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Office of Communications (Ofcom)

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For the attention of:
Mr Ed Richards
Chief Executive Officer

Fax: +44-20 7981 3504

Dear Mr Richards,

Subject: Commission decision concerning case UK/2011/1179: Modification of remedies concerning the leased lines markets in the UK

Article 7(3) of Directive 2002/21/EC¹: No comments

I. PROCEDURE

On 26 January 2011, the Commission registered a notification from the Office of Communications (Ofcom) concerning the modification of remedies in the leased lines markets in the UK.

The national consultation² is running in parallel with the EU consultation under Article 7 of the Framework Directive. The deadline for the EU consultation is 22 March 2011.

Pursuant to Article 7(3) of the Framework Directive, national regulatory authorities (NRAs) and the Commission may make comments on notified draft measures to the NRA concerned.

¹ Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive), OJ L 108, 24.4.2002, p. 33.

² In accordance with Article 6 of the Framework Directive.

II. DESCRIPTION OF THE DRAFT MEASURE

II.1. Background

Under case UK/2008/0859³ Ofcom sent the Commission details of the price control remedy related to the second review of the markets for wholesale terminating and trunk segments of leased lines. Ofcom proposed to introduce RPI⁴-X charge controls. These charge controls would apply across six charge control baskets⁵ proposed by Ofcom. Within those baskets, Ofcom also proposed to set sub-caps which would limit any potential increases in individual sub-baskets to the RPI.

Ofcom explained that its method to determine the charge control is split into five main stages: (i) identification of the appropriate charge control baskets; (ii) establishment of the base-year costs⁶; (iii) forecast of costs from the base year until 2012/13⁷; (iv) consideration of options for starting charge adjustments; and (v) determination of the proposed range for the values of X⁸.

The charge controls were imposed in the Leased Lines Charge Control Statement ('LLCC statement') adopted by Ofcom in 2009.

II.2. Current notification

The current notification concerns the cost recovery approach for points of handover (POH)⁹ used to deliver partial private circuits (PPC), more specifically the mechanism for recovering what Ofcom calls 'additional POH costs'¹⁰.

Ofcom explained that an appeal was lodged against the previously adopted LLCC statement before the Competition Appeal Tribunal (CAT). The appeal concerned, in particular, the level of BT's original additional POH cost estimates. In response to the appeal, the CAT referred a number of price control matters to the Competition Commission (CC), which ruled that certain POH price control matters should be referred

³ A decision supplementing the previous market analysis, notified to and assessed by the Commission under case UK/2008/0787.

⁴ Retail price index.

⁵ 'Charge control basket' is defined as a group of products and services which are subject to the same charge control restrictions.

⁶ Ofcom used current cost accounting with fully allocated costs (CCA FAC) as the cost basis.

⁷ On the basis primarily of volume changes, the impact of those changes on capital and operating expenditure, asset and other price changes, and anticipated improvements in BT's efficiency.

⁸ Ofcom has developed a cost forecasting model to calculate the ranges of 'X' for the traditional interface and alternative interface basket of services. This model is based on a number of assumptions. The most material ones include the volume forecasts for the services in question, the underlying base-year costs and assumptions about BT's future efficiency gains and cost of capital.

⁹ A 'POH' is a high-capacity link which connects an other communication provider's (OCP) network with that of BT and comprises the physical infrastructure (duct and fibre) and electronics at both ends or one end of the link. It is therefore a key component which allows infrastructure-based competition.

¹⁰ BT recovers some of the POH costs from OCPs by means of a combination of connection and rental charges. BT also levies an additional charge on all circuits delivered over a POH with the aim of recovering the part of the costs not recovered via the two above-mentioned charges (the additional POH costs).

back to Ofcom.

On the basis of the CC's ruling, the CAT issued an order referring the POH charges back to Ofcom and directing it to:

- (i) check the reasonableness of BT's POH cost estimates;
- (ii) consider various regulatory options for recovery of the additional POH costs; and
- (iii) set the new additional POH charges.

As a result of the above-mentioned ruling, Ofcom proposes to set the additional POH charges on the basis of a long-run incremental costs (LRIC)¹¹ approach instead of the pricing based on fully allocated costs (FAC) previously imposed. Ofcom proposes to set the charges based on LRIC estimates derived from a bottom-up model developed by Ofcom¹².

Ofcom sets the adjustments needed in order to bring current additional POH charges into line with LRIC and determines the new additional POH charges. In this regard, Ofcom takes the view that, in general, charges for Type I POH¹³ services are currently well above its estimates of LRIC and should therefore be reduced to LRIC with immediate effect. On the other hand, the charges for Type II POH¹⁴ services are well below LRIC estimates. Ofcom proposes that these charges should be brought into line with LRIC in two stages, with half the required adjustment taking place with immediate effect, following the publication of Ofcom's statement on these issues, and the remaining

¹¹ According to Ofcom: (i) LRIC pricing follows the cost causality principle closely (by including all costs incurred directly in order to provide POH, but only those); (ii) LRIC charging promotes effective competition by taking into account only the costs incurred as a result of OCPs' demand for POH; (iii) any advantage gained by OCPs compared with FAC-based charging is likely to be small but could be considered material given the overall additional POH costs; and (iv) whilst the proposed approach raises some issues regarding implementation, because of the difficulties of obtaining accurate LRIC estimates, Ofcom has used its bottom-up model to generate usable approximations.

¹² Following the CC's ruling, Ofcom developed a bottom-up model ('the Ofcom model') which it proposes to use in order to set the additional POH charges. Ofcom considers the estimates derived using its bottom-up model to be more robust than the top-down estimates provided by BT, particularly because the latter have been obtained using very broadly defined increments and tend to be volatile over time.

¹³ Type I POHs include the following network components: (i) POH equipment located in a BT exchange; (ii) physical infrastructure (duct and fibre) required between BT and the OCP's site, if the handover is not located at BT's site; and (iii) for customer-sited handover, POH equipment located at the OCP's site. Type I POHs are always provided using equipment based on synchronous digital hierarchy (SDH) technology and can exchange traffic at 155 Mbit/s (SMA-1), 622 Mbit/s (STM-4) and 2.5 Gbit/s (STM-16). In addition, BT also incurs maintenance costs for the link. Type I POHs are used only to carry PPCs.

¹⁴ Type II POHs are far more common and result from the reclassification of an existing POH purchased on retail terms as a wholesale POH. Type II POHs consist of network components similar to those listed above for Type I POHs. The main differences are: (i) Type II POHs can be provided using SDH (as for Type I) and plesiochronous digital hierarchy (PDH) technology. PDH POHs exchange traffic at much lower bandwidths than SDH (i.e. 4 x 2 Mbit/s and 16 x 2 Mbit/s) and PDH is considered to be an inefficient technology. In fact, OCPs can no longer buy new Type II PDH POHs from BT; (ii) Type II POHs can be delivered over both copper (i.e. Type II PDH POHs) and fibre (i.e. Type II SDH POHs); (iii) Type II POHs can be used to carry both wholesale PPCs and retail circuits. Type II POH circuits date back to the period before 2001, when BT was first required to supply PPCs as regulated wholesale products. Prior to that date, unless they extended their own network facilities, OCPs had to lease retail circuits from BT, in order to establish connections to their customer sites.

adjustment planned for 1 April 2012¹⁵.

III. NO COMMENTS

The Commission has examined the notification and has no comments¹⁶.

Pursuant to Article 7(5) of the Framework Directive, Ofcom may adopt the resulting draft measure and, where it does so, shall communicate it to the Commission.

The Commission's position on this particular notification is without prejudice to any position it may take *vis-à-vis* other notified draft measures.

Pursuant to Point 15 of Recommendation 2008/850/EC¹⁷, the Commission will publish this document on its website. The Commission does not consider the information contained herein to be confidential. You are invited to inform the Commission¹⁸ within three working days following receipt whether you consider that, in accordance with European Union and national rules on business confidentiality, this document contains confidential information which you wish to have deleted prior to such publication¹⁹. You should give reasons for any such request.

Yours sincerely,
For the Commission,
Robert Madelin
Director-General

¹⁵ Ofcom recognises that this approach will mean that, for several months (from publication of the statement until 1 April 2012), the charges for additional POH services will not, in aggregate, be sufficient to cover the LRIC of providing these services. However, Ofcom considers that phasing in the price increases for Type II services is desirable, because it will give OCPs time to respond to the planned changes (e.g. by moving to Type I POH services), and that BT will be able to recover the shortfall by adjusting its charges for other services within the traditional interface basket.

¹⁶ In accordance with Article 7(3) of the Framework Directive.

¹⁷ Commission Recommendation 2008/850/EC of 15 October 2008 on notifications, time limits and consultations provided for in Article 7 of Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services, OJ L 301, 12.11.2008, p. 23.

¹⁸ Your request should be sent either by email: INFSO-COMP-ARTICLE7@ec.europa.eu or by fax: +32 2 298 87 82.

¹⁹ The Commission may inform the public of the result of its assessment before the end of this three-day period.