Ofcom consultation: Charge Controls for Wholesale Line Rental and related services

Sky response

Introduction

1. Ofcom's decision on charge controls for Wholesale Line Rental (WLR) is important and will have a substantial impact on the evolution of competition. This is for three reasons:

2. First, it is important that the charge controls for WLR and Openreach's other Core Rental Services (SMPF and MPF) help promote efficient, sustainable downstream market entry whilst allowing BT to make a reasonable rate of return.

3. Second, the relative balance of charges for Core Rental Services is very important because bundled broadband and telephony can be supplied by using either MPF, or WLR+SMPF. There is significant additional investment required should an LLU operator wish to adopt MPF as opposed to WLR+SMPF. Some of BT's major residential competitors (TalkTalk, Sky, etc.) have either adopted MPF or are planning to do so. At the same time, BT has recently chosen not to adopt MPF for its own downstream businesses supplying retail broadband and fixed line voice services, and instead will continue to use WLR+SMPF. Therefore, the outcome of this consultation will determine the cost that BT's retail divisions bear; the cost that BT's competitors bear has already been decided through the Openreach pricing review. The combination of the two reviews will determine the effectiveness of competition in this sector for the next four years.

4. Third, the key concept of equivalence, contained within BT's Undertakings and the centrepiece of Ofcom's regulatory strategy in telecoms over the past four years, has effectively become irrelevant. BT is no longer intending to use any of the product stack that its key residential competitors will use. One consequence of this is that that there is an incentive on BT to load cost away from WLR and SMPF and into MPF. As a result, Ofcom should exercise particular vigilance in policing cost allocations and service performance between the Core Rental Services.

Structure of Sky's response

5. Ofcom's proposals for the WLR charge control draw heavily upon the analysis it conducted during the Openreach pricing framework review. Some of the points made in Sky's responses to Ofcom's earlier consultations remain pertinent, and only some of these were addressed in Ofcom's final statement on this review. We refer Ofcom to our responses to the Review's two consultations for a fuller explanation of our position.

6. In this response we start by repeating some of the points that we made in our responses to the pricing framework review, and in places update them as new

evidence has emerged. We focus particularly on the points we made on the scope for efficiency gains by Openreach.

7. We then address some of the proposals Ofcom has made around the structure of WLR charges; specifically:

- a single control covering residential and business services;
- the time period of the control;
- a straight line glide path with no one-off adjustments;
- inclusion of a part of line transfer charges in rental;
- charge controls around WLR ancillary services;
- level of charges; and
- correcting the 'X' factor in RPI-X to account for the expected negative RPI

Target efficiency gains are too low

8. The efficiency target decided upon by Ofcom on BT's costs is far too modest and does not adequately reflect compelling evidence of scope for higher efficiency gains. In our responses to the Openreach pricing review we set out the reasons for thinking this. We pointed out:

- The KPMG report into Openreach efficiencies (which was commissioned by Ofcom itself) targeted efficiency gains of over 4% on controllable costs to 2013 for Openreach to be comparable to that of a firm operating in a competitive market;
- The significant work that BT is currently undertaking to reduce headcount and other staff-related costs;
- Various public statements by BT Group indicating heightened efficiency levels in excess of Ofcom's proposals;
- Historic efficiency performance at BT which has consistently exceeded the levels proposed by Ofcom;[1]
- Further opportunities for efficiency gains as MPF volumes increase, allowing greater economies of scale around this product;
- An expected efficiency premium as a result of the relaxation of BT's OSS separation obligations within the Undertakings, meaning that Openreach will face lower than expected costs in complying with the Undertakings.

9. We highlight some of these points below:

10. **Incentives:** BT has an incentive to under-estimate future efficiencies during charge control consultations and appears to have acted on this incentive in the past. Indeed, during the two stage consultation into Openreach's Financial Framework, it initially stated that it would only be able to achieve 0.6% efficiency gains on all costs. It since readjusted its estimates upwards to 2.4%. This is a large readjustment and demonstrates the risks associated with being overly reliant on BT's own estimates. Moreover, we do not consider that Ofcom has

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[1] Paragraph A9.76 Ofcom statement on Openreach Financial Framework Review (22 May 2009), states that over the past 2 years efficiency gains have exceeded 4% p.a.

given sufficient weight to historic efficiency performance at BT and its own group-wide projections and instead relies too heavily on Openreach's arguments.

11. **Scope for future cost savings.** It is not a prerequisite for every cost saving opportunity to be identified prior to setting efficiency targets. It is reasonable to expect that further, as of yet unidentified, efficiencies will be realised throughout the period of the control. This tallies with previous experience whereby the cost saving projects that are being implemented today were not envisaged 4 years ago. We expect this to be the case going forward.

12. Ofcom's and BT's assertion that the scope for further efficiencies is reduced because most of the "quick wins" have been completed runs counter to this principle. The inference here is that Ofcom believes that Openreach is approaching its optimum efficiency. We do not think this is a fair assessment of Openreach today and do not consider that Ofcom have provided sufficient justification for this position.

13. **"Non-compressible" costs:** Ofcom's policy of applying efficiency gains only to costs which are deemed "compressible" (or "controllable") leaves little incentive on BT to reduce non-compressible costs even though, as Ofcom admits, these costs are controllable to some extent (particularly in the long term). This is a material concern because non-compressible costs constitute up to 40% of the overall costs of Core Rental Services.

14. Ofcom says it dealt with the largest non-compressible costs items, such as energy costs, individually when forecasting future costs. However, this exercise was ostensibly to understand these costs better in order to project forward likely costs during the charge control period. Ofcom did not seek to apply efficiency gains to these cost items. In spite of this, it appears highly likely that in the long run many of these costs are in fact controllable. For example, whilst energy costs maybe subject to long term forward looking contracts, they typically have clauses that allow for renegotiation mid contract term. The same holds true for many long term supplier contracts. Similarly, rates can be reduced by adjusting property portfolios and certain BT pension costs have already been negotiated downward.

15. **Allocation of Group costs:** As noted above, Group-wide BT is now making significant efficiency gains and, as such, we would expect these to feed through to the group overhead costs that are apportioned to Openreach. However, this does not appear to have been incorporated into Ofcom's efficiency assumptions. This is material because total group overhead costs recovered from Openreach constitute a sizeable proportion of Openreach's total cost base.

16. **Fault rates:** Ofcom has proposed a 2% year-on-year reduction in fault rates. This is considerably below both the original proposed range of 4%-6% (which Ofcom accepts represented a realistic target) and BT's actual performance over the last 20 years (where fault rates have reduced by 4%-10%, depending on the period of review).

17. At any moment in time there will be a series of factors that will put upward pressure on fault rates. Similarly, other factors will be present that will drive

down fault rates. Historically, over the last 20 years the net effect of these factors has been to reduce BT's fault rates at a rate in excess of Ofcom's newly proposed fault rate for the charge control period. If Ofcom considers that the set of circumstances prevalent today and expected to pervade during the charge control period are significantly different to warrant special treatment, then it should provide a more robust, quantitative justification. At this stage, we are concerned that it has not done this, and that there remains a lack of (in particular quantitative) justification for the lower fault rate assumptions.

18. Since the publication of Ofcom's statement on Openreach's pricing, further evidence has come to light of the scope for efficiency savings. In particular:

- On top of the headcount reductions made in 08/09, BT has announced a further 15,000 redundancies across the group in 09/10;
- BT Group has announced its intention to make a £1 billion reduction in operating costs and capital expenditure across the group in 09/10;
- BT announced in its 09/10 Q1 results that "*underlying costs and underlying capital expenditure reduced by £357m to £4295m, a reduction of 8% compared to the previous year*";[2] and
- BT also reported in its 09/10 Q1 results that the number of customer reported faults at Openreach had fallen by <u>30%</u> year-on-year

19. This evidence further reinforces the view that Ofcom's assessment of scope for efficiency savings, of 4% per year on compressible costs, tapering off to 2%, is particularly modest.

Ofcom's proposals on WLR charges

A single charge control covering business and residential services

20. Sky supports Ofcom's proposal to set a control on WLR core rental services to be available both to residential and business customers. In our view it is simpler; it simplifies the complexity of cost allocation between business and residential services, and it frees Openreach to innovate around premium levels of care.

Time period of the control

21. Sky supports the principle of aligning WLR and MPF/SMPF price control periods. As we discuss above, the industry is moving to a situation where BT's downstream divisions consume one product stack around SMPF and WLR, whereas its principal competitors consume a completely different product stack based upon MPF. This is already a departure from the principle of equivalence which runs through BT's Undertakings.

22. In the light of this, it is particularly important for fair competition that the price controls are made at the same time, and based upon the same assessment of Openreach's underlying costs.

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2 BT Group results for the first quarter to 30 June 2009, page 9

23. Though from 3.5 years' time Ofcom's intention is to align charge control periods, Sky is particularly concerned about the fact that in two years' time, SMPF and MPF charges will be set based upon a new assessment of Openreach's costs, but WLR charges will be left alone. It is therefore important that, and as Ofcom implicitly acknowledges itself (in paragraph 4.34 of the consultation document), should the assessment of Openreach's costs in two years time find a material difference to the costs projected in the current review, Ofcom has given itself the option to re-assess the WLR charge control at that point.

Straight line glide path with no one-off adjustments

24. Sky argued in that the MPF charge control should be based upon a glide path. In the event, Ofcom decided to combine a glide path with a one-off adjustment (and a very high proportion of the adjustment is in fact contained in the initial price change).

25. We have explained the significance for competition of the relative treatment of MPF costs and WLR costs. Therefore, we think it rather odd that Ofcom should arbitrarily decide to adopt one approach for one product, and a different approach for the other and that, in the absence of explanation, a consistent approach would appear appropriate.

Inclusion of a part of line transfer charges in rental charges

26. Sky notes Ofcom's original motivation to structure charges in this way: to keep the transfer charge down so as to encourage switching in the market.

27. This is a further example of Ofcom choosing arbitrarily to adopt one approach in the WLR market, and a different approach with MPF. In its review earlier this year, Ofcom did not propose that MPF connection or migration charges should partially be included in MPF rental.

28. We noted in our response to Ofcom's Review of mis-selling in telecommunications services the peculiarities of the telecoms switching process, and that this is different to switching processes in many other industries. In particular:

- there are high levels of ignorance about switching and high levels of inertia amongst particular groups of consumers; and
- some providers, notably BT, are constructing barriers to switching in the market through the introduction of rolling contracts and high early termination charges.

29. Because of these unique characteristics of the market, we agree that it is pragmatic and in consumers' interests for some of the line transfer charge to be included in rental. Ofcom should, however, be well aware of the competitive distortion it has created by not structuring MPF charges in the same way.

Charge controls around WLR ancillary services

30. We pointed out, in our responses to Ofcom's consultations on its Openreach pricing review, how material ancillary service costs were to service providers' costs. We provided Ofcom with (confidential) evidence to demonstrate this.

31. It is extremely important for efficient competition that connection and transfer charges for WLR and LLU are cost oriented, do not distort investment incentives or effectively discriminate between downstream CPs. This is particularly important as differing wholesale access inputs can be used to deliver the same set of retail products i.e. WLR+SMPF or MPF can be used to provide retail fixed line telephony and broadband.

32. Ofcom's has sought to bring certain connection and migration charges in line with fully allocated costs (FAC) and, to a certain extent, this has smoothed out inconsistencies in how these types of charges are levied.

33. Nonetheless, there are significant and arbitrary differences in the treatment of these costs between WLR and MPF, which tend to favour WLR operators.

34. First, WLR is not subject to cease charges, unlike LLU.

35. Second, LLU connection and transfer charges reside within the relevant ancillary service baskets (either SMPF or MPF) whereas WLR ancillary charges are individually controlled. Now that BT will continue to use WLR+SMPF to supply broadband and telephony to its retail customers whilst certain LLU operators are adopting MPF, there is a clear incentive on BT to structure price changes for services within the MPF ancillary baskets in such a way as to disadvantage MPF operators relative to providers using WLR+SMPF. Ofcom's decision to place MPF connection and transfer charges into a basket gives BT the ability to act upon that incentive.

36. Both MPF and SMPF ancillary baskets are very wide and offer further BT scope to introduce charges that can contribute to a distortion of downstream competition. This means that LLU operators (compared to WLR SPs) are inhibited from accurately predicting the level of Openreach's charges. As a significant proportion of an LLU operator's wholesale costs stem from these ancillary services, there is a direct impact on its ability to execute its business plans accordingly, and an unwarranted level of investment uncertainty is introduced. In contrast, WLR service providers are afforded greater certainty.

37. Despite these distortions between WLR and MPF, the proposed approach of individually controlling separate WLR ancillary services is the correct one. So just as we disagreed with Ofcom's decision to place LLU connection and transfer charges into a basket, we support its proposal to make the equivalent WLR charges subject to individual controls.

Level of charges

38. The levels of charges proposed are a function of Ofcom's assessment of BT's underlying costs, and its decision to adopt a glide path rather than any one-off adjustment. We comment on these elsewhere in this consultation response.

Correcting the 'X' factor in RPI-X to account for the expected negative RPI

39. We note that Ofcom has adopted the same approach to setting WLR charges as it adopted for MPF and SMPF; that is, to up-weight the 'X' factor in its RPI-X equation in the first year to account for the expected negative level of RPI in October 2009.

40. We support the adoption of a common approach between the two products.

41. However, stakeholders did not have an opportunity to comment on this mechanism in our responses to Ofcom's Openreach financial review, since it was announced only as part of the final statement.

42. This correction would be appropriate only if BT's costs did not decline in line with negative inflation. That may be true for some of BT's costs (for example, rents). But it is very unlikely to be true for other costs; indeed, some costs such as consultancy labour may decline substantially more than RPI. Therefore, before adopting such an approach Ofcom should have presented an analysis of how BT's costs could be expected to alter should RPI turn negative. It presented no such analysis with its statement on Openreach pricing in May, nor now.

Sky **August 2009**