PROPOSALS FOR WBA CHARGE CONTROL

MARCH 2011 NON CONFIDENTIAL

EXECUTIVE SUMMARY

- We welcome the general direction of the proposals for this charge control.

- We believe that Ofcom's choice to implement a hypothetical ongoing network (HON) model rather than a modern equivalent asset (MEA) model is misguided.

- Ofcom expects bandwidth demands to increase over the period. Backhaul bandwidth over the 20CN is less efficiently provided and consequently more costly putting 20CN network users at an ongoing price disadvantage which increases as bandwidth requirements increase.

- We understand Ofcom's rationale behind devising a control that protects the largest number of end users. However, we do not regard "anchor product regulation" as a concept that is transportable to other regulated markets and product regulation. This is a unique situation.

- We believe that the end users (IPStream and Datastream) not covered by the charge control should have the protection of a charge ceiling.

- When disaggregating the BT Group cost of capital Ofcom estimates the cost of capital for different parts of BT (Openreach and Rest of BT) on the grounds that they have different systematic risk profiles. Ofcom uses the total Openreach capital employed within its calculation. However when applying the Openreach cost of capital to actual products Ofcom then only applies it to copper access products. This approach is flawed. Ofcom should either determine the cost of capital for just the copper access products or it should apply the Openreach cost of capital to all Openreach provided products.

INTRODUCTION

In markets where Ofcom has determined that BT has SMP, cost orientated wholesale charges are essential for delivering vibrant retail competition. Where wholesale charges are not cost orientated retail competition can be suppressed by BT inflating wholesale charges and making its own (end to end) product margin at the wholesale level leaving little or unattractive retail margins. This in turn discourages and dampens competition and competitive entry at the retail level and ultimately leads to enduring high end user retail prices.

Choosing the right asset base

Ofcom has found three WBA markets, each varying in competitiveness. Whilst Ofcom concludes that previous wholesale charges where not excessive the ROCE enjoyed by BT was certainly healthy. The intention of this charge control ought to be the removal of excessive profits due to lack of competition and creation of the incentives for BT to invest in newer lower cost technology. We are doubtful that the current proposals will deliver the full benefits that Market 1 end users could expect.

We understand Ofcom's reluctance to presuppose BT's investment choices. In this situation we disagree that the choices that Ofcom faces are overly complicated. The choice of a MEA is not speculative and it is entirely reasonable to assume 21CN costs. We disagree that the HON approach taken the for the charge control costing model encourages BT to invest in the deployment of new networks in the Market 1 area. Ofcom effectively attributes ongoing hypothetical costs for assets which have already been fully depreciated. BT is left with the choice of milking its asset for a further three years or tying up part of its capital investing in new services in a market it already dominates. In our view it will only be the threat of competition from LLUOs extending networks into Market 1 which will push BT into new investment in the region. But this will not occur over the time frame of this charge control. BT has been shown to consistently lag behind LLUO roll out for its 21CN network rollout and we suggest that the same should be expected in this situation. Under the current proposals the majority of consumers served by BTW inputs will not receive upgraded services, or prices as low as those in other more competitive areas.

Use of the HON is further discredited as the expected increase in end user bandwidth demand drives up BT's 20CN revenue disproportionately compared to the same service provided over the 21CN network. Ofcom has modelled a level of demand (which may prove too conservative) into the charge control structure. This allows BT to continue to charge end users higher bandwidth charges based on the outdated technology. The phenomenal increase in bandwidth revenue results in almost a doubling of bandwidth revenue (on a conservative growth assumption) from £135Million at the close of this year to £250Million at the end of the control.

Anchor product as a concept

Ofcom introduces the concept of an anchor product for the purpose of setting a charge control. It is essential to note that we do not see anchor product regulation of this type being easily translated into other regulatory settings. The WBA market is unique in the scenario that a single service type dominates both internal and external wholesale supply. In general therefore we do not support the restriction of regulation / charge controls to a limited range of SMP supplied services. In particular we believe anchor product regulation could discriminate detrimentally to the supply of critical niche services and also lead to under / adverse regulation of critical lower volume business services which fall within an aggregated residential / business market (such as Datastream in this context).

Protection for other services

We propose a price ceiling cap to be introduced for services falling outside of the IPS Connect Max focused charge control. Such price security is of particular importance for the provision of Datastream users who are unable to switch to IPS in the event of price rises implemented by BT. We believe that a price ceiling is a lighter touch regulatory tool which is low cost to implement and administer whilst affording CPs and end users with a necessary level of protection with regard to future price changes. In contrast to Ofcom's current proposal (which leaves BT with too much freedom and ongoing profit from legacy and already depreciated networks), we believe that removing the ability for BT to make additional revenue in Market 1 via less tightly regulated services may provide greater incentives for BT to invest in new technology.

Cost of capital

We disagree with the cost of capital disaggregating approach. When disaggregating the BT Group cost of capital, Ofcom estimates the cost of capital for different parts of BT (Openreach and Rest of BT) on the grounds that they have different systematic risk profiles. Ofcom uses the total Openreach capital employed within the calculation to derive an Openreach specific cost of capital. However, when applying the Openreach cost of capital to actual products Ofcom then only applies it to copper access products (LLU and WLR only). This approach is flawed. The Openreach cost of capital calculation incorporates all of the capital employed by Openreach. It is therefore illogical that Ofcom is subsequently selective as to when it is used such as discriminating between Openreach provided copper products and other Openreach products. Ofcom should either determine the cost of capital for just the copper access products or it should apply the Openreach cost of capital to all Openreach provided products.

QUESTIONS

3.1 Do respondents agree with our proposals on the allocated bandwidth growth? If not explain why.

We believe that Ofcom's assumptions are too low.

Our experience of our own on-net end users illustrates a much higher average bandwidth per end user. [text removed]

It is understood that the average end user line in Market 1 can support a sync rate of circa 3Mbit/s and therefore capable of supporting much higher end user activity than is currently the case.

3.2 Do respondents agree with our proposals to charge control IPS Connect only?

We agree that charge control proposals should focus on IPS Connect Max

Ofcom's analysis identifies that within the WBA Market 1 that 87% of the wholesale services purchased are for IPS Connect. Circa 6% of the 87% relates to IPS Connect Home and Office leaving circa 81% of wholesale services offered being IPS Connect Max and Max premium. We agree that a proportionate regulatory response in this situation is for the detailed charge control to be targeted at this primary service.

A lighter touch control such as a charge ceiling is required for other IPS services

We disagree with Ofcom that the other wholesale services should be left to operate only with the protection of cost-orientation obligations. Ofcom sets out in the consultation document very clearly the issues of economic migration facing small CP users of IPS. Even in the case of large CPs similar issues of economics can arise. Many CPs have grown in recent years following acquisition of other ISPs and CPs. This has led to a portfolio of mixed WBA wholesale services connected to separate networks. The problems that Ofcom identifies for smaller CPs are not isolated to this category of CP. We agree that a detailed charge control for all IPS services would not be proportionate or justifiable. We do however contend that for the (easily identifiable and limited in number of) services falling outside of the proposed charge control, that some protection is given. An alternative simple to implement and low cost to administer restricting control such as a charge ceiling would be appropriate for these services.

A lighter touch control such as a charge ceiling is required for Datastream services

Ofcom does not address at all its decision not to charge control Datastream. Datastream is an important business service input. There is no alternative product for end users supported by Datastream to migrate to, the current WBC product available in Market 3 and 2 does not presently have the QoS characteristics required to make it a substitute. In the event that the 21CN IPS product is enhanced with the QoS functions the situation in Market 1 is not improved as only a 20CN network is present. Today Datastream users have no capability to switch to IPS Connect Max as proposed for IPS end users that fall outside the charge control. We do not agree that the protection of cost-orientation obligations are sufficiently strong to protect Datastream end users.

While cognisant that Datastream represents a low proportion of connections overall we contend that in a situation whereby substitution to a similar or like-priced product cannot occur, there is the serious potential for exploitation by BT of these end users in the absence of charge control protection. An alternative simple to implement and low cost to administer restricting control such as a charge ceiling would be appropriate for these services.

3.3 Do respondents agree with the proposed anchor product characteristics? If not explain why.

We have serious concerns regarding the introduction of the concept of anchor product regulation. Anchor product regulation appears to have two strands to it. Firstly its adoption, when Ofcom is reviewing the relevant network technology cost base for the network delivering the regulated services (we discuss our views on this in the introduction). Secondly, when Ofcom is considering how to regulate services in a market where BT has SMP.

It appears that Ofcom has grasped the concept of anchor product regulation as a concept which it can tie with its regulatory requirement to impose proportionate regulation. As a generic tool we do not see anchor product regulation being easily translated into other regulatory settings. The WBA market is unique in the situation that a single service type dominates wholesale supply. In general therefore we do not support the restriction of regulation / charge controls to a limited range of SMP supplied services. In particular we believe anchor product regulation could discriminate detrimentally to the supply of critical niche services and also adversely treat critical lower volume business services which fall within an aggregated residential / business market (such as Datastream in this context).

In the very specific situation of the WBA Market 1 it has been identified that IPS Connect represents 87% of the wholesale market. Ofcom is not planning to regulate this 87% of services but a sub set of products – IPS Connect Max and IPS Connect Max Premium. These two products represent circa 80% of wholesale sales and clearly represent the primary wholesale product. We agree that the concentration of regulatory focus should be on this product.

4.1 Do respondents agree that an RPI-X control is the appropriate form of charge control for the regulation of wholesale broadband Market 1?

Yes

4.2 Do stakeholders agree with the adoption Option 2 upstream input approach as our preferred option?

Ofcom proposes to create a control which excludes LLU pass through charges which are already regulated via the LLU charge control. Importantly the WBA control does include the parts of "end user access" that are beyond the LLU charge control, namely backhaul and handover.

4.3 Do respondents agree that a charge control duration of three years would be appropriate for WBA Market 1?

Yes

5.1 Do respondents agree that ancillary service charges should be included in the main basket?

We do not agree that ancillary services should be included in a single basket with IPS Connect Max and Premium. Ancillary services should form their own basket.

- For the Leased Lines Charge Control, Ofcom has found it necessary to create a separate ancillary services basket for each of the TISBO and AISBO ancillary services.

- For the LLU Charge Control, Ofcom has found it necessary to create a separate ancillary services basket for ancillary services.

We believe that ancillary charges are important supplementary and essential service to the provision of the core product. Ofcom correctly identifies the opportunities for BT to raise the price

of regrade and migration charges. We continue to believe that ancillary services should be held within a separate basket.

5.2 Do respondents agree with our proposal for the BT end user cease charge?

We agree with this proposal.

5.3 Do respondents agree with the use of the prior year revenue weights for the WBA charge control basket?

Yes. (It is not clear how any other method could be implemented.)

5.4 Do respondents agree that safeguard caps of RPI-0% should apply to ancillary service charges?

We prefer to see a separate ancillary services basket.

5.5 Do respondents agree that a safeguard cap of RPI-0% should apply to the contracted bandwidth charge?

It is Ofcom's expectation that BT will target reductions on the end user access due to the construction of the basket and use of prior year weights. We agree that BT should be prevented from off setting end user access price reductions with increases to the contracted bandwidth charge. It is precisely BT's ability to decrease prices with unexpected offsets in other services within the basket which bring into question the desirability of multi service baskets. CPs need predictability around the prices they will be paying for services. Where there is scope for BT to alter the balance of charges between services in a manner which may be unpredictable to purchasers then separate baskets or restrictive sub caps are required.

5.6 Do respondents agree with our approach to discounts under the charge control in WBA Market 1 area?

Yes

5.7 Do respondents agree that CCA FAC is appropriate cost basis to use in setting the charge control for WBA services in Market 1?

Yes

5.8 Do respondents agree that our adjustments to BT's base year costs in Market 1 are appropriate?

Yes.

We note that BT has requested the inclusion of ATM cost which had been omitted from the RFS. This is another example of inaccuracy in the BT Regulated Accounts. We would expect Ofcom to take a dim view against this ongoing corrective action and take some form of punitive action.

5.9 Do respondents agree with our approach to AVE and CVEs? If not please explain why?

No comment.

5.10 Do you agree with our central estimate of 2.5% for efficiency improvements? If not please explain why.

Ofcom proposes to include a catch up efficiency of 0%. Ofcom assumes a frontier shift of 2% to 5%. It appears that the selection of the 2.5% efficiency measure is reliant on data used for other recent charge controls and in the main the 2009 Leased Lines Charge Control. We believe that these proposals are overly conservative. Given that this is the first control of WBA Market 1 services we would argue that efficiency gains are far likely to be higher than in markets such as Leased Lines or NCC which have had a longer history of control and earlier programmes of efficiency saving reducing the longer term scope for efficiency improvement. We note with interest the related discussion within the NTS Uplift and PRS bad debt consultation regarding past efficiency trends which for the retailing of geographic calls evidences a rate of efficiency gain per year between 4.5%

and 9%. We would encourage Ofcom to revisit the assumptions used here taking account of data of efficiency gains achieved in products which are newly regulated. We do not agree that reusing the efficiency number of earlier controls is sufficiently robust in this situation.

5.11 Do you agree with our proposal not to make one off adjustments to WBA prices at the start of the control? If not please explain why.

Ofcom does not provide (or perhaps have access to) data of sufficient granularity for us to conclude whether or not one off starting charges for certain charges are warranted or not. Ofcom provides only a ROCE figure for WBA Market 1 in its entirety showing at 25% return. This figure provides a flavour of returns beyond what would be expected but it does not demonstrate whether a particular charge is to a high degree out of line with costs.

6.1 We welcome stakeholder's views on Ofcom's approach to estimating two different costs of capital for Openreach and Rest of BT.

A review of the history of the disaggregated cost of copper for BT Group suggests that Ofcom's approach to calculating the disaggregated values has evolved. If our understanding is correctly founded then we would argue that the present approach unfairly attributes a higher cost of capital to the services falling under the "rest of BT".

Within the final statement (18th August 2005) on "Ofcom's approach to risk in the assessment of the cost of capital" the methodology of disaggregating an access copper products cost of capital is based on the mean capital employed and on a split of access : rest being 40%:60% (para 7.78). At this time Ofcom's focus was on the mean capital employed by BT's copper access products while Openreach was just being established as a separate BT line of business.

In the next review (22nd May 2009) relating to the disaggregated cost of capital "A new pricing framework for Openreach" at para 8.74 it is stated "We also note that Openreach is now a larger proportion of BT Group (as measured by mean capital employed) than it was in 2005, having increased from around 40% in 2004 to around 50% in 2007 and 2008. This has a knock-on effect

for the beta of the rest of BT". We believe that it was at this point that Ofcom moved from using a specific copper access mean capital employed to a calculation which instead included all of Openreach mean capital employed.

Within the current consultation Ofcom states that Openreach (in its entirety) accounts for almost half of BT's capital employed. The (all of) Openreach mean capital employed figure is again used in the disaggregating calculation. A cost of capital is calculated for Openreach. However having determined a cost of capital for the Openreach business Ofcom then only applies the Openreach cost of capital to Openreach copper products (LLU and WLR).

Disaggregation of the BT Group cost of capital to generate distinct Openreach and rest of BT costs of capital has resulted in a tight balancing act in which Ofcom choose to support the interests of CPs purchasing Openreach inputs (but in reality this means purchasers of LLU and WLR products) over the interests of CPs purchasing other services. The creation of a reduced Openreach cost of capital (for LLU and WLR) is to the detriment of (all other) services which incur the rest of BT cost of capital. These other services must bear a higher cost of capital rate in order to arrive back at the overall BT Group rate. The present system approach is flawed. Ofcom should either

- determine the cost of capital for just the copper access products, or it
- should apply the Openreach cost of capital to all Openreach provided products.

6.2 We welcome stakeholder's views on Ofcom's approach to ERP estimates.

Ofcom's analysis and conclusions on this point is consistent with our own real life practise. It is our understanding the presently most commentators and companies are using an ERP of 5%. We ourselves would use 5% with reference to recommendation from LBS.

6.3 We would welcome stakeholders' views on Ofcom's approach to BT's Beta calculation.

We believe that the beta calculation needs to account for BT's pension treatment.

We note Ofcom's decision to exclude any adjustment to the cost of capital in connection with the existence of BT's large defined-benefit pension scheme deficit. We would reiterate the views that we expressed in October 2010, and disagree with the conclusion that Ofcom has reached on the issue. Based on the evidence presented, including the PWC report commissioned by Cable&Wireless Worldwide, Sky and TalkTalk we believe that there is more than enough evidence for Ofcom to mandate a small but significant reduction in BT's regulated cost of capital to remove the impact of the defined benefit pension scheme.

There has been an acceptance by Ofcom in the Pensions Review that the existence of a defined-benefit pension scheme tends to increase the observed WACC above the cost of capital of the operating assets. Given the size of the BT Pension scheme and its overhang (with comparatively few contributing members still employed) the phenomenon is likely to be more pronounced. We firmly believe that it is the WACC of the operating assets that should be used to derive wholesale prices. Ofcom has compelling evidence available to it on the size of the reduction and therefore we would urge Ofcom to reconsider its stance on this issue.

Ofcom proposes to rerun analysis on the BT Group beta to remove the period that fell within the uncertainty of the credit crisis. We support this approach as the credit crisis was an exceptional event.

Ofcom asks whether it should use reported net debt or Bloomberg's adjusted net debt. It is our understanding that the Bloomberg adjusted net debt includes adjustments for under funded pensions and capitalised leases. If this is correct then clearly Bloomberg's rate would be highly relevant.

6.4 Do respondents agree with the proposal that the "rest of BT" rate should be used for the WBA charge control in Market1?

We believe that Ofcom needs to review the manner in which it decides on a piecemeal basis which services use either the Openreach or rest of BT cost of capital. As a general rule of thumb we would expect that services that are provided out of Openreach as services which BT has

entrenched SMP and consequently their provision has the utility type characteristics of low risk and stable demand. All Openreach services should attract an Openreach cost of capital. Due to the timing of BT's separation there are services such as PPCs which have remained in BTW which on reflection may have been better suited to be provided from Openreach. The consequence of this should not be that all products under the leased lines banner such as Ethernet AISBO services retain the rest of BT cost of capital. The forthcoming BCMR should alter the AISBO cost of capital to that of Openreach.

The services with the WBA Market 1 are also SMP services. However they are supplied by BTW as alternative upstream inputs are supplied by Openreach and whilst BT has SMP presently competition via the upstream input might occur.