what the charges would be before making adjustments that are within the same product family. However, we have made the comparison after making the adjustment for reallocating TAM costs (as discussed in paragraphs 6.132 to 6.140). This is because the adjustment for TAM costs affects the relative prices of MPF-related, SMPF-related and WLR-related prices. The resulting comparison is shown in Figure 7.2 below (similar to Figure 6.20 in Section 6 of this Statement). The relevant differentials to compare with the LRIC estimates are therefore £9.05 for WLR rental vs. MPF rental and £18.73 for WLR+SMPF rental vs. MPF rental. We refer to these below as the 'relevant CCA FAC' differentials. (It can also be seen from Figure 7.2 that allocating TAM costs over all DSL lines makes approximately a £4 difference to the size of the MPF vs. WLR+SMPF differential).

[618] Sky response to the March 2011 Consultation, paragraph 90.
[619] C&WW response to the March 2011 Consultation, page 35.

Figure 7.2: Cost stacks used for setting prices

2013/14, £ per line per annum	**MPF rental**	**WLR rental**	**SMPF rental**	**WLR - MPF**	**WLR+SMPF - MPF**
Base case cost estimate	86.85	92.65	8.42	5.8	14.22
Reallocation of TAMs costs	-2.27		1.65	2.27	3.92
Relevant CCA FAC differences for comparison with LRIC	**84.58**	**92.65**	**10.07**	**8.07**	**18.14**
Other adjustments within same product family:					
Inclusion of costs relating to ceases	0.31		0.31	-0.31	0
Inclusion of costs relating to transfers		1.87		1.87	1.87
Restated cost stacks for pricing purposes	**84.89**	**94.52**	**10.38**	**9.63**	**20.01**

7.31 Figure 7.3 below compares the relevant CCA FAC differentials calculated in Figure 7.2 with our revised estimates of the LRIC differentials (as calculated in the rest of this section).

Figure 7.3: Revised estimates of LRIC differentials and CCA FAC differentials

2013/14, £ per line per annum	MPF vs. WLR	MPF vs. WLR+SMPF
Estimated LRIC differences	£3 to £8	£10 to £14
Relevant CCA FAC differences	£8.07	£18.14

7.32 Figure 7.3 shows that the relevant CCA FAC differentials used to set charges remains above the estimated LRIC range. We explain the reasons for the revision to the LRIC estimates in paragraphs 7.66 to 7.172 below.

Productive efficiency considerations imply absolute LRIC differentials

7.33 We remain of the view that only if the relevant CCA FAC differential is equal to the absolute difference in LRIC is the choice between alternative wholesale inputs (or the 'build/buy' decision) correct in terms of productive efficiency. We note that some stakeholders agreed with this view in their responses to the March 2011 Consultation.[620]

Allocative efficiency and switching costs

7.34 In response to the March 2011 Consultation, TTG argued that if voice and broadband customers are more price sensitive than voice-only customers (and TTG considered this to be likely), then setting differentials based on the absolute LRIC differences would be allocatively inefficient.[621] This is because MPF is currently only used for providing voice and broadband services, whereas WLR is used by some consumers who only take voice services. TTG notes that "*Ofcom had previously argued that any allocative efficiency benefit would be eroded by arbitrage*", but it considered that

[620] For example, TTG said this in its response (July 2011) to the March 2011 Consultation (paragraph 390) and it is central to EE's arguments provided in response to the March 2011 Consultation. Paragraph 8.7 and footnote 132 of the March 2011 Consultation illustrate this with an example.

[621] TTG response (July 2011) to the March 2011 Consultation, paragraph 391.

"*such arbitrage* [would] *not be fully effective since switching costs (between WLR and MPF) are high*".[622]

7.35 We agree that switching costs will mean that the alternative wholesale inputs are not perfect substitutes, especially in the short term. However, in the longer term, we consider that the MPF vs. WLR/WLR+SMPF price differentials will affect CPs choice of wholesale inputs (and end consumers' choice of retail product) and that attempting to recover more common cost from one set of wholesale inputs over the other would, to a considerable extent, be undermined by arbitrage in the longer term.

<u>Risk of systematically underestimating absolute LRIC differential</u>

7.36 TTG argued that in cost modelling, many costs are classified as fixed and common (and so excluded from LRIC costs) when there is insufficient information to be able to allocate them to end products. TTG illustrated this with an example of CEO costs, which "*will have been identified as fixed and common whereas in reality some of the CEO's remuneration will vary with size of the business. This suggests that the identified LRIC is an underestimate of the true LRIC. Some mark up on the identified LRIC would be appropriate to seek to arrive at a better estimate of true LRIC. LRIC + EPMU would be one way of achieving this*".[623]

7.37 We calculated the difference in LRICs by identifying the differences between the products and estimating the likely LRICs of those differences. TTG's argument would apply to our estimates to the extent that not all the differences were identified, or if we underestimated the LRIC of the differences.

7.38 There may be some costs that are to some extent incremental but which may not have been captured in our analysis. But these would only be relevant if they affected the difference between the amount of incremental cost for MPF and for WLR/WLR+SMPF. For example, if there were some minor incremental costs that should have been added to both MPF and WLR/WLR+SMPF, then these would not affect the LRIC differentials, unless the amounts added to MPF and WLR/WLR+SMPF were different.

7.39 TTG suggests that such missing incremental costs would vary with the size of the business and hence would be systematically bigger for WLR/WLR+SMPF compared to MPF. We do not consider that this is necessarily the case. There may be minor incremental costs that have not been taken into account which have drivers other than the size of the business. Some of these minor incremental costs might be higher for MPF than for WLR/WLR+SMPF. We therefore do not consider that any minor incremental costs that we have ignored would systematically tend to understate the LRIC differentials. We consider that these differences are anyway likely to be minor as we have taken account of all significant differences that can realistically be quantified.

7.40 We also note that a large proportion of the total common costs relate to ducts, which are used by both access and core networks. A line will make the same use of the duct whether it is used for MPF or WLR/WLR+SMPF.

7.41 While we accept that there is some uncertainty over the LRIC differentials, we therefore do not consider that this means our LRIC differentials are systematically

[622] Ofcom took this position in, for example, the 2009 WLR Appeal. See for example a description of Ofcom's position at paragraph 2.85 of the 2009 WLR Determination.
[623] TTG response (July 2011) to the March 2011 Consultation, paragraph 389.

underestimated. We have anyway used fairly wide ranges to reflect uncertainties over the LRIC estimates. We consider these ranges are likely to capture the effect of any missing incremental cost elements, given that these are likely to be minor compared to other uncertainties associated with the estimates.

Dynamic efficiency considerations

7.42 In response to the March 2011 Consultation, TTG argued there are dynamic efficiency reasons for setting a price differential between MPF and WLR/WLR+SMPF greater than the absolute LRIC differences, "*since it will allow 'deeper' competition which will deliver more innovation and pressure on costs*". TTG argued that more of the value chain would be exposed to competition and that there is additional scope for innovation in, for example, voice features such as SMS, voicemail and ring back. TTG considered that if some form of mark-up on the cost differences was warranted then LRIC+EPMU was a sensible approach to setting prices and hence the differentials between prices.[624]

7.43 TTG considered that "O*fcom seems to have disregarded dynamic consideration for two reasons. We do not think that these are valid*

- *First, Ofcom seem to suggest that TTG have argued that a 'significantly higher' price difference is required to deliver dynamic efficiency gains through MPF providing voice only services (§§8.10, 8.11). This is not the case, dynamic efficiencies from MPF providing voice-only services will be achieved by marginally increasing the cost / price difference above true LRIC particularly since, with the advent of GEA, MPF providers will effectively be providing voice-only services*

- *Second, setting the cost / price difference above LRIC would not, as Ofcom suggest, constitute 'entry assistance' (§8.11). It would merely reflect (to a limited extent) that certain models of competition are preferable for consumers than others*".[625]

7.44 TTG also argued that while the MPF vs. WLR price differential was relatively less important than the MPF vs. WLR+SMPF price differential, it would become increasingly relevant with increasing uptake of NGA. This was because TTG considered that MPF would be used to provide voice-only services alongside GEA (particularly for an existing customer who is already served using MPF).[626]

7.45 TTG appears to have assumed that, in the March 2011 Consultation, we proposed to set the price differences equal to the absolute differences in LRIC. Our proposal in the March 2011 Consultation was that it was inappropriate to have larger price differentials than those resulting from our CCA FAC estimates. However, the relevant CCA FAC differentials used to set prices were already greater than even the upper end of our estimates in the March 2011 Consultation of the absolute LRIC differential.

7.46 We also note that it is unclear whether a LRIC+EPMU approach would result in a higher or lower price differential than the one proposed in the March 2011 Consultation, which was based on CCA FAC. It depends on how costs are allocated by CCA FAC and without calculating the two sets of costs it is not possible to determine this.

[624] TTG response (July 2011) to the March 2011 Consultation, paragraphs 392 and 394.
[625] TTG response (July 2011) to the March 2011 Consultation, paragraph 392.
[626] TTG response (July 2011) to the March 2011 Consultation, paragraph 344.

7.47 From a different perspective, EE argued that it is inappropriate to set the price differentials higher than the absolute LRIC differentials, and they should be equal. EE argued this is important for productive efficiency reasons.

7.48 EE argued against there being dynamic efficiency reasons for preferring MPF over WLR+SMPF. EE considered Ofcom was making a flawed assumption that competition based on MPF will create greater competitive pressure. EE argued that there is no clear evidence that the, "*relatively small*" level of greater up front expenditure made by MPF-based service providers as compared with WLR+SMPF-based service providers creates greater competition or benefits to consumers. EE also argued that to "*the extent that it is a valid proposition that MPF based providers currently provide a greater competitive constraint than SMPF based providers – then we would suggest that this has far less to do with the small additional upfront investment made by MPF based providers, and far more to do with the fact that the regulatory playing field is currently tilted firmly in favour of MPF based providers, to the detriment of SMPF based competition*".[627]

7.49 EE considered that as the proposed price differentials were greater than LRIC, they would be damaging for efficiency by distorting investment choices away from operators competing on the basis of WLR and SMPF products. EE considered this distortionary effect was greater because the price differentials were considerably more than the LRIC estimates. EE considered that there had been inefficient investment as a result of the price differentials being more than the absolute differences in LRIC. EE also argues that the "*artificial preferment*" of MPF operators dampens incentives overall for operators other than BT to migrate to fibre products.

7.50 EE argued that this alleged distortion is an outcome that the CC decided firmly against in the 2009 WLR Determination. We disagree with this interpretation of the 2009 WLR Determination. In the 2009 WLR Determination, the CC did not take a view on whether it was appropriate for the price differential to be exactly equal to LRIC or slightly higher.[628]

7.51 We consider that MPF-based services do provide deeper competition (in the sense of competition over more of the value chain) compared to WLR/WLR+SMPF. However, we do not consider that this necessarily implies that it is efficient to have price differentials that are greater than the absolute difference in LRIC. We consider that MPF is now well established and that MPF and WLR/WLR+SMPF are alternative wholesale inputs for the same broadband and voice retail markets (though MPF is not currently used for voice only services). Given this, we consider that efficient future investment choices between different wholesale inputs would require the price differentials to be based on the absolute LRIC differentials. We therefore consider that one relevant aspect of dynamic efficiency points to price differentials equal to the absolute differences in LRICs. We consider this is the case for both the MPF vs. WLR differential and the MPF vs. WLR+SMPF differential.

7.52 However, we consider that another important aspect of dynamic efficiency is providing investors with a stable regulatory framework. We consider a stable and predictable regulatory framework will benefit consumers by providing CPs with good

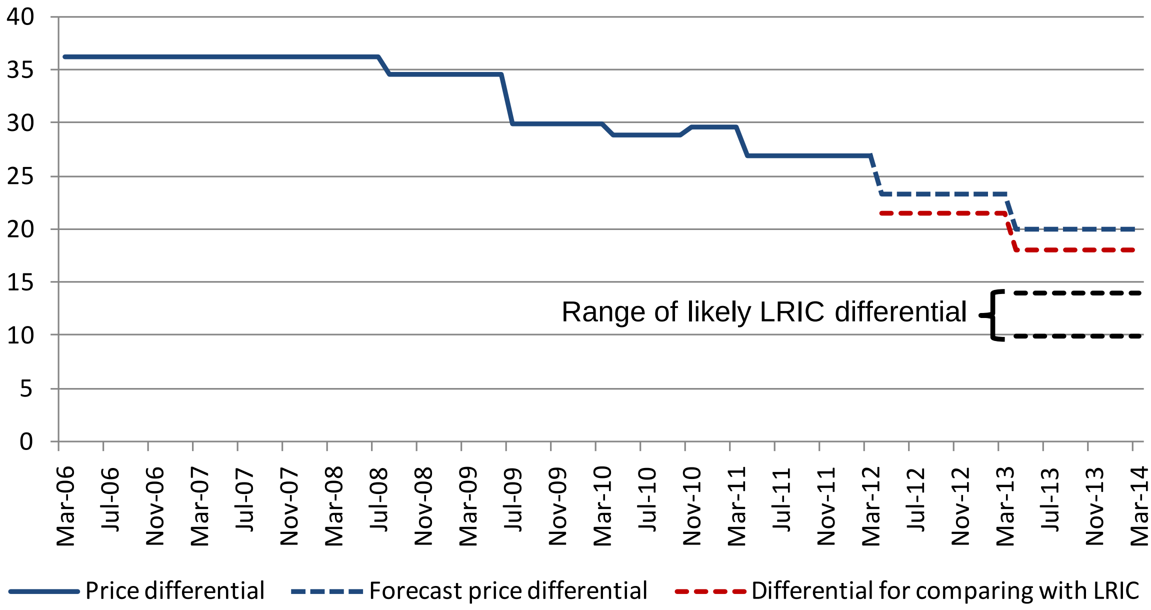
[627] EE response to the March 2011 Consultation, pages 41 and 42.
[628] In paragraph 3.222 of the 2009 WLR Determination, the CC said: "*We are required to determine whether Ofcom erred for the reasons stated by CPW and, in particular, in not adopting CPW's proposed LRIC+EPMU method. We concluded that Ofcom's approach was reasonable. We did not take a view on whether Ofcom should have given some or no weight to other considerations or have set the price controls so that the differential corresponded exactly to Ofcom's estimates of LRIC differentials*".

investment incentives. In our view this means we should give weight to how we have set charges in the past and to stakeholders' reasonable expectations of charges in the future.

7.53 Past investments in MPF and SMPF were made at a time when the MPF vs. WLR/WLR+SMPF price differential was greater than the absolute difference in LRIC, because prices were set on the basis of CCA FAC.[629] Accordingly, investment decisions may have been made based on expectations at that time that the MPF vs. WLR/WLR+SMPF price differentials would remain larger than the corresponding LRIC differentials.

7.54 Figure 7.4 below illustrates how the price differential between MPF and WLR+SMPF has fallen over time.[630]

Figure 7.4: MPF vs. SMPF+WLR price differential over time



7.55 Figure 7.4 illustrates that the forecast price differential (the dashed dark blue line) will continue to fall for the duration of the LLU / WLR charge controls. We note that the price differential has fallen from around £36 in 2006 to around £27 in January 2012 and is projected to fall to around £20 in 2013/14. The price differential therefore remains above the likely LRIC differential (this is largely now due to the adjustment made for TAMs).

7.56 As explained in paragraph 7.30 above, we consider that a more like-for-like comparison with the LRIC differential would be to consider what prices would have been without the adjustments made within the same product family (i.e. adjustments made to account for the treatment of WLR transfer and LLU Cease charges). We

[629] The prices included adjustments on the treatment of TAMs and similar costs which allowed CPs offering MPF based services to enter the market despite the far lower economies of scale.

[630] We note that there was an anomalous increase in the MPF vs. WLR+SMPF differential in October 2010. This was because the MPF rental charge was reduced slightly as a result of the 2009 LLU Appeal, but the WLR rental charge was not reduced as a result of the 2009 WLR appeal. At this time, there was also a small decrease in the SMPF rental charge, however, the net effect was an increase in the MPF vs. WLR+SMPF price differential.

therefore show in Figure 7.4 what prices would have been had they been set on the basis of the relevant CCA FAC differences for comparison with LRIC (the red dashed line) (as derived in Figure 7.2 above). It can be seen that the gap between this differential and the likely LRIC differential is projected to narrow, but remain greater than the LRIC differential for the duration of the LLU / WLR charge controls.

7.57 Given that the MPF vs. WLR+SMPF price differential has already fallen considerably since 2008 and we anticipate that it will continue to fall over the duration of the LLU / WLR charge controls, we consider that we should be cautious of adopting a more rapid reduction in the price differential. We consider that a more rapid reduction (i.e. beyond that which is anticipated with the LLU / WLR charge controls) could undermine reasonable expectations and threaten the provision of a stable regulatory framework.

7.58 In future price controls, we expect to continue reducing the MPF vs. WLR/WLR+SMPF price differential and consider whether a more explicit link between the price differential and LRIC differentials is required. In this context, it may also be appropriate to estimate a narrower range for the LRIC differentials as the precise level of the LRIC differential would be more important if it determined prices, rather than being simply a cross check.

Conclusion on relative importance of different efficiency considerations

7.59 We consider that productive efficiency and dynamic efficiency are important efficiency considerations. We consider that allocative efficiency considerations are far less relevant because the Core Rental Services are used to supply the same downstream retail markets and an attempt to recover more common costs from one set of wholesale inputs over the other would, to a considerable extent, be undermined by arbitrage especially in the longer term.

7.60 We consider that for productive efficiency the differential should be equal to the absolute difference in LRIC. This ensures that the choice between alternative wholesale inputs (or the ‘build/buy’ decision) is correct.

7.61 There are two relevant aspects of dynamic efficiency that work in different directions. Firstly, as with productive efficiency, we consider the price differentials should reflect absolute LRIC differences to ensure efficient investment incentives. We do not see a strong argument for continuing to set large differentials to stimulate further MPF based competition at the expense of WLR/WLR+SMPF based competition. Secondly, we consider that it is important to provide investors with a stable regulatory framework, including having regard to stakeholders’ reasonable expectations for charges in the future. We consider that a stable regulatory framework argues for caution in relation to a more rapid reduction in the price differentials between MPF and WLR/WLR+SMPF. However, longer term, as noted above (paragraphs 7.51 to 7.58) we expect to continue reducing the price differentials to the differences in absolute LRICs.

7.62 On balance, we consider that the price differentials resulting from the relevant CCA FAC differentials are reasonable. The resulting price differentials are likely to be greater than the LRIC differentials. We do not consider there is a strong case for even greater price differentials being in the interest of consumers. This is because of the productive inefficiencies that could result. Conversely, we also do not consider there is a strong case for a more rapid reduction in the price differential, because of the potential to undermine expectations of a stable and predictable regulatory framework.

Consistency with legal obligations

7.63 EE said that Ofcom was legally obliged (making specific reference to section 4(6) of the Act) to ensure that, so far as is practicable, retail broadband providers using MPF as an input to their services were not favoured over those who used WLR and SMPF input products, or vice versa.[631]

7.64 We consider that the LLU / WLR charge controls we have set in this Statement are in accordance with our duties and legal tests (see further section 8 of the Statement). In particular, in relation to the LRIC differential between the Core Rental Services, we have considered how the prices we have set would promote efficiency and benefit end users, taking account of the desirability of not favouring either MPF or WLR/SMPF over the other, but have weighed that consideration against other relevant efficiency considerations, which we consider is in accordance with our duties.

Our conclusions

7.65 We consider that the price differentials resulting from relevant CCA FAC are reasonable from the point of view of efficiency for the LLU / WLR charge controls. Longer term, we expect to continue to reduce the price differentials to the differences in absolute LRICs.

Estimating the LRIC differentials for MPF vs. WLR/WLR+SMPF

March 2011 Consultation proposals

7.66 In Section 8 of the March 2011 Consultation we set out preliminary estimates of the LRIC differentials for MPF vs. WLR/WLR+SMPF. We concentrated on the differences in the LRICs of the products, and as such ignore all the elements of the costs that appear in both LRICs.

7.67 Our approach was therefore to:

- first, identify and categorise the actual differences between the two products (e.g. WLR involves a 'line card' and MPF does not); and
- second, consider the likely LRIC difference for each of the categories identified, drawing on the relevant CCA FAC numbers and other sources if possible.

7.68 The main differences we identified between the Core Rental Services were:

- line card costs. WLR includes a line card, whereas MPF and SMPF do not;
- exchange wiring and line test equipment. The wiring and line test equipment is different depending on the services provided;
- directories. WLR includes a directory or phone book, but MPF and SMPF do not;
- fault repair and standard of care. Both MPF and SMPF have a higher standard of care than WLR; and

[631] EE response to the March 2011 Consultation, page 4.

- product management and other costs. Each product has its own support costs, although we consider these differences are likely to be minor.

7.69 We discussed these in turn in the March 2011 Consultation and asked stakeholders the following question:

Question 8.2*: Do you agree with Ofcom's assessment of the likely differences in LRICs between MPF and WLR/WLR+SMPF?*

March 2011 Consultation responses

7.70 Openreach said "*Ofcom's approach to the assessment of the likely differences in LRIC between MPF and WLR/WLR+SMPF is consistent with its approach in the 2009 WLR Statement. The CAT found that Ofcom did not err in relation to the differential per the 2009 WLR Statement*".[632]

7.71 GC said it "*generally agree*[d]*"* with Ofcom's approach.[633]

7.72 TTG considered the LRIC costs were underestimates and provided detailed comments on some aspects of our estimates (e.g. on line cards and fault repair costs). We discuss these in turn below when we consider the different components.[634]

7.73 Sky said any efficiency test "*requires a robust calculation of FAC for each of the services* [i.e. WLR, MPF and SMPF]*. However, such a calculation is not achieved in this review* [i.e. the March 2011 Consultation]*. As such, even if Ofcom's promotion of productive efficiency considerations was the right choice and that measuring LRIC differentials between the relevant FACs of the wholesale services was appropriate, the exercise will be rendered meaningless if there are material inaccuracies in the FAC calculations in the first place*". Sky also said that "[g]*iven the difficulties in identifying and allocating to each of the services all truly incremental costs, it is questionable how robust any estimate of LRIC would be in practice*". [635] As we set out in Section 3, Sky considered there were material inaccuracies in the FAC calculations.

7.74 EE did "*not have any detailed comments on Ofcom's broad brush estimates of the incremental costs of MPF, WLR and WLR + SMPF. At the level of detail at which Ofcom has undertaken this assessment these figures appear broadly in line with EE's expectation of the differences in the costs of providing these different services. It is important to note that these are also an indication of the differences in the non-BT network costs which different types of provider will incur (which EE considers would be at or just below the bottom end of Ofcom's range)*".[636] As described in paragraph 7.47 above, EE was however concerned with the way Ofcom used the estimates, arguing that, for reasons of productive efficiency, it is inappropriate to set the price differentials higher than the absolute LRIC differentials, rather, they should be equal.

[632] Openreach response to the March 2011 Consultation, paragraph 513.
[633] GC response to the March 2011 Consultation, page 10.
[634] TTG response (July 2011) to the March 2011 Consultation, paragraph 395.
[635] Sky response to the March 2011 Consultation, paragraph 95 and footnote 40.
[636] EE response to the March 2011 Consultation, page 43.

Our response

7.75 We have considered each of the identified product differences in turn (and, in doing so, we have considered specific stakeholder comments provided in relation to question 8.2 for each identified product difference).

Line card costs

March 2011 Consultation proposals

7.76 Line cards are the electronic equipment that copper telephone lines connect to in the local exchange. Line cards represent an important input for WLR but do not form part of the provision of MPF.

7.77 In paragraphs 8.26 to 8.39 of the March 2011 Consultation, we set out our reasoning for our estimates of the likely LRIC costs of line cards. We noted that currently BT predominantly uses TDM technology, which involves PSTN line cards that only recognise voice traffic. When BT provides wholesale broadband it generally uses a separate piece of equipment (a DSLAM) that is connected to the line in addition to the PSTN line card. However, there is now equipment available – an MSAN – which contains line cards that have both voice and broadband capabilities – known as combination cards (or combi cards). An MSAN is capable of supporting both voice and broadband.

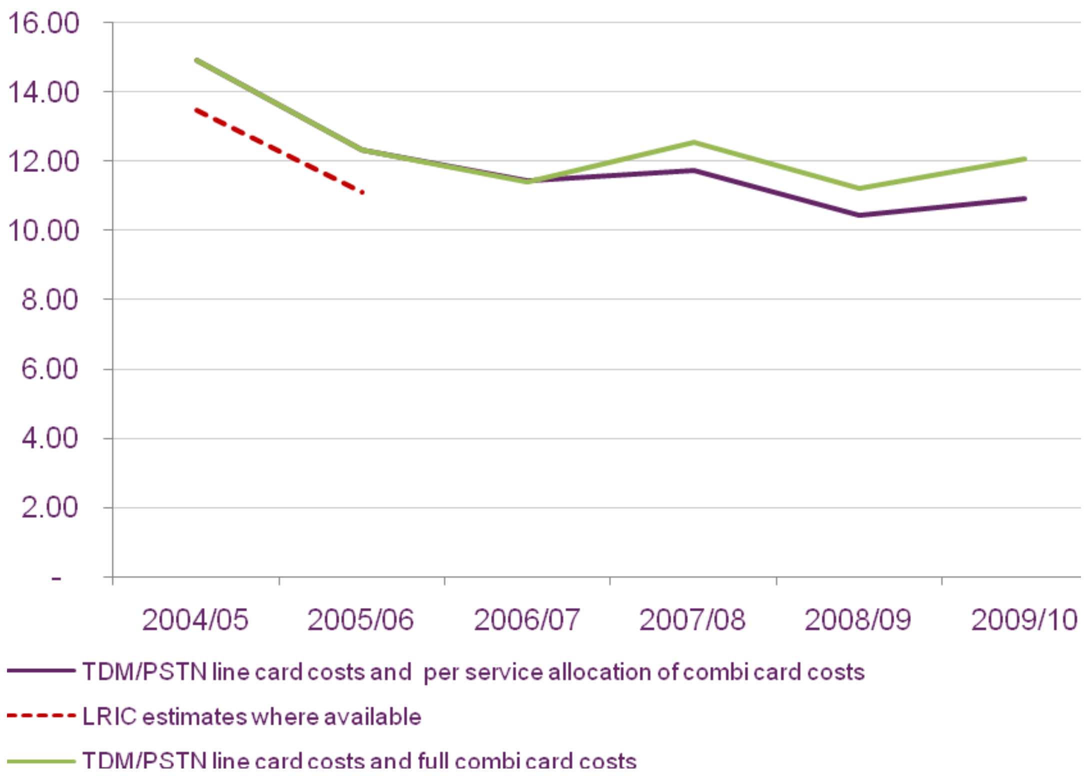
7.78 BT has deployed a limited number of MSANs in certain exchanges as part of a trial, as it planned to install MSANs as a single replacement to both its TDM and DSLAM technology. Within this trial BT only used the MSANs to support voice – the intention was to establish the MSAN voice platform before migrating broadband services onto the MSAN. However, in March 2009, BT changed its plans and decided not to generally move its voice services off the TDM technology and onto MSANs. This meant that BT was left with the trial MSANs in its network being used to support voice only.

7.79 In the March 2011 Consultation, we considered that the line card costs should continue to be estimated based on TDM technology (consistent with our ‘anchor product pricing’ approach in the context of NGA). The anchor product pricing approach involves capping charges for existing products at what they would cost based on the hypothetical continuation of the ‘old’ technology until the ‘new’ technology becomes well established (this is independent of the choice of technology actually chosen by the regulated company). This is to provide good investment incentives for both BT and CPs to invest in new technology when it is efficient to do so. In the March 2011 Consultation, we explained that we did not consider that it was clear that MSANs would be lower in terms of overall cost, nor that MSANs are the most efficient solution, in particular given that MSAN technology may be overtaken by FTTP and FTTC.

7.80 Our estimate of the cost of ongoing use of TDM line cards was approximately £11 to £13 per line per year for 2013/14. Our estimate was primarily based on figures in BT’s RFS for line card costs for the period 2004/05 to 2009/10, which were broadly consistent with this range.

7.81 In Figure 7.5 below we have reproduced Figure 8.3 in the March 2011 Consultation. This illustrates the LRIC figures for line cards in the RFS for 2004/05 and 2005/06[637] and CCA FAC for line cards for 2004/05 – 2009/10 derived from the RFS. It illustrates that the LRIC estimates were around 90% of the CCA FAC figures for the years 2004/05 and 2005/06 when both figures were produced.

Figure 7.5: Line card costs derived from the RFS



7.82 Up until 2007/08, the estimates in Figure 7.5 relate purely to TDM technology. From 2007/08, there are no pure TDM/PSTN line card cost estimates available in the RFS, because a minority of line cards are combi cards (i.e. MSAN technology). In Figure 7.5, we have illustrated the total CCA FAC line card costs from 2007/08, calculated in two ways in order to show how the allocation method for combi cards affects the total cost:

- Adding the TDM/PSTN line card costs to the full costs of the combi cards and divided by the total number of voice lines; and

- Adding the TDM/PSTN line card costs to a ‘per service allocation’ for the combi cards.

7.83 Given the deployment of MSANs/combi cards was relatively limited, the difference between these two methodologies for allocating combi cards was relatively small.

7.84 To be consistent with the anchor product pricing approach, in the March 2011 Consultation, we considered that it would be inappropriate to use the full cost of the MSANs if this increased the price compared to using the old technology. Using the TDM/PSTN costs and the full combi card costs would therefore tend to be too high as

[637] Prior to 2004/05, line card costs are not available in the RFS and post 2005/06 the LRIC of the line cards were not published.

an estimate of the cost of line cards using TDM technology (this is assuming that the cost of a combi card is greater than the cost of a TDM/PSTN line card).

7.85 In the March 2011 Consultation, we recognised that we need to be careful in putting weight on recent CCA FAC estimates of line card costs, because these may involve some fully depreciated equipment. This could mean that the CCA FAC understate the true economic cost of providing voice services.

7.86 As the CC noted, there are two effects of Openreach continuing to use fully depreciated line cards. First, if many of the line cards being used are fully depreciated, the more recent CCA FAC figures for line cards would tend to underestimate the LRIC, as these would make no allowance for the cost of capital or depreciation of these assets. Second, because the economic life of the line cards had exceeded the length of time over which they were depreciated (which was ten years), historic CCA FAC figures may overstate the LRIC by depreciating the assets over too few years.[638]

7.87 We also noted that, the line card estimates include an allocation of the cost of the line card, accommodation and power costs for the housing of the line card ports, as well as maintenance costs.

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7.88 TTG argued that basing prices on TDM technology (which it referred to as "l*egacy*" technology) rather than MSAN technology was "*inappropriate*". TTG argued that it was inappropriate because LRIC costs should be based on long run forward looking costs and that they should therefore be based on the MEA which TTG argued was MSAN technology.[639]

7.89 TTG argued that the "*practical effect of the anchor pricing approach in this case is to set WLR prices lower than they would be under a situation where the MEA (MSANs) would be assumed. In effect WLR prices are held artificially low*".[640]

7.90 TTG considered that WLR costs increased even though MSAN technology was more efficient than using TDM and DSLAM technology. TTG argued the "*increase in cost is due to (a) the MSAN cost per line is higher than the PSTN cost per line even though overall the costs of an MSAN based network are much lower due to a combination of significantly reduced costs in the traffic sensitive part of the network (switching and transmission) and economies of scope with a single network providing both voice and broadband services and (b) moving to an MSAN will involve one off migration costs which have in the recent past been at a cyclically low level due to the longer than expected operating life of PSTN line cards*".[641]

7.91 TTG considered that using an anchor pricing approach and basing prices on TDM technology had some serious negative consequences:

> *"First, though anchor pricing will reduce prices paid by consumers who only purchase line rental services it will result in higher overall prices for consumers who buy line rental, calls and broadband services (since the overall cost of delivery of line rental, calls and broadband is higher using legacy technology).*

[638] See paragraph 3.138 of the 2009 WLR Determination.
[639] TTG response (July 2011) to the March 2011 Consultation, paragraph 406.
[640] TTG response (July 2011) to the March 2011 Consultation, paragraph 356. Footnote 159 has not been included, but is quoted in the next paragraph of this document.
[641] TTG response (July 2011) to the March 2011 Consultation, footnote 159, page 91.

Over 70% of consumers purchase voice and broadband. Thus a minority of consumers will actually benefit from lower prices as a result of using the anchor pricing approach. The majority of consumers will experience higher prices.

Second, the main consideration when deciding what approach to use for setting prices should be economic efficiency and particularly productive, allocative and dynamic efficiency. Notably against each one of these factors the anchor pricing approach is inferior versus using the MEA approach. This is predominantly because the costs used in anchor pricing are based on the costs of legacy technology and not based on forward looking efficient costs – setting prices using forward looking efficient costs is at the heart of ensuring efficiency.

In terms of productive efficiency, BT's incentives to move to the lowest cost technology are unequivocally diluted by the use of the anchor pricing approach. This is because BT know that if they do not migrate to modern technology then they can still fully recover the higher legacy technology costs and if they do migrate then prices will be set at the cost of the new technology. This means that BT will not fully benefit from reductions in cost that they achieve. This reduces their incentive to reduce costs. The CC accepted this point when it said: "… we agree with CPW that, generally, incentives are strongest when price controls are set independently of actual behaviour or performance …".

In fact there is now empirical evidence that may corroborate this theoretical point. BT has delayed migration to MSANs (i.e. 21CN). This suggests ceteris paribus that this disincentive to be efficient is now being played out in real life – now that BT knows Ofcom will revise prices when it moves to the new technology it has less incentive to move.

Allocative efficiency will also be reduced by anchor pricing because there would be less demand than if prices were set at the level of efficiently incurred costs.

In terms of dynamic efficiency, setting prices based on legacy technology limits competitive entry so reducing the extent of the benefits of competition. This is because all new entrants use MEA technology (i.e. MSANs) and the lower WLR prices deter voice-only entry. In particular, anchor based pricing will deter the efficient use of MPF to provide voice-only services alongside GEA. As GEA rolls out and is taken up MPF-based operators will be faced with the decision of whether to use MPF or WLR to provide the voice component of the service. If the anchor based approach is used it will encourage inefficient behaviour because the WLR price will be set artificially low and will deter entry by efficient competitors".[642]

7.92 TTG considered that the FAC costs of an MSAN (and associated facilities) was £20 per line and the LRIC was "*about £18*". TTG considered that this should be the LRIC considered for assessing the LRIC differential between WLR and MPF.[643]

7.93 TTG also said that equipment replacement, adjustments for fully depreciated equipment and maintenance should also be included even if full adoption of MSAN technology was not included.[644]

[642] TTG response (July 2011) to the March 2011 Consultation, paragraphs 358 to 363. Note footnotes have been excluded from this quotation.
[643] TTG response (July 2011) to the March 2011 Consultation, paragraph 407.
[644] TTG response (July 2011) to the March 2011 Consultation, paragraph 408.

Our response

TTG's application of MEA approach is incorrect.

7.94 We consider TTG's proposals incorrectly apply the principles of MEA asset valuation. This is because TTG's approach takes no account of the need for 'abatement', which we explain below.

7.95 The MEA is an asset that replicates an existing asset using the most cost effective proven technology to perform the given function. When valuing assets based on use of MEA, the MEA is often not the asset actually deployed. It is not unusual for older technology assets to actually be in place, which are likely to be more expensive and/or inferior to the MEA. Older assets could be inferior because they have higher running costs or inferior quality performance compared to the MEA. When valuing the old asset by reference to the MEA, it is necessary to take this into account by reducing, or 'abating', the value of the old assets compared to the MEA.[645] We therefore consider the need for such abatement to be a fundamental part of the standard approach to MEA valuations.[646]

7.96 While we do not necessarily consider that MSANs in local exchanges are the MEA,[647] we explore the implications if they were, and if an MEA approach were adopted for setting charges.

7.97 BT will be using mainly TDM/PSTN technology to provide WLR services for the duration of the LLU / WLR charge control (and well beyond). To value these assets and set charges on the basis of the MEA, we would need to assess:

- What would be the cost of deploying MSANs in exchanges throughout Openreach's network; and

- How much to reduce the value of the existing TDM assets for the fact that they do not offer the same functionality as the MEA, i.e. to assess how much less TDM assets are worth because they do not have the functionality of being able to provide both voice and broadband, and have higher usage costs. This would require assessing the value that some consumers would place on having this functionality.

7.98 It is possible that this MEA approach may lead to lower line card costs than that based on the continued use of TDM/PSTM technology. This would be likely if MSAN technology were significantly more efficient overall than TDM technology. If this were the case, the value of the TDM assets would need to be reduced to reflect the availability of the MEA which offered greater overall efficiency.

[645] A simple example may help to explain this. Compare an old technology asset that had cost 100 and the MEA which costs 70. To simplify, suppose that the old technology asset has in no way deteriorated and is as good as when it was new. If the MEA were merely cheaper than the old technology, then an MEA approach would value the old asset at 70. However, suppose that as well as being cheaper, the MEA is also superior in that it had lower running costs than the old technology asset, and suppose these were equivalent to a lump sum of 20. In this case, we would need to reduce (or 'abate') the value of the old asset by a further 20 to reflect it being inferior to the MEA. In this case, an MEA approach would involve valuing the old asset at 50 (70 minus 20). This would accurately reflect the resource costs in using the old technology asset.

[646] Ofcom takes the standard approach to MEA valuations to be that set out in the "Byatt report" ("Accounting for economic costs and changing prices, a report to HM Treasury by an advisory group", HMSO 1986). We consider this the most authoritative source on the relevant principles.

[647] For example, a case might also be made that FTTC and/or FTTP were the MEA.

7.99 We therefore disagree with TTG that the practical effect of basing line card costs on TDM technology rather than MSAN technology is necessarily to set WLR prices lower than they would be under a situation where MSANs were assumed to be the MEA. On the contrary, it is possible that the anchor pricing approach would result in higher prices than using an MEA approach.

7.100 In practice, we consider it likely that the MEA value which is the equivalent of a TDM/PSTN line card (i.e. one which does not have additional functionality) may be well proxied by estimates based on an anchor pricing approach using TDM/PSTM technology. Ofcom's anchor pricing approach may therefore result in a cost that is broadly consistent with a cost based on a correct interpretation of MEA principles.

Practical advantages of anchor pricing over correctly applied MEA approach when faced with major shifts in technology

7.101 When faced with major shifts in technology, we consider that our anchor pricing approach deals well with providing incentives to Openreach to move from one technology to another when it is efficient to do so while protecting consumers for inappropriate increases in charges. It would be efficient for Openreach to move from one technology to another when costs are reduced overall and/or consumers are prepared to pay for the higher functionality offered by the new technology.

7.102 Our anchor pricing approach caps prices for existing products at what they would cost based on the hypothetical continuation of the 'old' technology until the 'new' technology becomes well established.[648] This means the introduction of new technology cannot increase prices for the same services. Once a new technology has been well established (even if not adopted by the incumbent[649]), prices can gradually be moved to reflect the new technology. If necessary to enable a reasonable expectation of efficient cost recovery, this gradual movement in prices could be over an extended period.

7.103 In contrast, using an MEA approach for valuing line cards (which would involve abatement when valuing TDM technology assets) would be challenging because it would require:

- Ofcom taking a firm view about what was the MEA in this context, the costs of that MEA and on how much to abate the old assets, including for lower functionality of the existing assets compared to the MEA (which entails assessing the value that some customers would place on the MEA outputs compared to the outputs of the existing assets).

- We would also need to take a view about the most appropriate *transition* to the new technology. If it were efficient to move to the new technology (which may or may not be the case), the costs of transitioning to that technology would need to

[648] We generally set prices based on the MEA approach, but the anchor pricing approach may be applicable when there are major shifts in technology. More specifically, it could be appropriate when there is considerable uncertainty over: what technology is the MEA, the cost and cost structure of the MEA technology, the demand for new services if the MEA has greater functionality than existing technology, and the appropriate speed of transition to using the MEA technology.

[649] If the new technology were to become well established but for some reason were not taken up by a regulated company, then it might be appropriate to start move prices towards the new technology even though the regulated company had not taken up that new technology. However, we would be cautious in doing this, especially if the regulated company had an incentive to move to the new technology when it was efficient to do so.

be allowed. For the regulator to determine the optimal path of transition would be challenging.

- We would need to ensure that Openreach had an expectation that it would recover its reasonable costs, to ensure an incentive to invest. We would therefore want to be consistent over time, including between different charge controls. This would require assessing when a nascent technology might become the MEA and depreciating existing technology with that in mind.

7.104 By avoiding necessarily taking a view on these issues, our anchor pricing approach reduces the practical difficulties of setting prices. It thereby reduces the risk of regulatory failure. To a large extent, it pushes the assessment of whether and when it is appropriate to introduce new technology away from Ofcom, and onto Openreach. Openreach bears the risks associated with introducing the new technology, rather than the consumer. If the new technology is successful and results in lower costs, then Openreach retains the benefits of introducing the new technology, until prices are gradually moved to reflect the new technology. Conversely, if the new technology is unsuccessful, consumers are protected from higher prices.[650]

7.105 Similarly, the incentives on other CPs to invest in new technology are also good with the anchor pricing approach: if other CPs can provide new technology that is more attractive to consumers than Openreach's existing technology they have an incentive to do so if regulated prices are based on Openreach's existing technology.

7.106 We do not agree with TTG's argument[651] that the fact that BT has delayed migration to MSANs shows that it faces poor investment incentives. There were a number of factors driving BT's decision in March 2009 not to generally move its voice services off the TDM technology and onto MSANs (as discussed at paragraph 7.78 above). These reasons were discussed in the 2009 WLR Determination at paragraphs 3.85 to 3.103. We also consider that BT has not necessarily merely delayed investment in the MSANs in exchanges, but may now leapfrog that technology to go straight to an NGA technology.

[650] There are parallels to a more general comparison between rate of return regulation and incentive based regulation. As with incentive based regulation in general, our approach to pricing accepts the potential for the regulated company to over-recover for a period, but by doing that, it ensure good incentives to invest in the new technology when efficient to do so. We consider this is recognised by the CC in the 2009 WLR Determination. At paragraph 360 of TTG's response (July 2011) to the March 2011 Consultation, TTG quoted part of paragraph 3.41 of the 2009 WLR Determination. A fuller extract of what the CC said is: "*... whilst we agree with CPW that, generally, incentives are strongest when price controls are set independently of actual behaviour or performance, in practice, regulators are frequently required to strike a balance between maintaining incentives and the need periodically to reset charges so as to ensure that they allow firms to recover efficiently-incurred costs or consumers do not pay excessive prices. This approach is expected to give companies an incentive, in the form of higher profits, during the period between reviews to become more efficient and in so doing to reveal the efficient costs that can be reflected in future price controls, to the benefit of consumers.*
In this case, Ofcom said that the level and structure of prices would, for a period, be set by reference to existing technology costs, even if BT were to invest in new technology over this period. Charges would be brought into line with the costs of this new technology only when it was established and, even then, this would be achieved gradually by a glide path. It is this deliberate regulatory lag that creates the financial incentive to invest in cost-reducing technology, as BT would retain the cost savings in these years in the form of higher profits" (2009 WLR Determination, paragraphs 3.41 and 3.42).
[651] TTG response (July 2011) to the March 2011 Consultation, paragraph 361.

Implications for consumers and economic efficiency of setting charges based on MSAN technology without abatement

7.107 We have also considered the implications for consumers and economic efficiency if the differential between WLR prices and MPF prices were based on the assumption that MSAN technology in local exchanges were the MEA, but without abatement, as TTG proposes. However, we consider that this approach would not be in the interests of consumers and lead to economic inefficiencies.

7.108 If the differential between WLR prices and MPF prices were based on the assumption that MSAN technology in local exchanges were the MEA, but without abatement, WLR prices would rise to reflect the higher per line costs of MSAN technology compared to TDM/PSTN technology. CPs purchasing WLR (and ultimately end consumers) would therefore pay higher prices as if MSANs were installed, but they would not actually be receiving the higher functionality offered by MSANs because MSANs are not actually installed. WLR customers would only be receiving voice functionality and not the benefits of both voice and broadband functionality. WLR customers would therefore be paying more for something they were not receiving.

7.109 If we were to assume that all other relevant regulated charges (such as fixed wholesale call origination and call termination services) would also be set on this basis for consistency, it would mean that while fixed per line charges would be higher, there would be some off-setting gains for customers from lower usage charges. However, these customers would still be paying for the broadband functionality of MSANs through the WLR charge when they would not be able to receive that functionality through the WLR service. Customers would be paying for something they were not receiving. We consider this would clearly be against customers' interests. We note that this would be the case whether they purchased only WLR or whether they purchased WLR and also purchased broadband functionality separately (i.e. SMPF). We therefore disagree with TTG that the majority of consumers would see lower prices overall.

7.110 We consider that our anchor pricing approach gives good incentives on Openreach and CPs to invest in new technology. TTG's approach would lead to a price differential between MPF and WLR/WLR+SMPF that would be considerably greater than it would otherwise be. It would be significantly above the actual LRIC that Openreach would be incurring in providing WLR compared to MPF, and above what the LRIC would be when based on a correctly applied MEA methodology. This could lead to inefficient investment and switching to MPF. We therefore disagree with TTG's assessment of the potential upsides for economic efficiency from basing prices on MSAN technology without abatement.

Line cards estimates based on TDM/PSTN technology

7.111 We have updated Figure 7.5 above to take account of BT's 2010/11 RFS. BT changed its methodology for allocating combi card costs in the 2010/11 RFS. We consider that this new methodology better illustrates the cost of the small number of combi cards that are used to provide voice services.

7.112 To explain the nature of the changed allocation and why we consider the new allocation to be better, we first explain the nature of BT's use of MSANs/combi cards:

- BT made a limited investment in combi cards for a trial (known as the 'Pathfinder' trial). The original intention was to use these combi cards for both voice and broadband. However, due to the change in BT's strategy, these combi cards will now be used only for voice services, and not for broadband services (see paragraph 7.79 above for more detail on the trial and change of strategy).

- BT also continues to invest in combi cards for upgraded broadband use. BT is not expecting to use these combi cards for voice services.

7.113 Until 2010/11, BT took the total cost of both of these uses and apportioned it to 'combi card voice' and 'combi card broadband' based on the total number of users of voice and broadband users on the network (for example in the 2009/10 RFS there were 8 million broadband and 22 million voice users). For the voice allocation, this assumed that most of these customers were served on the TDM network but may obtain some benefit from combi cards in the future.

7.114 Over time this approach has become a less accurate cost estimate because a growing portion of the total combi card costs relate to combi cards installed for broadband-only use. The investments for broadband-only use has nothing to do with the provision of voice only services and we know from BT's approach to NGA that it has no intention of using these combi cards for voice services. However, given BT's allocation methodology, the broadband-only combi card investments were pushing up combi card voice costs.

7.115 In 2010/11, BT revised its methodology, now allocating the total combi card costs by the actual number of lines using each service. The lines used for voice, only relate to the combi cards used in the trial area. Broadband lines relate to sites where combi cards had been installed to provide ungraded broadband only services. We understand that BT considered it appropriate to change the methodology given it no longer plans to migrate voice to the combi cards installed for broadband.

7.116 This change significantly reduces the combi card costs allocated to voice. We consider that the revised methodology gives a more meaningful view of the combi card costs because the combi cards installed for broadband have nothing to do with the provision of voice services.

7.117 The line card cost in the 2010/11 accounts are shown in Figure 7.6 below. Figure 7.6 also shows the TDM line card cost throughout the period, which will understate the total line card costs because it excludes the costs of the combi cards used for voice in the trial area.

Figure 7.6: Updated line card costs derived from BT's Regulatory Financial Statements

7.118 The total costs published in the RFS are significantly lower in 2010/11 than earlier years because of the different treatment of combi cards. However, figures in recent years are likely to be too low to use to estimate the LRIC costs because they include some fully depreciated equipment. As noted in paragraph 7.86 above, there are two effects of Openreach continuing to use fully depreciated line cards. First, if many of the line cards being used are fully depreciated, the more recent CCA FAC figures for line cards would tend to underestimate the LRIC, as these would make no allowance for the cost of capital or depreciation of these assets. Second, because the economic life of the line cards had exceeded the length of time over which they were depreciated (which was ten years), historic CCA FAC figures may overstate the LRIC by depreciating the assets over too few years.

7.119 On balance, we consider that our proposed range of £11 to £13 per line per year for 2013/14 is likely to be a reasonable estimate of the LRIC for line cards, though we recognise that there is uncertainty around this estimate.

Our conclusions

7.120 We consider that our approach of estimating line card costs on the basis of continued use of TDM/PSTN technology is reasonable and that the range of £11 to £13 per line per year for 2013/14 is likely to be reasonable.

7.121 We note that these issues were considered at length by the CC in the 2009 WLR Appeal. The CC concluded that Ofcom did not err by estimating the LRIC differentials by reference to continued use of TDM/PSTN technology.[652]

Exchange wiring and line test equipment

7.122 We discuss single jumpering separately in Annex 9, which includes setting out our views in the March 2011 Consultation, comments received from stakeholders and our conclusions in the light of those comments and further data that we have gathered from BT. Amongst other things, we conclude that single jumpering should not be assumed when considering costs for the current MPF product. We do not repeat our assessment of single jumpering here, and assume that the LRIC differentials should be based on the current jumpering arrangements.

March 2011 Consultation proposals

7.123 In paragraphs 8.40 to 8.61 of the March 2011 Consultation, we set out the reasoning for our estimates for the LRIC differences for frame costs (including frame repair). Our estimates of the LRIC differentials were:

- MPF being around £2.50 more than WLR for 2013/14; and
- MPF being around 80p more expensive than WLR+SMPF for 2013/14.

7.124 These LRIC estimates were derived from our estimates of 2013/14 CCA FAC.

7.125 In paragraphs 8.62 to 8.65 of the March 2011 Consultation, we set out the reasoning for our estimates for the LRIC differences for line test equipment.

7.126 We noted that for the purposes of setting charges, we proposed spreading the costs of the TAMS over all MPF and SMPF services. However, for the LRICs of the line test equipment, we considered it appropriate to differentiate between services depending on what test equipment was used for each service, because it is the use that affects the LRICs.

7.127 MPF uses a TAM, whereas SMPF and WLR do not use a TAM. WLR has different testing equipment, partly associated with the line card equipment (though not included in the line card costs). The large majority of lines with SMPF do not use any test equipment that is additional to what is already there for WLR. However, some SMPF lines may use an evoTAM. For the purposes of considering the LRIC differentials, we proposed to ignore evoTAMs, because there were separate charges relating to them.

7.128 If all the costs that were associated with the TAM were allocated to MPF, the costs would be around £2.30 higher based on our CCA FAC modelling for the March 2011 Consultation, with a total line testing cost of around £4 per MPF line per annum on a CCA FAC basis in 2013/14. This compares with the cost for WLR of £0.45 on a CCA FAC basis for 2013/14. In general, we might expect the LRIC estimates to be lower than the CCA FAC figure, because there will be some common costs included in CCA FAC. But it is possible that the CCA FAC figures for the WLR test equipment may include some fully depreciated assets, meaning that the LRIC costs for WLR

[652] In the 2009 WLR Determination see in particular paragraphs 2.163 to 2.251 for the views of Ofcom and TTG (and BT and Sky as interveners) and 3.17 to 3.110 for the CC's assessment: http://www.competition-commission.org.uk/appeals/communications_act/wlr_determination.pdf.

could be higher than CCA FAC. We considered that there was uncertainty around the LRIC differential for testing equipment and as such assumed a wide range with MPF being £1 to £3 more expensive than WLR (and also WLR+SMPF) per line per annum in 2013/14.

7.129 In paragraphs 8.66 to 8.68 of the March 2011 Consultation, we considered the number of tie cables. With the current jumpering approach for MPF, both MPF and WLR+SMPF involve three tie cables. However, only some of these tie cables are included in the rental price, other tie cables are paid for separately. For example, for MPF, CPs pay for one tie cable separately and two tie cables are included in the rental price.

7.130 Figure 7.7 below reproduces Figure 8.11 from the March 2011 Consultation and shows the total number of tie cables involved for each of MPF, WLR and WLR+SMPF (top row), the tie cables bought separately (middle row), and the tie cables included in the rental charges (bottom row). In terms of the rental charges on a LRIC basis, we would expect MPF to involve higher tie cable costs than WLR and also than WLR+SMPF, because it involves more tie cables included in the rental product.

Figure 7.7: Number of tie cables

	MPF	WLR	WLR+SMPF
Total tie cables	3	1	3
Tie cables paid for separately	1	0	2
Tie cables included in rental charge	2	1	1

7.131 In the March 2011 Consultation, we assumed a tie cable may be of the order of £1 per line per annum, and therefore assumed that MPF is £1 more than WLR and WLR+SMPF due to an extra tie cable.

March 2011 Consultation responses

7.132 TTG considered that the LRIC costs should reflect the fact that SMPF should have the same fault repair cost as WLR, and that it was unhelpful that we had aggregated the frame use and frame repair costs (TTG also disagreed with our assumption of the current jumpering arrangements, which we discuss in Annex 9).[653]

7.133 TTG considered that "*TAM / testing LRIC costs should properly reflect forward looking costs which should include the use of evoTAMs for SMPF and WLR*".[654]

7.134 We also received comments from other stakeholders related to the use of TAMs and evoTAMs but these comments were made in the context of the CCA FAC costs and are discussed at paragraphs 6.132 to 6.140 and Annex 4 of this Statement.

[653] TTG response (July 2011) to the March 2011 Consultation, paragraph 401.
[654] TTG response (July 2011) to the March 2011 Consultation, paragraph 405.

Our response and conclusions

7.135 We consider that the LRIC differences we set out in the March 2011 Consultation for frame related costs and tie cables are reasonable. Our estimates of the CCA FAC frame related costs (which are used to inform the LRIC estimates) have changed slightly since the March 2011 Consultation, but the changes are very minor.

7.136 We do not agree with TTG that the frame related costs for SMPF should be exactly the same as for WLR, although we acknowledge that they are similar. This is partly due to the 'MDF licence fee' (as explained in paragraph 8.60 of the March 2011 Consultation) and partly because we have based frame related repair costs on actual fault rates, that is, the costs are related to the level of faults linked to the specific service.

7.137 However, we have revised our estimate of the LRIC difference resulting from test related costs. We concluded in Section 6 that, for CCA FAC, evoTAM should be recovered from WLR and SMPF lines, even though only some WLR and SMPF lines may use an evoTAM. For the point of view of the LRICs, we consider that evoTAM expenditure is fundamentally driven by the use of SMPF. WLR may nevertheless receive some benefit from evoTAM expenditure in the sense that other investment might otherwise have been needed to maintain the voice line testing equipment if there were no investment in evoTAMs.

7.138 If the evoTAM expenditure were all allocated to SMPF and none to WLR, then the total line test costs for WLR+SMPF would be around £3.75 per line per annum for 2013/14, on a CCA FAC basis. This compares to around £3.90 for MPF, on the same basis.[655] MPF would therefore have around £0.15 higher costs than WLR+SMPF on a CCA FAC basis. It is possible that the CCA FAC figures for WLR test equipment may include some fully depreciated assets, but we consider this is likely to be a relatively small effect when we are comparing MPF with WLR+SMPF, because of the significant investment in evoTAMs, which allow voice and broadband testing on the line. For the WLR+SMPF vs. MPF comparison, we consider that the LRICs are likely to be broadly similar, given the WLR+SMPF includes investment in evoTAMs. We assume that MPF is between £0.15 and £0 more expensive than WLR+SMPF. This allows for the possibility that the WLR line test equipment is slightly understated in the CCA FAC figures because it is fully depreciated.

7.139 If the evoTAM costs were excluded, then on a CCA FAC basis the WLR test equipment cost would be £0.45 per line per annum for 2013/14. However, it is possible that these costs may understate the LRIC costs because they exclude some fully depreciated assets and it is possible that without the evoTAM investment there may have been a need for other investment to maintain the voice line testing equipment. To reflect the uncertainties, we have maintained the wide range we assumed in the March 2011 Consultation of MPF being £1 to £3 more expensive than WLR per line per annum in 2013/14.

Directories

March 2011 Consultation proposals

7.140 In paragraphs 8.69 to 8.70 of the March 2011 Consultation, we set out our views on the difference in LRICs due to directories. We explained that the WLR service

[655] These figures include the return on the relevant test related assets as well as the relevant operating costs. These figures also assume that all TAM costs are allocated to MPF.

contained a contractual commitment for Openreach to provide a directory (i.e. a phone book) to each end user, whereas MPF and SMPF do not.

7.141 We explained that in our 2009 WLR Statement, we included a rough estimate of the incremental cost for directories of £0.50 per line per year to cover the costs of printing and distributing a directory. This was based on an estimate of the incremental costs by TTG. We considered this a reasonable broad estimate and in the March 2011 Consultation proposed to retain this estimate of the cost for directories.

7.142 We also noted that it could be argued that the directory cost allocation is not relevant when considering how whether there is a distortion in the choice of wholesale input. This is because directories are delivered by BT regardless of whether an end consumer is supplied with a service using MPF or WRL/WLR+SMPF. In fact, the directories are delivered to all households and businesses regardless of whether they have a BT line. BT's costs may therefore be the same whether a line uses MPF or WLR/WLR+SMPF. However, because there is a contractual commitment to provide a directory with WLR, we included this cost for WLR but not MPF.

March 2011 Consultation responses

7.143 In relation to the CCA FAC costs, EE argued that the directory costs should be excluded from the WLR cost base.[656]

Our response and conclusion

7.144 We discuss EE's comments in relation to the CCA FAC costs associated with the directory at paragraphs 6.113 to 6.115 of this Statement. We did not receive any comments from other stakeholders. Accordingly, from the point of view of the LRIC differential, we consider that the rough estimate of £0.50 per line per year for WLR rental is reasonable.[657] We note that this LRIC estimate is considerably less than the FAC figure of £2.23 per line per year. One reason for this is that a significant part of the costs may not depend on volumes, for example, there are likely to be common and fixed costs connected with the preparation of directories that are independent of volumes. In the event that we were to set future price controls with a more explicit link to the LRIC differentials (as suggested in paragraph 7.58 above), then we expect to explore in more detail the reasonableness of the LRIC estimate for directory costs.

Fault repair and standard of care

March 2011 Consultation proposals

7.145 In paragraphs 8.71 to 8.80 of the March 2011 Consultation, we considered differences in fault repair costs, including those relating to differences in standard of care.

Fault repair

7.146 We noted that the differences in recent network and end user faults rates for WLR without SMPF and MPF appeared relatively small. Also, the differences were not systematically in one direction, meaning that the average could be sensitive to the

[656] EE response to the March 2011 Consultation, page 32.
[657] There is no cost allocation to MPF and SMPF rental as the provision of directories is not included within the MPF and SMPF service.

particular months selected for the comparison. Because the differences appear small and are not systematically in one direction, we proposed to assume no material difference in the LRICs for MPF and WLR (without SMPF) for the rate of network and end user faults.

7.147 Lines with WLR+SMPF appear to have around 10% higher network and end user-related faults than MPF. In terms of the CCA FAC for network repair (excluding frame-related repair), our base case estimate of the costs for MPF in the March 2011 Consultation was around £12.81 per line per year for 2013/14. This was made up of £12.15 of direct network repair costs and £0.66 of service centre costs. For WLR+SMPF it was around £15.92, composed on £13.27 of direct network repair costs and £2.65 of service centre costs. This implies that WLR+SMPF was around £3.11 more than MPF on a CCA FAC basis.

7.148 We considered that there was considerable uncertainty over the possible size of any such LRIC difference between MPF and WLR+SMPF for fault repair, and as such assumed a wide range of £1 to £3.

Differences in standard of care

7.149 Given that both MPF and SMPF enjoy the same standard of care, we assumed that there was no material differences in LRICs between MPF and WLR+SMPF for the standard of care.

7.150 We considered there was considerable uncertainty over the size of the LRIC differential for the standard of care between WLR and MPF. Given the uncertainty, we assumed a wide range, and that MPF was probably between £1 and £5 more than for WLR per line per year.

March 2011 Consultation responses

7.151 TTG commented specifically on the estimates of the LRIC differential for fault repair. TTG argued that assuming no fault rate difference between MPF and WLR was inconsistent with the fault rate data which TTG considered showed that by 2013/14 the cost of MPF duct/copper repair would be less than WLR. TTG considered that a range of £1 to £3 for MPF versus WLR+SMPF was inappropriate because, firstly, most of the cost of fault repairs are highly variable in the long run (eg the cost of engineer and service management centre) and, secondly, the range did not reflect the fact that in 2013/14 MPF would have a lower fault repair cost than WLR.[658]

7.152 TTG also considered that the impact of the different standard of care for MPF and WLR was likely to be small. This was because the cost of actually fixing a fault will not differ significantly whether the fault is repaired the day after it is reported (as with MPF) or the day after that (as with WLR) since the same engineering effort is required. TTG considered that the only difference would be slightly more complex systems that allow suitable job prioritisation and a very small increase in the levels of staff to allow for this slightly higher level of responsiveness. TTG considered that £0.50 was a reasonable estimate of the maximum LRIC cost difference resulting from the different standard of care, which TTG considered was consistent with the analysis Ofcom provided in the 2009 WLR Statement that the incremental cost differences were 51p.[659]

[658] TTG response (July 2011) to the March 2011 Consultation, paragraph 399.
[659] TTG response (July 2011) to the March 2011 Consultation, paragraph 400.

7.153 In the context of the CCA FAC costs, Openreach said the cost differential between MPF and WLR Basic for repair service delivery was 20%, based on the SLA that guarantees an engineer attends a MPF/WLR Premium fault a day earlier than WLR Basic fault.[660]

Our response and conclusion

7.154 In Annex 4 we have set out how we have taken account of differences in fault rates and differences in standard of care in our CCA FAC modelling. We explain that we have considered these two factors together. The resulting CCA FAC figures are shown in the table below. These include service centre and dropwire costs as well as E-side and D-side copper. We also explain at paragraph A4.305 why we do not consider that the relative fault rates are distorted by the proportion of 'young lines' that will change over time.

7.155 Our CCA FAC estimates for 2013/14 are summarised in Figure 7.8 below.

Figure 7.8: CCA FAC repair related costs (excluding frame repair)[661]

	MPF	WLR	SMPF	WLR+SMPF	WLR minus MPF	WLR+SMPF minus MPF
Repair of E-side copper	2.50	2.27	0.36	2.63	(0.23)	0.13
Repair of D-side copper	6.54	5.95	0.94	6.89	(0.59)	0.35
Sub total for E-side and D-side copper repair	9.04	8.22	1.30	9.52	(0.82)	0.49
Ratios for D-side and E-side copper	*1.10*	*1.00*	*0.16*	*1.16*		
Repair of Dropwire & NTE	2.96	2.89	0.06	2.95	(0.07)	(0.01)
Service Centres	1.44	1.02	0.26	1.27	(0.43)	(0.17)
Total	**13.44**	**12.13**	**1.62**	**13.75**	**(1.32)**	**0.31**

7.156 We consider the MPF vs. WLR differential and then the MPF vs. WLR+SMPF differential.

7.157 In relation to the MPF vs. WLR differential, the CCA FAC costs are higher for MPF than WLR partly because MPF is associated with higher actual faults and partly because it has a higher standard of care. If we consider the network and service centre costs in total, then MPF is £1.32 per line per annum more than WLR. Of this £1.32 difference, around £0.50 of this relates to the higher standard of care for MPF than WLR.

7.158 In our CCA FAC figures we have now explicitly considered the cost of the differences in standard of care (see Figure 7.8 above).[662] On the basis of that estimate, we consider that our view of the LRIC differential in the March 2011 Consultation that MPF was £1 to £5 per line per year more than WLR because the level of care was too high. We now consider a much lower and narrower range is appropriate, and assume £0.50 to £1.50. We have considered a wider range than the CCA FAC

[660] Openreach response to the March 2011 Consultation, paragraphs 165 and 501.
[661] The figures in this table may not sum to due to rounding differences.
[662] See paragraphs A4.282 to A4.304.

estimate to reflect the remaining uncertainties around the cost of the standard of care in the CCA FAC figure.

7.159 Turning to the MPF vs. WLR+SMPF differential, actual faults are higher for WLR+SMPF than for MPF. However, service centre costs are only fractionally higher for MPF than WLR+SMPF. Overall, MPF has slightly higher costs than WLR+SMPF. Given the revised CCA FAC figures, we consider that the range for the LRIC difference in the March 2011 Consultation of WLR+SMPF being between £1 and £3 more than MPF per line per annum is too high. We have now assumed a range of £0 to £1.

7.160 Accordingly, for fault repair and standard of care, we assume that MPF is between £0.50 to £1.50 more expensive than WLR per line per year, and WLR+SMPF is between £0 to £1 more than MPF per line per year.

Product management and other costs

7.161 In paragraphs 8.81 to 8.83 of the March 2011 Consultation, we considered differences in product management, sales, systems and development and other minor costs.

7.162 We noted that during the 2009 WLR Appeal, TTG argued that WLR involved many more capabilities and features than MPF. TTG argued that the provision of WLR involves assets and resources that are additional to MPF.[663] We saw MPF and WLR as two distinct products, each with its own product-specific costs. We accepted that there are some WLR-specific product costs. However, some of the WLR specific features are connected with providing voice features and would already be included in the line card costs. WLR is an established product with users who have fairly homogenous demands, leading to comparatively low product development and management costs. In contrast, MPF users tend to have diverse requirements, and accommodating these tends to increase product development and management costs. We therefore considered it unclear whether WLR or MPF would have a higher LRIC for these types of activities and that any difference was anyway likely to be small. We therefore did not include any difference in our estimate of the LRIC difference between WLR and MPF for these items.

7.163 For the comparison between WLR+SMPF and MPF, we expected SMPF+WLR to have higher product management and systems costs than MPF as it involves two products rather than one. We considered there was considerable uncertainty over the possible size of any such difference and have assumed a wide range for the LRIC difference of £0.50 to £2.

March 2011 Consultation responses

7.164 Comments received from stakeholders in relation to our proposals in the March 2011 Consultation did not focus on minor difference in costs due to product management and other costs.

7.165 We received a question on the March 2011 Consultation asking us to clarify what we meant by the more 'diverse requirements' of MPF users compared to WLR users.[664]

[663] See for example paragraph 2.350 in the 2009 WLR Determination: http://www.competition-commission.org.uk/appeals/communications_act/wlr_determination.pdf.
[664] See the last question at: http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/clarifications/Information_disclosure.pdf.

We said that the LLU equipment used in exchanges varies between CPs and this is reflected in the wide range of different ancillary products bought for MPF services (as shown by the long list of comingling services). But the management costs of this diverse range of products should be captured in the cost of the ancillary services rather than the core rentals. It is therefore not obvious that that the diverse requirements for full unbundling products tend to mean that the LRIC of product management costs for MPF rental are higher than WLR rental.

7.166 TTG responded with an argument on the LRIC differential related to cumulo rates. This is not relevant to product management related costs, but as we have not discussed TTG's point elsewhere, we cover it here. Specifically on the LRIC differential, TTG argued that the "*Cumulo rates cost for WLR and WLR+SMPF should be higher than MPF given they generate more profit for BT. The LRIC cost difference should equal the FAC cost difference since the cost is fully incremental*".[665]

Our response and conclusions

7.167 For the MPF vs. WLR differential, we remain of the view that it is unclear whether there is any material difference between MPF and WLR in terms of most product management and related costs. Each of the two products will have its own product specific costs and we do not consider it clear that one product will have higher costs than the other, and the costs are anyway relatively small.

7.168 For most product development and related costs, the differences in the CCA FAC figures are very minor. We have explored these differences in the CCA FAC costs in more detail. An important exception to the difference being very minor in the CCA FAC costs relates to computing costs. The MPF rental (and SMPF rental) has £0.65 per line per annum allocated to it in CCA FAC terms while the WLR rental has no computer costs allocated to it. This is because the CCA FAC treatment of computer costs is different for LLU and WLR. For LLU the computing costs are allocated to both rental and provisioning, whereas for WLR the computing costs are not allocated to rental, but are instead all recovered from other WLR related charges, including WLR Transfer.

7.169 Given that we want to compare the MPF rental and WLR rental on a like-for-like basis and more of the computing costs are picked up in other WLR related charges, when considering the LRIC differences we need to reflect the higher computing costs in the MPF rental. These computing costs are incremental costs for LLU related products as a whole. Because there is considerable uncertainty on the appropriate amount to include for the additional computing costs for MPF rental on a LRIC basis, we have assumed a range of MPF being £0.25 to £0.50 per line per annum more than WLR rental.

7.170 For the comparison between WLR+SMPF and MPF, we would expect SMPF+WLR to have higher product management and systems costs than MPF as it involves two products rather than one. Computing costs are less of a concern, because both SMPF and MPF need to include more computing cost than WLR, with little net effect on the WLR+SMPF vs. MPF differential.

7.171 In the March 2011 Consultation, we said that there was considerable uncertainty over the possible size of any such difference and assumed a wide range for the LRIC difference of £0.50 to £2. The current CCA FAC estimates involve a difference of less than £0.50. While it is possible that this may under-reflect the LRIC differences

[665] TTG response (July 2011) to the March 2011 Consultation, paragraph 404.

because of allocations, the absolute size of the costs is not large so we consider that our initial range was probably too wide and we have reduced it to £0.50 to £1.

7.172 We discuss TTG's arguments about cumulo rates in the context of CCA FAC at paragraphs A4.41 to A4.94. We conclude that the CCA FAC costs in 2013/14 for MPF and WLR do not differ significantly on a per line basis and we consider this appropriate. We do not consider there should be any difference in the LRIC differential.

Summary of Ofcom's estimate of LRIC differentials

7.173 Figure 7.9 below summarises our estimates of the LRIC differentials MPF vs. WLR/WLR+SMPF (including for each of the identified product differences) as set out in the March 2011 Consultation and in this Statement.[666]

Figure 7.9: Comparison of Ofcom's estimates of LRIC differences

	March 2011 Consultation		**Statement**	
£ per line per year (for 2013/14)	**MPF vs. WLR**	**MPF vs. WLR+SMPF**	**MPF vs. WLR**	**MPF vs. WLR+SMPF**
Line card	£11 to £13	£11 to £13	£11 to £13	£11 to £13
Frames	-£2.50	-£0.80	-£2.50	-£0.80
Line test equipment	-£3 to -£1	-£3 to -£1	-£3 to -£1	-£0.15 to £0
Tie cables	-£1	-£1	-£1	-£1
Directories	£0.50	£0.50	£0.50	£0.50
Network fault repair and standard of care	-£5 to -£1	£1 to £3	-£1.50 to -£0.50	£0 to £1
Product management and other costs	-	£0.50 to £2	-£0.50 to -£0.25	£0.50 to £1
Likely range for LRIC differentials	**£0 to £8**	**£8 to £15**	**£3 to £8**	**£10 to £14**

7.174 Our final estimates of the LRIC ranges have narrowed to £3 to £8 for the MPF vs. WLR differential and to £10 to £14 for the MPF vs. WLR+SMPF differential.

7.175 Given these estimates, in paragraphs 7.5 to 7.65 above we describe why we consider that the charge controls we have set are appropriate. In particular, the price differentials are likely to be greater than the absolute LRIC difference and are declining towards the LRIC difference over time.

[666] March 2011 Consultation, Figure 8.12.

Section 8

Charge control implementation and legal tests

8.1 In this Section we explain how the charge controls for LLU services and WLR services are structured and how the conditions will work in practice. In particular we discuss the following:

- How the conditions would work alongside other regulation;
- The effects of the conditions and the structure of the "baskets" of services;
- How we calculate whether Openreach is complying with the charge ceilings created by the RPI-X style of controls, including;
    - o How we have determined what the overall change of prices has been for each service or group of services; and
    - o What information we require from Openreach to enable us to monitor their compliance with the controls; and
- How the conditions allow for corrections where there has been over or under recovery.

8.2 We also explain in this section how the legal instruments in this Statement satisfy the legal tests set out in the Act.

8.3 In setting the charge controls we have also had regard to the WBA and ISDN30 charge controls. We have set an RPI-X control that is consistent in its application and effect with those controls imposed in the WBA review and proposed in the ISDN30 review.

Interaction with other remedies

8.4 The WLA and WFAEL market review determinations imposed a number of SMP conditions on Openreach in the WLA market and the wholesale WFAEL market, respectively. These conditions currently place a number of obligations on Openreach in relation to how they offer wholesale services in these markets. For example, Openreach are required to:

- provide network access on reasonable request (FAA1 and AAAA1(a));
- not to unduly discriminate in relation to matters connected with network access (FAA3 and AAAA2);
- publish a reference offer (FAA5 and AAAA5);
- notify charges and technical information (FAA6, FAA7, AAAA6(a) and AAAA6(b));
- publish Key Performance Indicators (KPIs) (AAAA7 and KPI Direction (WFAEL only)); and

- provide local loop unbundling services (FAA9) and wholesale line rental services (AAAA10).

8.5 The above mentioned obligations will therefore work alongside the charge controls set out in this Statement.

The conditions

8.6 The SMP services conditions FAA4(A) and AAAA4(WLR) will, as set out in this Statement, have three key effects; they will each:

- set charge controls until 31 March 2014 for the services specified;
- ensure that average charges for services subject to charge controls do not change by more than the value of 'X' as specified; and
- require Openreach to provide information annually to Ofcom to enable compliance monitoring.

8.7 In addition, for LLU services. condition FAA4(A) provides for:

- the charges levied for individual services in the baskets to be restricted by an inertia clause; and
- the charge made for each level of LLU Enhanced Care service to be equal to the charge made for the equivalent level of Enhanced Care service in respect of WLR.

8.8 Conditions FAA4(A) and AAAA4(WLR) are set out in full at Parts I and IV of Annex 12.

Basket Structure

8.9 In Section 4 we have set out three separate baskets for LLU ancillary services.

8.10 We have structured the condition FAA4(A) to effect this approach. We have decided to impose a control on each of the three separate baskets of LLU ancillary services which are separately identified in SMP condition FAA4(A).1(a), (b) and (c) as SMP Ancillary Services, MPF Ancillary Services and Co-Mingling Services, respectively. This structure means that the aggregate charges for each basket of services will be subject to a separate RPI-X charge control.

The values of X

8.11 The values of 'X' for each service or basket are set out in Section 6, figures 6.21-6.24.

We have set formulae to show how the Percentage Change is calculated for each service

8.12 In this Statement, we have imposed controls on single product services and, for LLU services, multi service baskets.

8.13 At each of FAA4(A).5 and AAAA4(WLR).4 we have set out the formula that we have used (and expect Openreach to use) to determine the Percentage Change for single product services. For the First Relevant Year, various products are subject to charge ceilings rather than having a Percentage Change applied and these ceilings are set out at FAA4(A).2 and AAAA4(WLR).2.

8.14 In relation to multi-service baskets (which are only relevant to LLU), as set out at FAA4(A).4, the formula is necessarily more complex in order to take account of the number of products/service within the basket. We will monitor Openreach's compliance with the controls using the prior-year revenue weight approach. The prior-year revenue weight formula is shown at FAA4(A).4 in relation to the basket controls for LLU ancillary services.

8.15 Each of the formulae is consistent with the approach we have taken in previous charge controls and with the controls for WBA services and proposed controls for ISDN30 services.

8.16 Additionally, we have at FAA4(A).3 and AAAA4(WLR).3, required Openreach take all reasonable steps to secure that the revenue it accrues as a result of all individual Charge Changes during any Relevant Year shall be no more than that which it would have accrued had all of those Charge Changes been made on a fixed point in the year (generally, 1 April). In order to assist Openreach, we provide guidance as to how this would be satisfied if a single Charge Change is made within the year, setting out a formula that can be used to demonstrate compliance. If more than one Charge Change was made by Openreach, they would still need to ensure that they could show that they had satisfied this obligation.

LLU specific provisions

8.17 Condition FAA4(A) also provides for some specific controls on particular LLU services.

8.18 For the reasons explained in Section 4 of this Statement, condition FAA4(A).6 requires that each of the categories of service in the MPF Ancillary Services basket, the SMPF Ancillary Services basket and the Co-Mingling Services basket can be increased or decreased by no greater than 7.5 per cent. FAA4(A).7 sets out a formula for the purposes of complying with the obligation in FAA4(A).6.

8.19 FAA4(A).11 imposes a requirement for the charges made for certain MPF SFI2 services to be the same as the charge made for the equivalent SFI2 service for SMPF. We explain our reasons for this in Section 4 of this Statement. This does not prevent the charges for the respective services being increased and/or decreased, only that if the charge made for a specific MPF/SMPF service is changed, that the equivalent SMPF/MPF service is also changed to the same extent.

8.20 FAA4(A).12 similarly requires the price of certain LLU Enhanced Care services to be the same as the equivalent Enhanced Care service for WLR. The reasons for this are set out in Section 4 of this Statement. As with FAA4(A).11, this does not prevent Openreach from increasing or decreasing the charge made for WLR/LLU Enhanced Care provided that the charge made for the LLU/WLR Enhanced Care Service of an equivalent level is also increased/decreased by a corresponding amount.

The rules that Openreach needs to follow to determine compliance with the charge controls

Openreach is allowed to carry over differences in the average charge for a basket to the next charge control year

8.21 For charge controlled services, Openreach will be able to carry over any price reductions it makes in excess of the requirements of the charge control for that year. That is, if Openreach's average price change for these single charge categories and baskets at the end of the Relevant Year is lower than required by the associated RPI minus 'X' constraint, it will be able to carry over the difference into the following charge control years. This means that the benchmark for assessing Openreach's compliance with the control in the following year will be the level of charges Openreach was required to achieve, rather than the level it actually achieved. Conversely, if its average charge is higher than the required level, it has to take the excess into account in the following year. There is an exception to this general principle in the First Relevant Year in respect of those products where we have specified price ceilings rather than a controlling percentage.

8.22 Paragraphs FAA.9, FAA.10, AAAA4(WLR).6 and AAAA4(WLR).7 of the Conditions define the "Excess" and "Deficiency" scenarios set out above to give effect to this policy.

8.23 It should also be noted that FAA4(A).15 and AAAA4(WLR).10 provide for the case where, in the last year of the controls, if Openreach is likely to fail to secure that the change in price of a controlled service (the Percentage Change) does not exceed the relevant X (the Controlling Percentage), then Ofcom can direct that Openreach should make an appropriate adjustment of its charges.

8.24 Given that the controls apply for only two years (rather than the two and a bit years proposed in the March 2011 Consultation), these provisions mean that the carry over provisions will apply only to those products other than those in respect of which we have specified price ceilings rather than a controlling percentage in the First Relevant Year.

We have set out the information Openreach is required to supply to Ofcom

8.25 We have set out at FAA4(A).14 and AAAA4(WLR).9 the information that Openreach needs to supply to us in order for us to be able to monitor its compliance with the control. This information is required to be supplied by Openreach on an annual basis, by no later than the 30 June after the end of the relevant financial year (three months after 31 March). It should be noted that although the period of the control ends on 31 March 2014, the Condition itself would remain in force, in order to maintain the obligation to supply data (and should it be necessary to direct an adjustment of pricing in the event of non-compliance).

Legal tests

8.26 In the 2010 WLA Market Review and the 2010 WFAEL Market Review, we considered respectively whether the imposition of a charge control on LLU and WLR would be fulfills the relevant tests set out in the Act.[667] For the purpose of this

[667] See the WLA 2010 Market Review, paragraphs 5.95 to 5.96 and the WFAEL Market Review, paragraphs 7.14 to 7.21.

Statement, in light of the reasoning in the market review, we have considered whether the specific form of the charge control in the case of each of LLU and WLR meets the relevant tests. We have also done this for the other legal instruments we impose.

8.27 To give regulatory effect to the conclusions set out in this Statement, we have set two new SMP conditions, Condition FAA4(A) (in respect of LLU) and Condition AAAA4(WLR) (in respect of WLR). The text of those conditions is set out respectively in schedule 1 to the statutory notifications published under sections 48 and 86 of the Act in Part I and Part IV of Annex 12.

8.28 Our Statement also sets out a modification to SMP condition AAAA10 to make clear that the obligation on Openreach to provide wholesale line rental includes an obligation to provide such ancillary services as may be reasonably necessary for the use of wholesale line rental. The amendment is set out in schedule 2 to the statutory notification published in Part IV of Annex 12.

8.29 We are also making directions dis-applying certain cost orientation requirements in respect of MPF rental, MPF Cease, SMPF Cease and LLU Enhanced Care services, and in respect of Analogue Core WLR rental and WLF transfer. These directions are set out in Part II and V of Annex 12.

8.30 We also, in this Statement, give consent to certain notification requirements being reduced from 90 days to 23 days in relation to the notification of the changes required following entry into force of Condition FAA4(A) and Condition AAAA4(WLR). These consents are set out in Part III and VI of Annex 12.

8.31 We set out in the March 2011 Consultation and November 2011 Consultation the reasons why we considered the specific form of the charge control in the case of each of LLU and WLR met the relevant tests. We received no specific comments from stakeholders on this. Insofar as other comments in relation to specific proposals may also be said to relate to this, we have dealt with those comments where we respond to the comments on the specific proposal. In light of this, we are satisfied that this regulation meets our duties and the tests under the Act. Our reasoning for this view is set out below.

Part I of Annex 9: Condition FAA4(A)

Schedule 1 to the notification

Aims and effects

8.32 The new SMP condition FAA4(A) requires Openreach to ensure that its charges for the LLU rental services and associated ancillary services do not increase by more than RPI minus/plus a value of ‘X’ that varies according to each relevant basket and individually controlled service. The baskets and services with their respective values for ‘X’ are set out in the SMP Condition.

8.33 Ofcom’s reasons for imposing this particular form of control and the values for ‘X’ are set out above. The control period will last for a period of 2 years, ending on 31 March 2014. As a general principle, prices should move towards the underlying CCA FAC in the final year of the control.

Our duties and policy objectives

8.34 We discuss our duties and objectives specific to this charge control in detail in Section 2 of this Statement. We are satisfied that the performance of our general and specific duties under section 3 and 4 of the Act is secured or furthered by our conclusion to adopt the charge controls.

8.35 In particular, we consider that the charge controls will ensure that charges for wholesale services are set at a level that will enable CPs (other than Openreach) to compete in the provision of downstream services. Existing charge controls have promoted competition in this way to the clear benefit of consumers in respect of choice, price and quality of service and value for money. Our review confirms that such controls are necessary to sustain this level of competition.

8.36 We have had particular regard to the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers, which are relevant to both sections 3 and 4 of the Act. We have placed particular emphasis on the promotion of competition, which we consider is likely to be the most effective way of furthering citizen and consumer interests in the relevant markets.

8.37 We have also sought the least intrusive regulatory measures to achieve our policy objectives.

8.38 In addition, we have taken into account further objectives, including:

- prices: to ensure that services are available at prices that are reasonably related to the efficient costs of supply, preferably as a result of effective competition; and

- investment and innovation: to promote efficient investment in the development of new and innovative services by Openreach and other CPs.

Powers under sections 87 and 88 of the Act

8.39 Section 87(1) of the Act provides that, where Ofcom has made a determination that a person (here, BT) has SMP in an identified services market (here, the wholesale local access services within the UK, but not including the Hull Area), Ofcom shall set such SMP conditions authorised by that section as Ofcom considers it appropriate to apply to that dominant provider in respect of the relevant network or relevant facilities and apply those conditions to that person.

8.40 Section 87(9) of the Act authorises the setting of SMP services conditions to impose on the dominant provider, including:

- such price controls as Ofcom may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities;

- such rules as Ofcom may make in relation to those matters about the recovery of costs and cost orientation;

- obligations to adjust prices in accordance with such directions given by Ofcom as they may consider appropriate.

8.41 Linked to that matter is the requirement under section 88 of the Act in that Ofcom should not set a condition falling within section 87(9) of the Act except where it appears to it from the market analysis that there is a relevant risk of adverse effects arising from price distortion and it also appears that the setting of the condition is appropriate for the purposes of:

- promoting efficiency;
- promoting sustainable competition; and
- conferring the greatest possible benefits on the end-users of the public electronic communications services.

8.42 In determining the charge controls, section 88 of the Act also requires that we must take account of the extent of the investment in the matters it relates to by Openreach.

8.43 In our opinion, Condition FAA4(A) satisfies section 88 of the Act.

8.44 In the corresponding market review we confirmed that there is a real risk of adverse effects arising from price distortion by Openreach as it might fix and maintain some or all of its prices at an excessively high level or margin squeeze.[668] We confirm in Annex 11 of this Statement that there has been no material change in the WLA market since Ofcom's market power determination in relation to that market.

8.45 We also consider that the charge control conditions set out in this Statement are appropriate for the purposes of promoting efficiency and sustainable competition and conferring the greatest possible benefits on the users of public electronic communications services.

Efficiency

8.46 We consider that the SMP Condition is appropriate for the purpose of promoting efficiency.

8.47 In the absence of competitive pressures, we believe that Openreach would have limited incentives to seek to reduce its costs of providing LLU services. By setting an RPI-X charge control Openreach is encouraged to increase its productive efficiency. This is achieved by allowing Openreach to keep any super-normal profits that it earns within a defined period by reducing its costs over and above the savings envisaged when the charge control was set. The benefits of any cost savings would potentially accrue to the regulated company in the short run and this would give Openreach incentives to make those efficiency savings. In the longer run, these cost savings could be passed to consumers through reductions in prices, either as a result of competition or through subsequent charge controls. This form of price regulation is also preferable to a rate of return type of control. In addition:

- by bringing prices more in line with costs, our charge control will increase allocative efficiency;[669] and
- when forecasting Openreach's forward looking costs for LLU services, we have assumed underlying efficiency gains of 5%. In coming to a view of the likely efficiency of Openreach's costs, we have considered a range of evidence including benchmarks from other markets (section 88(4) of the Act) and we have

[668] See paragraphs 5.54 to 5.92 of the 2010 WLA Statement.

[669] When prices better reflect the underlying costs of production, allocative efficiency is enhanced. Meeting demand at cost-reflective prices will result in resources being allocated to the goods or services that consumers value most.

had regard to the appropriate cost accounting methods (section 88(4)(b) of the Act).

8.48 By having baskets for each of MPF Ancillary services, SMPF Ancillary services and Co-Mingling services, we also provide Openreach the flexibility to change its prices to meet the necessary demand conditions by recovering common costs in the most efficient manner across these services.

Sustainable competition

8.49 We also consider that the charge controls are appropriate to ensure sustainable competition and to confer the greatest possible benefits on users of public electronic communication services.

8.50 Preventing excessive pricing via an RPI-X type charge control will promote sustainable competition.

8.51 Although part of our charge control applies to baskets of services, we have included appropriate safe-guards to ensure that Openreach does not use the pricing flexibility offered to it in an anti-competitive manner to the detriment of any end-user.

Investment matters

8.52 When setting the charge controls we have also taken into account the need to ensure that Openreach has the correct incentives to invest and innovate.

8.53 We consider that our charge control strikes a good balance between potential risk and reward. As the charge control is set for a fixed duration, Openreach can benefit under the control if it manages to increase market share or if outturn costs are lower than anticipated when the charge control was set.

Test in section 47 of the Act

8.54 In addition to above-mentioned matters, Ofcom must be satisfied that Condition FAA4(A) satisfies the test in section 47(2) of the Act, namely that it is: objectively justifiable; not unduly discriminatory; proportionate; and transparent.

8.55 We are satisfied that this test is met in relation to the condition FAA4(A).

Objective justification

8.56 As regards objective justification, BT's SMP in the access markets allows it to set charges unilaterally and, in the absence of any controls, Openreach would have the ability to set prices above the competitive level. This would have adverse impacts on both the ability of companies to compete in the downstream provision of services and on consumer choice and value for money. Openreach is unlikely to be incentivised to reduce its costs or set prices at the competitive level. Our charge controls have been structured to deliver the lowest possible charges to competitors for the wholesale services, while ensuring that Openreach is able to recover costs, including a reasonable return on investment. Additionally, we have reviewed each service within the market so that we have concluded an appropriate level of control for individual services where appropriate.

8.57 The structure of the controls are such that Openreach has an incentive to continue to seek efficiency gains and it is able to benefit from efficiencies achieved that are in excess of that anticipated in the review.

8.58 The controls are also objectively justifiable in that the benefits of RPI-X price controls are widely acknowledged as an effective mechanism to reduce prices in a situation where competition does not act to do so.

Undue discrimination

8.59 Secondly, the charge controls will not discriminate unduly against a particular person or particular persons because any CP (including BT itself) can access the services at the charge levels fixed. The charges are set to ensure a fair return and price level for all customer groups. In any event, Ofcom considers that the charge controls do not discriminate unduly against BT as it is the only CP to hold SMP in this market (for the UK excluding the Hull Area) and the controls seek to address that market position, including Openreach's ability and incentive to set excessive charges for services falling within the controls.

Proportionate

8.60 Thirdly, the charge controls are proportionate because Openreach's obligations apply to the minimum set of charges required for the delivery of the bottleneck services. The charge controls are focussed on ensuring that there are reasonable prices for those access services, which are critical to the development of a competitive market. Openreach is, however, allowed to recover a reasonable return on investment. Openreach will also have incentives to continue to invest and develop its access network. Moreover, the maximum charges Openreach is allowed to set over the period of the control has been formulated using information on Openreach's costs and a consideration of how these costs will change over time. We have also only imposed controls on services within the market that we consider need to be controlled.

8.61 We therefore consider that the charge controls pursue our policy objectives and the means employed to achieve those aims are both necessary and the least burdensome to address effectively the concerns we have set out.

Transparent

8.62 Finally, for reasons discussed above, we consider that the charge controls are transparent. The aims and effects of the charge controls are clear and they have been drafted so as to secure maximum transparency. We discussed our proposals for the LLU charge controls in detail in both the March 2011 Consultation and the November 2011 Consultation, as well as in this Statement. We also published the RAV model and various non-confidential versions of the Cost Forecast model and the Cost Allocation model together with the extensive description and explanation of that charge control modelling provided in Section 7 of the March 2011 Consultation and the supporting annexes. The text of the condition has been published with this Statement and its operation is aided by our explanations in this Statement. Our Statement sets out our analysis of responses received from our consultation (i.e. the March 2011 Consultation and November 2011 Consultation) and the basis for our decision.

We have considered sections 3 and 4 of the Act

8.63 We also consider that the charge control condition fits with our duties under sections 3 and 4 of the Act.

8.64 For the reasons set out above, we consider that the charge control will, in particular, further the interests of citizens and of consumers in relevant markets by the promotion of competition in line with section 3 of the Act. In particular, the charge control seeks to ensure the availability throughout the UK of a wide range of electronic communications services. In imposing the charge control, we have had regard to the desirability of promoting competition in relevant markets, the desirability of encouraging investment and innovation in relevant markets and the desirability of encouraging the availability and use of high speed data transfer services throughout the United Kingdom.

8.65 Further, we consider that, in line with section 4 of the Act, the charge control will, in particular, promote competition in relation to the provision of electronic communications networks and will encourage the provision of Network Access for the purpose of securing efficiency and sustainable competition in downstream markets for electronic communications networks and services, resulting in the maximum benefit for retail consumers.

Compliance with SMP Condition FAA1 (Requirement to provide Network Access on reasonable request)

8.66 In reaching our decisions in this Statement on the LLU charge control, we have considered whether the charges we have set are consistent with the obligation in SMP Condition FAA1 to provide network access "*on fair and reasonable terms, conditions and charges…*". Having done so, it is our view that the prices we set out in this Statement are consistent with SMP Condition FAA1.

Part II of Annex 9: direction regarding removal of cost orientation obligation for MPF Rental, MPF Cease and SMPF Cease and LLU Enhanced Care Services

8.67 We are marking a direction to dis-apply the cost orientation requirement in paragraph FAA4(A).1 of SMP condition FAA4(A) for MPF Cease, SMPF Cease and LLU Enhanced Care Services. Although the cost orientation requirement in paragraph FAA4(A).1 of SMP condition FAA4(A) is already dis-applied for MPF Rental by virtue of paragraph FAA4(A).2, for the sake of completeness and for the avoidance of doubt we are including a direction that the requirement is also dis-applied in respect of MPF Rental. The direction is set out at Part II to Annex 12.

8.68 In making any direction Ofcom must be satisfied that the direction is objectively justifiable, not unduly discriminatory, proportionate and transparent, in accordance with section 49(2) of the Act. We set out below why we consider that the direction fulfils those tests.

Objective justification

8.69 For MPF Cease and SMPF Cease it is necessary to exclude the LRIC+ cost orientation requirement since we are, for the reasons set out in Section 4 of this Statement, setting each of these charges to zero. This is therefore not consistent with SMP Condition FAA4(A).1 which requires Openreach to ensure that its charges for Network Access in the wholesale local access market are 'based' on LRIC+.

8.70 For LLU Enhanced Care services, as explained in Section 4, by imposing a new requirement to ensure that the charges for LLU Enhanced Care are aligned to the equivalent services applied to WLR, we will need to remove the LRIC+ for cost orientation requirement. This is because the obligation to align LLU and WLR enhanced care charges will mean that the MPF and WLR rental prices will act as an ‘anchor’ to constrain the charges for LLU Enhanced Care services.

8.71 As explained above, the LRIC+ cost orientation requirement was excluded in relation to the MPF Rental charge ceiling first in 2005 and again in the 2010 WLA Statement. The reasons for excluding cost orientation remain valid. That is, because one of the assumptions taken into account in setting the charge control is the RAV adjustment and given that Openreach’s pre-1 August 1997 copper access network assets account for a significant proportion of the costs that make up the MPF rental charge ceiling, the charge ceiling itself cannot be said to be ‘based’ on LRIC+. Therefore, on the face of it, this is therefore not consistent with SMP Condition FAA4(A).1 which requires Openreach to ensure that its charges for Network Access in the wholesale local access market are ‘based’ on LRIC+.

Undue discrimination

8.72 The direction applies only to products provided by Openreach, so it affects all CPs and therefore their customers equally.

Proportionate

8.73 We consider that the direction is proportionate as the approach we are taking to the charge control in this Statement makes it unlikely that MPF Cease and SMPF Cease meet the requirements of paragraph FAA4(A).1 of SMP condition FAA4(A). Therefore, it would be disproportionate on that analysis to continue to apply a remedy to these services. Further, for LLU Enhanced Care Services, we believe that if we align LLU and WLR Enhanced Care charges, imposing a cost orientation obligation will be disproportionate. For MPF Rental, we consider that these requirements are already excluded.

Transparent

8.74 We consider that the direction clearly sets out the position as to how the basis of charges obligation should apply to this market. We consider that we have clearly identified the services that we consider should be exempted from the obligation in order to ensure that it is clear and unequivocal as to when the obligation does not apply.

Part III and Part VI of Annex 9: notification under section 49 of the Act of consent to reduce price notification period

8.75 We deal with both Parts III and VI together as the reasons for issuing the notification in each case are the same.

8.76 As with a direction, in giving any consent Ofcom must be satisfied that the consent is objectively justifiable, not unduly discriminatory, proportionate and transparent, in accordance with section 49(2) of the Act. We set out why we consider that the consents set out in our Statement fulfil this test.

Objective justification

8.77 For the reasons explained in Section 3, the notice period for notifying the charge controls is to be reduced from 90 days to 23 days (where the 90 day period currently applies). We believe that this is objectively justifiable as CPs were aware of the draft Statement changing the charges prior to this formal notification of the new charges in this Statement.

Undue discrimination

8.78 We consider that the notice period will not unduly discriminate as it will apply to all parties.

Proportionate

8.79 We believe that the notice period is proportionate. Following publication of this Statement, all parties are aware of the changes. The reduced period of notification will allow a quick adjustment of charges to the appropriate level. Given we are smoothing the transition of charges over a number of years we do not believe that the new charges will be unduly disruptive and, therefore, a quick introduction is proportionate to the impact.

Transparent

8.80 Our changes are transparent. We have fully consulted on revising the notification period (with the change from 28 days to 23 days not being material).

Part IV of Annex 9: Condition AAAA4(WLR)

Schedule 1 to the notification

Aims and Effects

8.81 The SMP condition AAAA4(WLR) requires Openreach to ensure that its charges for WLR rental services and ancillary services do not increase by more than RPI -/+ X that varies according to each individually controlled service. Each of the values of X is set out in the condition.

8.82 Ofcom's reasons for imposing this particular form of control and the values of X are set out above. The control period will last for a period of 2 years, ending on 31 March 2014. As a general principle, prices should move towards FAC in the final year of the control.

Our duties and policy objectives

8.83 As indicated above, we discuss our duties and objectives specific for this charge control in detail in Section 2 of this Statement. We are satisfied that the performance of our general and specific duties under section 3 and 4 of the Act is secured or furthered by our conclusion to adopt the charge controls.

8.84 In particular, we consider that the charge controls are designed to ensure that charges for wholesale line rental services can be set at a level that will enable other CPs (other than Openreach) to compete in the provision of downstream services. As for LLU services, existing charge controls have promoted competition in this way to the clear benefit of consumers in respect of choice, price and quality of service and value for money. Our review confirms that such controls are necessary to sustain this level of competition.

8.85 We have had particular regard to the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers, which are relevant to both sections 3 and 4 of the Act. We have placed particular emphasis on the promotion of competition which we consider is likely to be the most effective way of furthering citizen and consumer interests in the relevant markets.

8.86 We have also sought the least intrusive regulatory measures to achieve our policy objectives.

8.87 In addition we have taken into account further objectives, including

- prices: to ensure that retail services are available at prices that are reasonably related to the efficient costs of supply, preferably as a result of effective competition; and

- investment and innovation: to promote efficient investment in the development of new and innovative services by Openreach and other CPs.

Powers under sections 87 and 88 of the Act

8.88 Section 87(1) of the Act provides that, where Ofcom has made a determination that a person (here, BT) has SMP in an identified services market (here, wholesale fixed analogue exchange lines services within the UK, but not including the Hull Area), Ofcom shall set such SMP conditions authorised by that section as Ofcom considers it appropriate to apply to that dominant provider in respect of the relevant network or relevant facilities and apply those conditions to that person.

8.89 As indicated above Section 87(9) of the Act authorises the setting of SMP service conditions, including price controls and the setting of rules in relation to recovery of costs and cost orientation. Further, where Ofcom seek to set an SMP condition falling within section 87(9) of the Act Ofcom is also required to comply with the requirements of section 88 of the Act which are set out above.

8.90 In our opinion, Condition AAAA4(WLR) satisfies section 88 of the Act.

8.91 In the corresponding market review we confirmed that there is a real risk of adverse effects arising from price distortion by Openreach as it might fix and maintain some or all of its prices at an excessively high level or margin squeeze.[670] We confirm in Annex 11 of this Statement that there has been no material change in the WFAEL market since Ofcom's market power determination in relation to that market.

8.92 We also consider that the charge control conditions set out in our Statement are appropriate for the purposes of promoting efficiency and sustainable competition and conferring the greatest possible benefits on the users of public electronic communications services.

Efficiency

8.93 We consider that the SMP Condition is appropriate for the purpose of promoting efficiency.

[670] See paragraphs 7.3 to 7.21 of the 2010 WFAEL Statement.

8.94 In the absence of competitive pressures, we believe that Openreach would have limited incentives to seek to reduce its costs of providing WLR services. By setting an RPI-X charge control Openreach is encouraged to increase its productive efficiency. This is achieved by allowing Openreach to keep any super-normal profits that it earns within a defined period by reducing its costs over and above the savings envisaged when the charge control was set. The benefits of any cost savings would potentially accrue to the regulated company in the short run and this would give Openreach incentives to make those efficiency savings. In the longer run, these cost savings could be passed to consumers through reductions in prices, either as a result of competition or through subsequent charge controls. This form of price regulation is also preferable to a rate of return type of control. In addition:

- by bringing prices more in line with costs, our charge control proposals will increase allocative efficiency[671]; and

- when forecasting Openreach's forward looking costs for WLR services, we have assumed underlying efficiency gains of 5%. In coming to a view of the likely efficiency of Openreach's costs, we have considered a range of evidence including benchmarks from other markets (section 88(4) of the Act) and we have had regard to the appropriate cost accounting methods (section 88(4)(b) of the Act).

Sustainable competition

8.95 We also consider that the charge controls are appropriate to ensure sustainable competition and to confer the greatest possible benefits on users of public electronic communication services.

8.96 Preventing excessive pricing via an RPI-X type charge control will promote sustainable competition.

Investment matters

8.97 When setting the charge controls we have also taken into account the need to ensure that Openreach has the correct incentives to invest and innovate.

8.98 We consider that our charge control strikes a good balance between potential risk and reward. As the charge control is set for a fixed duration, Openreach can benefit under the control if it manages to increase market share or if outturn costs are lower than anticipated when the charge control was set.

Test in section 47 of the Act

8.99 In addition to above-mentioned matters, Ofcom must be satisfied that Condition AAAA4(WLR) satisfies the test in section 47(2) of the Act, namely that it is: objectively justifiable; not unduly discriminatory; proportionate; and transparent.

8.100 We are satisfied that this test is met in relation to the condition AAAA4(WLR).

[671] When prices better reflect the underlying costs of production, allocative efficiency is enhanced. Meeting demand at cost-reflective prices will result in resources being allocated to the goods or services that consumers value most.

Objective Justification

8.101 As regards objective justification, BT's SMP in the access markets allows it to set charges unilaterally and, in the absence of any controls, Openreach would have the ability to set prices above the competitive level. This would have adverse impacts on both the ability of companies to compete in the downstream provision of services and on consumer choice and value for money. Openreach is unlikely to be incentivised to reduce its costs or set prices at the competitive level. Our charge controls have been structured to deliver the lowest possible charges to competitors for the wholesale services, while ensuring that Openreach is able to recover costs, including a reasonable return on investment. Additionally, we have reviewed each service within the market so that we have concluded an appropriate level of control for individual services where appropriate.

8.102 The structure of the controls are such that Openreach has an incentive to continue to seek efficiency gains and it is able to benefit from efficiencies achieved that are in excess of that anticipated in the review.

8.103 The controls are also objectively justifiable in that the benefits of RPI-X price controls are widely acknowledged as an effective mechanism to reduce prices in a situation where competition does not act to do so.

Undue discrimination

8.104 Secondly, the charge controls will not discriminate unduly against a particular person or particular persons because any CP (including BT itself) can access the services at the charge levels fixed. The charges are set to ensure a fair return and price level for all customer groups. In any event, Ofcom considers that the charge controls do not discriminate unduly against BT as it is the only CP to hold SMP in this market (for the UK excluding the Hull Area) and the controls seek to address that market position, including Openreach's ability and incentive to set excessive charges for services falling within the controls.

Proportionate

8.105 Thirdly, the charge controls are proportionate because Openreach's obligations apply to the minimum set of charges required for the delivery of the bottleneck services. The charge controls are focussed on ensuring that there are reasonable prices for those access services, which are critical to the development of a competitive market. Openreach is, however, allowed to recover a reasonable return on investment. Openreach will also have incentives to continue to invest and develop its access network. Moreover, the maximum charges Openreach is allowed to set over the period of the control has been formulated using information on Openreach's costs and a consideration of how these costs will change over time. We have also only imposed controls on services within the market that we consider need to be controlled.

8.106 We therefore consider that the charge controls pursue our policy objectives and the means employed to achieve those aims are both necessary and the least burdensome to address effectively the concerns we have set out.

Transparent

8.107 Finally, for reasons discussed above, we consider that the charge controls are transparent. The aims and effects of the charge controls are clear and they have been drafted so as to secure maximum transparency. We discussed our proposals for the WLR charge controls in detail in both the March 2011 Consultation and the November 2011 Consultation, as well as in this Statement. We also published the RAV model and various non-confidential versions of the Cost Forecast model and the Cost Allocation model together with the extensive description and explanation of that charge control modelling provided in Section 7 of the March 2011 Consultation and the supporting annexes. The text of the condition has been published with this Statement and its operation is aided by our explanations in this Statement. Our Statement sets out our analysis of responses received from our consultation (i.e. the March 2011 Consultation and November 2011 Consultation) and the basis for our decision.

We have considered sections 3 and 4 of the Act

8.108 We also consider that the charge control condition fits with our duties under sections 3 and 4 of the Act.

8.109 For the reasons set out above, we consider that the charge control will, in particular, further the interests of citizens and of consumers in relevant markets by the promotion of competition in line with section 3 of the Act. In particular, the charge control seeks to ensure the availability throughout the UK of a wide range of electronic communications services. In imposing the charge control, we have had regard to the desirability of promoting competition in relevant markets and the desirability of encouraging investment and innovation in relevant markets.

8.110 Further, we consider that, in line with section 4 of the Act, the charge control will, in particular, promote competition in relation to the provision of electronic communications networks and will encourage the provision of Network Access for the purpose of securing efficiency and sustainable competition in downstream markets for electronic communications networks and services, resulting in the maximum benefit for retail consumers.

Compliance with SMP Condition AAAA1(a) - Requirement to provide Network Access on reasonable request

8.111 In reaching our decisions in this Statement on the LLU charge control, we have considered whether the charges we have set are consistent with the obligation in SMP Condition AAAA1(a) to provide network access "*on fair and reasonable terms, conditions and charges…*". Having done so, it is our view that the prices we set out in this Statement are consistent with SMP Condition AAAA1(a).

Schedule 2 to the notification

8.112 In Schedule 2 to the notification we amend SMP condition AAAA10 to make it clear that the obligation imposed on BT by paragraph AAAA10.1 to provide wholesale line rental includes, where also requested by a third party, such ancillary services as may be reasonably necessary for the use of Wholesale Line Rental. In our Statement, we have included a further consequential amendment to make clear that such ancillary services are to be cost orientated.

8.113 Although we consider that the obligation in condition AAAA1(a), which requires that BT shall provide Network Access where this is reasonably requested by a third party, is wide enough to include such ancillary services as may be reasonably necessary for the use of Wholesale Line Rental, we have, in our Statement, amended SMP condition AAAA.10 to make this explicit. This amendment also makes the position consistent with the obligation to provide LLU services (SMP condition FAA9).

8.114 We consider that the modification in particular furthers the interests of citizens in relation to communications matters and furthers the interests of consumers in relevant markets by the promotion of competition in line with section 3 of the Act. We also consider that the modification meets the requirements as set out in section 4 of the Act.

8.115 When modifying an SMP condition, Ofcom must be satisfied that the modification is objectively justifiable, not unduly discriminatory, proportionate and transparent, in accordance with section 47(2) of the Act. We set out below why we consider that our modification fulfils those tests.

Objective justification

8.116 We believe the modification is objectively justifiable. Where Openreach is obliged to provide Wholesale Line Rental, it should also provide those ancillary services necessary for the use of that service. Otherwise those CPs purchasing Wholesale Line Rental would not be able to make full use of that product.

Undue discrimination

8.117 The modification applies only to BT who has been found to have SMP in the relevant market.

Proportionate

8.118 We consider that the modification is proportionate as it is necessary to enable competition but it is not unduly burdensome on Openreach. Further, the modification should not impose a greater burden on Openreach since we consider that the obligation already imposed on BT in condition AAAA1(a) is wide enough to include such ancillary services as may be reasonably necessary for the use of Wholesale Line Rental.

Transparent

8.119 We consider that the modification improves transparency since it makes the position explicit.

Part V of Annex 9: direction regarding removal of cost orientation obligation for Analogue Core WLR rental and WLR transfer

8.120 We are making a direction to dis-apply the cost orientation requirements in paragraph AAAA3.1 of SMP condition AAAA3 and paragraph AAAA10.2 of SMP condition AAAA10 for WLR Transfer. Although the cost orientation requirement in paragraph AAAA3.1 of SMP condition AAAA3 and paragraph AAAA10.2 of SMP condition AAAA10 is already dis-applied for Analogue Core WLR rental by virtue of paragraph AAAA3.2, for the sake of completeness and for the avoidance of doubt we are including a direction that the requirement is also dis-applied in respect of Analogue Core WLR rental. The direction is set out at Part VI of Annex 12.

8.121 In making any direction Ofcom must be satisfied that the direction is objectively justifiable, not unduly discriminatory, proportionate and transparent, in accordance with section 49(2) of the Act. We set out below why we consider that the direction fulfils those tests.

Objective justification

8.122 In relation to WLR transfer it is necessary to exclude the LRIC+ cost orientation requirement since we are, for the reasons set out in Section 5 of this Statement, setting this charge below LRIC for the period of the charge control. This is therefore, not consistent with SMP Conditions AAAA3 and AAAA10 which require Openreach to ensure that its charges for Network Access in the wholesale fixed analogue exchange lines market are 'based' on LRIC+.

8.123 As explained above, the LRIC+ cost orientation requirement was excluded in relation to the Analogue Core WLR rental charge ceiling in 2005. Namely, for reasons discussed in the 2009 Openreach Financial Framework Statement, one of our assumptions taken into account in assessing the cost bases that applied to copper access products (MPF and WLR) was the RAV adjustment. Given that Openreach's pre-1 August 1997 copper access network assets account for a significant proportion of the costs that make up the Analogue Core WLR rental charge ceiling in the first control year (and then followed by indexation of that ceiling in subsequent years), the charge ceiling itself cannot be said to be 'based' on LRIC+.

Undue discrimination

8.124 The direction applies only to products provided by Openreach, so it affects all CPs and therefore their customers equally.

Proportionate

8.125 We consider that the direction is proportionate as the approach we are taking to the charge control in this Statement makes it unlikely that WLR Transfer meets the requirements of paragraph AAAA3.1 of SMP condition AAAA3 and paragraph AAAA10.2 of SMP condition AAAA10. Therefore, it would be disproportionate on that analysis to continue to apply a remedy to this service. For Analogue Core WLR rental, we consider that these requirements are already excluded.

Transparent

8.126 We consider that the direction clearly sets out the position as to how the basis of charges obligation should apply to this market. We consider that we have clearly identified the services that we consider should be exempted from the obligation in order to ensure that it is clear and unequivocal as to when the obligation does not apply.

We have completed the process of EU consultation and are now notifying our final decision to the European Commission and the Secretary of State.

8.127 As set out in paragraphs 2.12 to 2.14 above, under the revised EU Framework, Ofcom is required to complete a process of EU consultation before reaching a final decision.

8.128 In accordance with that process, we notified the European Commission, BEREC and the national regulatory authorities in every other Member State of our proposed decision. We sent a copy of our draft Statement setting out the reasons for our poposed decision to these bodies on 3 February 2012. This draft Statement was also published on our website.[672]

8.129 We received no comments on that notification from BEREC or any national regulatory authority. The European Commission did not comment on our conclusions except to invite us to review our analysis upon publication of its proposed recommendation on costing methodologies.

8.130 Therefore we are giving effect to our decision, without any modifications in this final Statement.

8.131 We are notifying our final decision to the Secretary of State, the European Commission and BEREC in accordance with section 48C of the Act.

672 http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc/statement/LLU_WLR_CC_statement.pdf.