Charge controls for Wholesale Line Rental and related services

Consultation

TalkTalk Group response

13 August 2009

Introduction

This is TalkTalk Group's (TTG) response to Ofcom's consultation titled 'Charge controls for Wholesale Line Rental and related services'.

TalkTalk Group provides voice and broadband services to over 4 million customers – both residential customers (under the TalkTalk, AOL and Tiscali brands) and business customers (under Opal and Tiscali brands). We operate two broadband only networks (which use SMPF) and also the UK's largest NGN network (which uses MPF) to offer voice and broadband services. We are also a major purchaser of WLR. Overall TTG is Openreach's largest external customer for LLU/WLR services.

TalkTalk Group is wholly owned by the Carphone Warehouse plc.

This consultation on prices for WLR services is critical to the future of network based competition. In particular, if WLR prices are set too low (as Ofcom is proposing) it will deter efficient NGN investment and reduce competitors ability to viably provide consumers with innovative and attractive services.

If there are any questions regarding this submission please contact Andrew Heaney (HeaneyA@cpwplc.com)

1. Summary

Ofcom's proposals for WLR prices in this consultation are based to a very large degree on the methodology and assumptions for costs outlined in the statement 'A new pricing framework for Openreach' (referred to as MPF/SMPF Statement).

Throughout the consultation process leading up to that Statement, TTG provided evidence that Ofcom had made serious errors in its analysis of the costs and prices (for MPF, WLR and SMPF). However, in the MPF/SMPF Statement Ofcom failed to address these errors (and in addition made some further mistakes). TTG has appealed Ofcom's decision. Since the proposed WLR prices rely on much of the same cost analysis the proposed WLR prices are also, in TTG's opinion, seriously flawed.

In this response, we highlight the relevant mistakes from the MPF/SMPF Statement that affect the WLR price as well as a number of additional issues that have become apparent in this consultation. The main areas where flaws have been made are:

- Ofcom has made a number of serious errors in the underlying assumptions used to derive costs such as allocation of BT Group costs, efficiency, inflation and cost of capital
- Ofcom has used CCA cost estimates that do not accurately reflect the appropriate efficient forward looking costs of providing WLR and therefore significantly underestimate the WLR cost (and thus price)
- Ofcom has failed to ensure an efficient level of price difference as between MPF and WLR and also as between MPF and WLR+SMPF. In particular it appears to arbitrarily excluded costs in order to depress WLR prices

In addition we have a number of other comments on other aspects of Ofcom's proposals such as price regulation of the enhanced service component and MPF to WLR conversion charges as well as the length of the charge control period.

At the end we provide responses to the individual questions Ofcom posed. This summarises some of the points made in the main sections as well as providing answers to other questions Ofcom poses.

2. Errors in underlying assumptions

As we outlined in our responses to the Openreach financial framework (ORFF) consultations[1] and in Carphone Warehouse plc appeal ('Appeal') of that decision[2] we believe, with good justification, that Ofcom has significantly overestimated the cost of MPF, SMPF and WLR services (referred to as core rental services, CRS). These WLR charge control proposals are based on the same overestimated costs. Unfortunately, Ofcom has not provided any additional transparency or justification in this consultation to rebut the evidence we previously presented.

The main areas where we believe that there is an overestimation of costs are described below. The full detail can be found in TTG's Appeal.[3]

Ofcom has failed to adjust the **cost allocation** of BT Group costs to Openreach / CRS to check against BT's incentive to load excessive costs to CRS. For instance, Ofcom did not:

- address BT's use of biased allocation bases
- reduce the allocation to properly reflect Openreach's independent and non-retail nature
- correct the non-allocation of costs to BT's overseas activities
- adjust the allocation over time to reflect Openreach's reducing share of the BT Group activity

Despite lip service to the contrary, Ofcom effectively adopted BT's claim for its potential average **efficiency gain** of only 1.65%[4] per year even though:

- BT has a strong incentive and track record of significantly understating its potential efficiency improvements by about 2% versus the actual out-turn
- There existed several more objective benchmarks of likely efficiency improvement which Ofcom effectively chose to ignore such as what Openreach has achieved historically, what Ofcom's consultants said Openreach could achieve and what BT has told its shareholders. Taken together these suggest efficiency improvements of around 4% to 5% per year
- There is a wealth of other evidence that demonstrates huge potential for efficiency gains in overhead costs and operations
- Furthermore, Ofcom assumed that 40% of costs were not subject to any efficiency improvements and also assumed that efficiency gains would reduce over time – both these assumptions are manifestly wrong and inconsistent with what Ofcom and other regulators have done

[1] For example, response to Second Consultation http://www.ofcom.org.uk/consult/condocs/openreachframework/responses/Talk_Talk_Group.pdf
[2] Notice of Appeal submitted to Competition Appeals Tribunal on 22 July 2009 by Carphone Warehouse plc. Ofcom have both the Notice of Appeal as well as the supporting Witness Statements. The Notice of Appeal is annexed to this submission
[3] TTG's points regarding cost allocation can be found in the Notice of Appeal at §§76 – 84 (efficiency), §§85 – 87 (cost of capital), §§88 – 91 (cost allocation) and §101 (inflation)
[4] Average efficiency gain on all costs including 'so-called' non-compressible costs and compressible costs

We believe that the appropriate efficiency improvement is about 4.5% per year on all costs.

Ofcom used a **cost of capital** of 10.1% that was based on a number of erroneous assumptions. Ofcom's errors included that it:

- Increased the cost of capital to reflect short term effects (resulting from the current economic situation) which are inappropriate for setting a cost of capital for the overall period of the control and in particular the cost of capital for 2012/13[5]
- Did not sufficiently adjust the BT Group cost of capital for CRS services downwards to reflect for the substantially lower risk of Openreach/CRS versus the rest of the BT Group
- Failed to properly exclude the risk associated with BT's pension fund from the cost of capital for CRS which is inconsistent with Ofcom's approach of excluding pension deficit contribution costs

As we explain in our Notice of Appeal we believe that a reasonable estimate of the cost of capital lies between 8.7% and 9.1%.

Has used **inflation** assumptions that simply do not make sense. For instance:

- Ofcom have incorrectly assumed that certain cost changes (for instance, pay) will not reflect RPI changes when manifestly they will
- Rather than using RPI, Ofcom adopted a new underlying inflation index (which excluded VAT and mortgage interest payment cost changes) to derive the inflation rate for certain costs. Whilst the approach may have been appropriate for certain costs, Ofcom incorrectly calculated this alternative index in 2010/11 (and onwards) by including the impact of VAT and mortgage interest payment cost changes

Together these result in costs that are about 15% too high in 2012/13 for each of MPF, WLR and SMPF. This would equate to the WLR rental charge being about £15 too high in 2012/13.

The question for Ofcom is if and how these errors should be corrected in this WLR charge control given Ofcom have initially 'baked in' the excessive cost estimates into the MPF and SMPF charges.

- The 'best' approach would be for Ofcom now to take stock and, appreciating the force of the evidence, use corrected assumptions to set WLR prices and also to simultaneously change the MPF prices to correct for the errors. This would avoid inconsistency and excessive prices and could also partly obviate the need for CPW's appeal in relation to the MPF/SMPF Decision. We invite Ofcom to adopt this sensible course

[5] In determining the prices for the period up to 2012/13 the only costs that are, in fact, relevant are those in 2012/13. This is because Ofcom use a glidepath to gradually adjust prices from the 08/09 level to the cost in 2012/13. Therefore, in effect, the cost of capital in 2009/10, 2010/11 and 2011/12 has no impact on the prices.

- If Ofcom does not take that approach it means that Ofcom is left with two unpalatable approaches:
    - It could use the excessive cost assumptions to set the WLR charge (which would result in excessive prices for both of MPF and WLR)
    - It could correct the erroneous cost assumptions in setting the WLR charge only. This would result in the difference in MPF and WLR prices being even lower than it should be and cause substantial further inefficiencies and consumer harm

The predicament that Ofcom finds itself in is a direct result of rushing through the MPF/SMPF charge control without sufficient diligence. It is unfortunate that Ofcom has effectively now boxed itself into such a difficult corner and, as a consequence, consumers will suffer.

3. Incorrect use and application of CCA cost standard

In determining WLR costs, Ofcom has intended to base the costs on efficient forward looking costs in order to promote efficient competition and investment. To do this, Ofcom has used current cost accounting (CCA) cost estimates[6] from BT. Whilst in principle, CCA based costs estimates can provide a reasonable proxy for efficient forward looking costs in this case they do not provide a good proxy since the CCA standard has not been applied correctly. This means that the CCA cost estimates materially depart from efficient forward looking costs.

We explain why below.

3.1 Rationale for use of forward-looking costs / CCA

The underlying concept behind the use of current cost accounting (rather than historic cost accounting, HCA) is that assets are valued and costs determined on the basis of the replacement or forward looking cost rather than the historic cost. The reason underlying this is that forward-looking costs send better investment signals to potential competitors and so promotes efficient competition and investment. Ofcom has been clear that it sees forward looking / CCA costs as the appropriate cost standard for assessing the costs of regulated products. For instance:

> In relation to valuing the copper access network: *The reason for the change [from HCA to CCA] is that it allowed regulated prices to be set based on what it would cost to replace the network or for somebody else to build the same thing. Thus, if somebody could do it cheaper than BT then they should be encouraged to build their own network and under-cut BT's prices. Ofcom still believes that this is the right way to do things where, as in most cases, entry signals are a major consideration*[7]
>
> *<u>CCA will provide</u> appropriate price signals to both suppliers and consumers as well as providing regulatory consistency and <u>consistency with Ofcom's forward-looking approach generally.</u>* [8]

In other words, forward looking / CCA costs are preferred over HCA since they are more likely to promote economic efficiency, particularly productive efficiency.

The approach of using forward-looking / CCA costs is consistent with the aim of regulation to mimic the outcome of a competitive market. In markets that are or could become competitive, prices would be expected to reflect the costs of the most efficient technology to provide the service, based on forward looking costs since these are the costs that new entrants would face. Were prices set below that level, efficient entry would be deterred, and prices set above that level, would not be sustainable in the longer term.[9]

[6] The full methodology is CCA FAC. FAC refers to a methodology whereby common/fixed costs are fully included in costs. The use, or otherwise, of FAC is not relevant to the application of CCA
[7] http://www.ofcom.org.uk/consult/condocs/copper/value2/statement/statement.pdf §1.5
[8] http://www.ofcom.org.uk/consult/condocs/copper/value2/statement/statement.pdf §3.3
[9] This issue of setting prices based on efficient forward-looking costs is also particularly relevant in relation to the relative prices of, for example, MPF and WLR. This is explored in more detail in Section 4

We agree with the use of CCA[10] provided that it properly reflects efficient forward looking costs.

3.2 Basis for preparing forward-looking / CCA costs

In order that the CCA costs appropriately reflect efficient forward looking costs they need to be prepared on the correct basis. Ofcom have not been transparent or explicit about the basis upon which the CCA costs have been prepared. However, one can infer from what Ofcom has said the principles that should underlie the CCA standard in order that the CCA costs would promote efficient competition and investment.

The first principle is that CCA costs should be **forward looking** i.e. based on future costs not historic ones. This is made clear by the following statements from Ofcom:

> *CCA will provide appropriate price signals to both suppliers and consumers as well as providing regulatory consistency and consistency with Ofcom's forward-looking approach generally.* [11]

> *As we explained in the Openreach Pricing Framework Statement, we consider that it is appropriate to use a four year period as the basis for the modelling of forward costs.*[12]

> *… we have concluded that there is no reason at this stage to move away from our proposal to exclude all the costs of funding the pension deficit on the basis that they do not represent forward looking costs.* [13]

The second principle is that the costs should be based on **long run** costs not, say, short run. This is since short run costs can include anomalies that can over- or under-estimate true costs and short run costs can ignore costs that are invariant over short periods. The fact that it is long run costs that are appropriate is clear from the 'Basis of Charge' obligation that Ofcom imposes on many regulated wholesale products including WLR. The obligation on WLR reads:

> *AA3.1 … [BT] shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge … is reasonably derived from the costs of provision based on a forward looking long-run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.*[14]

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[10] However depending on the nature of the assets for which capital charges are being calculated and the implementation, CCA based prices may depart from this ideal. In particular where a high proportion of assets have been fully depreciated having reached the end of the assumed accounting lives, CCA based estimates of capital charges will be zero for these assets which clearly does not reflect the costs of an efficient entrant.
[11] http://www.ofcom.org.uk/consult/condocs/copper/value2/statement/statement.pdf §3.3
[12] WLR CC Consultation §6.5
[13] MPF/SMPF Statement §A6.76
[14] http://www.ofcom.org.uk/consult/condocs/review_wholesale/fnwm.pdf SMP Condition AA3.1

The third principle is that CCA costs should be based on the most efficient approach i.e. **efficiently incurred costs**. This is born out by various statements by Ofcom:

The prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred) …[15]

… we have estimated the efficiently incurred costs of providing each of the Core Rental Services[16]

Obviously, using efficiently incurred costs also best mimics a competitive market.

The fourth principle is the use of an **MEA** or **efficient technology**. Implicit in assessing the efficient and forward looking cost is the concept that the cost should be based on the most efficient technology that would be deployed in the future. Using the most efficient technology also obviously mimics a competitive market.

This concept of basing costs on the use of the most efficient technology is encapsulated in the MEA (modern equivalent asset) approach. As Ofcom describe the MEA:

A Modern Equivalent Asset (MEA) is an asset that replicates assets already in existence using the most cost effective proven technology to perform the same function[17]

The MEA approach (and use of efficient forward-looking costs) is also clearly recommended by the European Regulators Group (ERG). In relation to how costs are determined ERG recommended as follows:

It is recommended that NRAs, having adopted a decision on a cost accounting system based on current costs … Evaluation of network assets at forward-looking or current value of an efficient operator, that is, estimating the costs faced by equivalent operators as if the market were vigorously competitive, is a key element of the "current cost accounting" ("CCA") methodology. This requires that the depreciation charges included in the operating costs be calculated on the basis of current valuations of modern equivalent assets, and consequently the reporting on the capital employed also needs to be on a current cost basis. Other cost adjustments may be required to reflect not only the current purchase cost of an asset but also its operating cost base. [18]

An NGN technology is clearly the MEA for the case of providing voice services. No operator would today deploy additional PSTN equipment to provide WLR-like services since, on a forward looking basis, it is more expensive and the equipment is no longer available. As Ofcom itself noted:

BT currently uses PSTN line cards which only recognise voice traffic. These have a ten year life span and are no longer manufactured.[19]

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[15] MPF/SMPF Statement §2.36
[16] MPF/SMPF Statement §7.18
[17] http://www.ofcom.org.uk/consult/condocs/adsl_price/statement/statement.pdf §2.59 (footnote 10)
[18] http://www.erg.eu.int/doc/publications/erg_0415rev1_caas_opinion.pdf ERG OPINION on PROPOSED CHANGES TO COMMISSION RECOMMENDATION of 1998 on Accounting separation and cost accounting (2004). 'Recommendation' §2
[19] WLR CC Consultation §A5.18

Ofcom's own numbers also show that 21CN line cards are lower cost / more efficient.[20]

Indeed Ofcom have adopted an MEA approach by using some 21CN costs (albeit to a limited but unspecified degree). This is evident from the following statement:

> *We have set the line card allocation to recover both the legacy PSTN line cards and a contribution to voice related 21CN line card costs, as the new 21CN line card costs are phased in*[21]

What is unclear is why Ofcom has decided to use a mix of old technology (PSTN) as well as new technology in its MEA.

ERG have also made clear that an NGN is the relevant MEA.

> *CCA when used to inform pricing decisions sends economically sound signals to the market as it calculates the costs relevant for decision making in a competitive market. NGNs will become or are already the accepted modern equivalent asset (MEA) for core*[22] *networks.*[23]

Thus it is clear that (a) costs should be based on an MEA or most efficient technology and (b) that in this case the MEA is an NGN.

From these various statements we can conclude that the costs that Ofcom should be using to derive WLR costs should be based on:

- forward looking,
- long run costs
- efficiently incurred,
- based on using the MEA / most efficient technology which is NGN

We refer to this standard as 'efficient forward-looking' costs. If prices are set on the basis of efficient forward-looking costs this will best ensure efficient competition and investment.

The CCA standard that Ofcom has chosen to use should provide costs that equal efficient forward-looking costs if Ofcom is to achieve its objective of efficient competition and investment. However, as we describe below the costs that Ofcom has used are not equal to efficient forward-looking costs.

[20] Ofcom provide a figure that the total cost of line cards falls by 25% between 2007/08 and 2012/13. During that period WLR lines fell by 23% (see MPF/SMPF Statement Annex 7) implying a 2% unit cost fall in nominal terms. Given inflation averages ~2% per year this implies a 5% fall in real terms. This result (given that 21CN line cards only represent a part of the total cost [with PSTN still being used]) implies 21CN line cards cost less (or more specifically the voice allocation of a line card costs less)

[21] MPF/SMPF Statement §A6.182

[22] The core network includes an MSAN which is used to provide WLR

[23] http://erg.ec.europa.eu/doc/publications/erg_08_26_final_ngn_ip_ic_cs_081016.pdf §C.5

3.3 Ofcom errors in using and applying CCA

The costs that Ofcom has derived using its CCA standard are not equal to efficient forward-looking costs. The errors it has made include:

- Ofcom has in some cases effectively used historic costs not forward looking ones
- Where Ofcom has purported to use forward looking costs it has actually used backwards looking costs
- Ofcom has not properly used the MEA or based costs on the most efficient technology to deploy in the future
- The line card costs are based on sharing a line card between voice and broadband which is impossible given BT's deployment approach

We explain each of these below.

First, Ofcom has used historic costs in some cases. Below we provide two examples.

From the following statement regarding the cost of tie cables it is clear that costs were based on historic costs not forward looking:

> *Given that the existing tie cables for this are largely depreciated, there is little in our cost stacks for tie cables*[24]

The exclusion of costs since they are fully depreciated is, in effect, disregarding the forward looking costs and is clearly inconsistent with the efficient forward-looking cost standard.

Also network fault related costs were derived based on historic fault levels and costs not forward looking ones. This is clear from the following statement: "*Repair costs are allocated using actual observed fault rates for each service (WLR, MPF, SMPF) separately*."[25]

As Ofcom has said it self, these 'actual observed' fault rate are different to the future / forward looking fault rates.[26] [27]

Second, where Ofcom have purported to use forward looking figures they have actually used backwards looking figures.

In determining the costs in any particular year, the cost should be based on the forward looking costs from that year into the future since these would be the costs

[24] MPF/SMPF Statement §A4.80
[25] MPF/SMPF Statement Fig A4.6. Ofcom subsequently informed TTG that the following usage factors were used in deriving fault cost· MPF: 1.22; WLR Residential: 1.15; and WLR Business: 1.00.
[26] "*When considering a potential distortion to the choice of either MPF or WLR+SMPF for the same line, there are no obvious differences in the costs of network faults as we are assuming that both MPF and WLR+SMPF are used for both broadband and voice*" (MPF/SMPF Statement Fig A4.7). In fact, we have evidence that shows MPF fault rates are lower than WLR
[27] It is unclear whether the equalisation of fault rates and costs will result in WLR costs going up or MPF down. However, clearly by using historic fault rates one or both of MPF costs or WLR costs are incorrect.

that a new entrant would consider when assessing whether to enter the market or not.

In assessing the forward looking costs (for each and every year from 2009/10 to 2012/13) Ofcom have based these on the 'average' costs for the period 2009/10 to 2012/13. This is clear from the following statements:

> *… we consider that it is appropriate to use <u>a four year period as the basis for the modelling of forward costs.</u>*[28]

> *However, our assessment is that the cost assumptions set out in the Openreach Pricing Framework remain sound and there is no significant additional migration related <u>costs in the period now under review</u> [i.e.2009/10 to 2012/13]* [29]

If we consider the derivation of costs for 2012/13[30], Ofcom's approach is clearly wrong. In assessing the CCA costs for 2012/13 Ofcom should look forward from that point for the life of the asset (i.e. five to ten years). In other words, Ofcom should base its 2012/13 CCA costs estimates on likely costs in the period 2012/13 to 2017/18. Instead Ofcom has based its 2012/13 CCA costs estimates on the costs in the period from 2009/10 to 2012/13 – in other words it has used a period that is backwards looking from 2012/13[31].

Third, Ofcom has not used the MEA but a historic legacy technology (PSTN) for which equipment can no longer be purchased[32]. This is evident from the following comment:

> *Our cost forecasts are based on BT's actual expected costs (on a CCA FAC basis), which largely relate to 20CN architecture.*[33]

The correct MEA is an NGN/21CN and this must be the basis of all the costs used. Ofcom's approach is clearly inconsistent with the need to estimate efficient forward looking costs based on the technology that an efficient entrant would use (which is NGN equipment).

Ofcom have further erred by excluding migration costs between technologies. An efficient operator using the NGN MEA will incur migration costs during transition from its existing technology to the MEA. These costs will need to be recovered in the rental charge[34] since it would be inappropriate / not possible to recover these costs at the time of migration from WLR customers who will perceive no direct benefit from the migration. Ofcom claimed that since it was only looking at the next 3½ years there will be no migration costs. Ofcom said:

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[28] WLR CC Consultation §6.5
[29] WLR CC Consultation §4.18
[30] In fact, in determining the prices for the period up to 2012/13 the <u>only</u> costs that are relevant are those in 2012/13. This is because Ofcom use a glidepath to gradually adjust prices from the 08/09 level to the cost in 2012/13. Therefore, in effect, the cost of capital in 2009/10, 2010/11 and 2011/12 has no impact on the prices.
[31] Rather peculiarly Ofcom seem to have used the charge control period as the period over which costs should be based
[32] The incorrectness of using PSTN costs is all the more evident when one consider that given the equipment is not available prices cannot be adequately derived
[33] MPF/SMPF Statement §A4.80
[34] A more appropriate approach would be to recover the migration costs in the rental charge over the lifetime of the equipment

However, our assessment is that the cost assumptions set out in the Openreach Pricing Framework remain sound and there is no significant additional migration related costs in the period now under review [i.e.2009/10 to 2012/13][35]

To include no migration costs in the costs for 2012/13 because there are no significant migrations in the period 2009/10 to 2012/13 is clearly flawed. The costs of migrations in 2012/13 should be based on the long run forward looking costs from 2012/13.

Fourth, Ofcom assumed line card sharing whereas in fact BT's 21CN plans are based on dedicated line cards for voice which would make sharing impossible.

BT are planning to deploy separate MSANs for voice and broadband. BT said recently that "*Voice and WBC [broadband] will therefore be delivered via separate MSANs*." [36] Therefore, it is not appropriate to base the cost of the MSAN / line card on the basis that it is shared with broadband but rather that it is dedicated to providing voice. Ofcom seem to have agreed with this approach when they used the full cost of the line card in their LRIC difference calculation[37]. However, in deriving the CCA costs Ofcom has assumed that the line cards are shared.

During the consultation process, we asked Ofcom to explain this clear inconsistency. Ofcom declined to provide any answer except to refer us back to what was said in the consultation document.[38]

Furthermore, even if in some cases MSANs are being used to deliver both voice line rental and broadband services customers, in cases where customers are using voice services alone the full cost of the line card should be recovered from these customers since, by definition, the line card will be exclusively used to provide voice services.

As a consequence of these mistakes, Ofcom has substantially underestimated the true and appropriate CCA costs that reflect efficient forward-looking costs. Given the limited transparency and justification it is difficult to be precise about whether there are other mistakes in addition to those we have identified. However, we suspect there probably are.

We estimate that the effect of properly including the appropriate efficient forward-looking costs would increase WLR rental costs by about £20.[39] As Ofcom's own figures show, solely correcting the error regarding use of only a portion of the line card cost would result in an increase in the cost of £6.82[40].

[35] WLR CC Consultation §4.18
[36] Steering Board Slidepack 25 June 2009 slide 4
[37] MPF/SMPF Statement Table A4.7
[38] See Letter Sivak to Heaney 12 August 2009 response to question Line card costs (d)
[39] The underestimate of LRIC costs differentials was about £20. The error on LRIC cost differentials will not equal the error on CCA but is probably an illustrative proxy (see Section 4).
[40] Impact in 2012/13 of changing from voice taking a share of the line card cost to voice taking full cost is £18.86 less £12.04 (figures from table at WLR CC §A5.29)

Although not directly pertinent to this consultation it is worth noting that the underestimation of these WLR costs will have resulted in an excessive amount of common cost being allocated to MPF. This is because, *ceteris paribus*, an increase in WLR assets/costs would increase the allocation of certain common costs such as corporate overhead to WLR and so reduce the allocation to MPF.

4. Not ensured correct price difference

In setting prices for products that can be used as alternatives (such as MPF and WLR), it is critical that the relative price differences are set so to avoid economic inefficiencies. Ofcom have broadly accepted this principle. If the price differences are too high or too low is can result in inappropriate and inefficient wholesale product choices being made by wholesale customers.

The actual appropriate price difference will depend on the dominant efficiency consideration[41]:

- if productive efficiency was the only consideration then a price difference equal to the LRIC cost difference would be appropriate
- if allocative efficiency was the only consideration then
  - a LRIC plus mark-up (based on EPMU[42]) difference would be appropriate if price (super-) elasticities were the same
  - a larger difference than LRIC+EPMU would be appropriate if, as is likely, the price (super-) elasticity of MPF was higher than WLR
- and if dynamic considerations (such as competition and innovation[43]) were relevant (which Ofcom believe is true to some degree) then that would suggest the need for a larger price difference than suggested by productive and allocative considerations alone

In our Appeal we provided estimates of the LRIC[44] costs differences

- MPF vs WLR – £31.81
- MPF vs WLR + SMPF – £44.93

These are about £20 higher in each case than Ofcom's estimates. In the Appeal we outlined the basis for our estimates and where we believe Ofcom erred. In general Ofcom failed to correctly estimate the LRIC cost differences since they did not use efficient forward-looking costs that are appropriate for the estimation of LRIC cost differences and arbitrarily ignored certain costs[45].

In fact, Ofcom did not engage with the issue of LRIC until the MPF/SMPF Statement itself. It appears that the derivation of Ofcom's LRIC figures in the MPF/SMPF Statement (which coincidentally support its CCA FAC approach) was an obvious exercise in *ex-post* rationalisation.

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[41] Notice of Appeal §95
[42] EPMU. Equi-proportional mark-up. Assumes mark-up for common cost for each service is in proportion to the incremental / non-common cost of each service
[43] For instance, if efficiency gains such as cost reductions from increased competition/innovation (based on MPF) were considered relevant then a larger price difference would be appropriate to encourage MPF based entry
[44] note CCA and LRIC cost principles have the same underlying principles (forward looking, efficient, long run, MEA etc). However, CCA FAC which is used to derive costs includes an allocation of fixed and common costs (based on the fully allocated cost principle). LRIC costs do not include any costs that fixed and common in the long run. Another difference between appropriate CCA costs (used to derive prices) and LRIC costs (used to derive price differences) is that certain adjustments may be handled differently – for example, in the CCA costs it might be appropriate to include line length differences but to exclude this impact in LRIC cost differences
[45] For instance, Ofcom ignored migration costs, higher cost resulting from not sharing line cards and tie cables. See Witness Statement Heaney Annex 1 (to the Appeal) for fuller explanation

On the assumption that the total cost recovery remains unchanged the prices that would ensure a price difference equal to the correct LRIC cost differences would be as follows[46].

2012/13 prices[47]

	Ofcom decision / proposal	With price differences equal to true LRIC cost differences
Prices		
MPF	£97.62	£81.71
WLR	£108.34	£113.52
SMPF	£15.60	£13.12
Price differences		
MPF vs WLR	£10.72	£31.81
MPF vs WLR + SMPF	£26.32	£44.93

As can be seen above the level of price difference proposed by Ofcom is far below the appropriate level and will result in significant economic inefficiencies.

Ofcom have provided extremely limited reasoning or justification for the approach and assumptions they have used.

Below we comment on a number of flaws in Ofcom's approach

First, in the ORFF and in this consultation, in assessing the WLR price Ofcom appears to have disregarded the need for a sufficient difference as between MPF and WLR and focussed almost exclusively on the difference as between MPF and WLR+SMPF. There is no reason provided for this omission.

Second, in terms of the costs that are included Ofcom has provided some rather vague and unspecific reasoning for its approach. It said the following in the WLR consultation:

> *4.19 … Some of the responses to the Openreach Pricing Framework consultation suggested we should focus also on the differential between MPF and WLR.*
>
> *4.20 In particular, there was a concern expressed by the TalkTalk Group that the WLR cost stack underestimated the 21CN costs of WLR, and hence the differential between WLR and MPF was too small. The TalkTalk Group proposed an approach that involved setting the WLR charge to include the full combi card cost and also*

[46] Notice of Appeal §99
[47] Note: these number were prepared on the basis of the WLR price (£108.34) being equal to the CCA FAC costs provided in the MPF/SMPF Statement. In the WLR CC Consultation a slightly different WLR price was estimated (£107.93)

> *the cost of migration to 21CN. <u>There could be an argument for this approach on the grounds that it would help wholesale competition in voice only services</u>. This is because it would push up the WLR charge significantly and would help CPs using MPF to compete for voice only customers.*
>
> *4.21 However, consumers of WLR would have to pay higher prices as a result, at least in the short term. <u>There is no clear evidence that this would be promoting effective competition</u>. For such competition to be effective, voice only competition based on MPF would need to develop so as to be sufficient to constraint Openreach's incentive to increase the price of WLR, and ultimately offer consumers better value in terms of lower prices and more choice. It is not clear that this is a likely outcome. As discussed in Annex 4 of the Openreach Pricing Framework Statement, we consider that the dynamic efficiency benefits of wholesale voice only competition are limited.*[48]

During the consultation we asked Ofcom to explain what was meant by this. Ofcom provided very little extra clarity though regarding the inclusion of total line card cost and migration costs Ofcom reiterated their position by saying

> *As set out in the WLR CC condoc, a reason for including the total costs would be to increase the WLR such that MPF competition for voice service would be encouraged*[49]

Ofcom's reasoning for the exclusion of these costs seems to be that inclusion of full card and migration costs would further encourage competition, competition that Ofcom judges would be undesirable. Ofcom offers no other justification.

Ofcom's approach is simply incorrect. The reason to include the costs is that since they are efficient forward-looking LRIC costs[50] and so including them will result in a price difference that will ensure efficient competition.

It is not appropriate for Ofcom to arbitrarily include or exclude certain costs on the basis of what it judges (on the basis of almost no evidence) will promote effective competition. The sole basis for including or excluding costs should be whether they are efficient forward-looking LRIC costs.

By excluding these costs Ofcom will set the price difference to be less than the forward-looking LRIC cost differences – this will unequivocally result in productive <u>and</u> allocative inefficiencies. It should be obvious to Ofcom that such a situation is harmful to consumers.

The question of whether more competition than that which would be achieved by setting price differences at LRIC cost difference is desirable or not is a further issue (that can be considered separately). If there are dynamic benefits (and Ofcom's whole network-based competition strategy implies that there are some) then that would be reason to set the price difference to be greater that the LRIC cost

[48] WLR CC Consultation §§4.19 – 4.21
[49] Letter Sivak to Heaney. Answer to question titled 'MPF versus WLR pricing'
[50] Ofcom seems to have accepted that the full line card cost should be included in the LRIC cost differences (in Figure A4.7 in MPF/SMPF Statement Ofcom estimate of the LRIC cost differentials includes the full line card cost)

difference. Further if there were allocative efficiency considerations then this would necessitate prices being set above LRIC.

Ofcom's approach seems predicated on using assumptions that will fit the desired answer rather than a proper economic and cost analysis. They appear to have arbitrarily excluded costs in order to depress WLR prices with the consequence that it will discourage efficient competition and investment.

Third, there are a number of other issues that should be considered.

Ofcom appear to be saying (in §4.21) that competition for WLR service cannot be effective in providing lower prices and more choice. This is wholly inconsistent with Ofcom's overall strategy to promote network-based (rather than resale based) competition which in Ofcom's own words:

> *"whilst downward pressure on pricing can be achieved by a combination of regulation and arbitrage-based services [resale] competition, we concluded that the choice, diversity, and innovation required by consumers in today's much more diverse and fast-moving market could not be achieved in this way. Innovation in particular cannot be imposed on a market as a regulatory requirement. Services-based [resale] competition does encourage innovation in relation to branding, billing, and packaging of services, but much of the innovation that consumers value in telecoms stems from the ability to combine both network and service capabilities."* [51]

The voice-only wholesale line rental market is a massive market of some 14m lines[52] that currently has a monopoly provider in BT[53]. By preventing efficient competition in this market, Ofcom is depriving these customers of significant choice and reduced prices. The market comprises:

- 9m homes / lines do not take broadband (at the moment an LLU operator cannot easily use MPF to provide to these customers since it prevents the customer from taking broadband from a different provider at a later point)
- 5m homes which take broadband but decide to take voice from a different provider to the broadband (at the moment an LLU operator cannot use MPF to provide to these customers since it would not allow the customer to take broadband from another provider)

Ofcom has suggested that competition cannot be effective since there is not a wholesale LLU product (such as xMPF) that would allow LLU operators to provide a WLR-like product and allow the customer to take broadband from another provider. The obvious answer to that is to require Openreach to provide xMPF.

Quiet extraordinarily elsewhere in the NGN consultation[54] Ofcom has suggested that xMPF is not viable since there is insufficient margin. Ofcom should act in a joined up

[51] http://www.ofcom.org.uk/consult/condocs/statement_tsr/statement.pdf §3.11
[52] Note: competition in the wholesale market can be direct (i.e. competition versus WLR) and indirect (where competition at the retail level results in indirect competition at the wholesale level)
[53] At the wholesale level excepting Virgin Media providers which accounts for less than 18% market share
[54] http://www.ofcom.org.uk/consult/condocs/ngndevelopments/main.pdf e.g. §§ 1.22 – 1.26

way on this issue tackling the margin and product issues in a coherent and consistent manner. It is simply madness to say there is no demand for the product since the margin is insufficient and elsewhere to say that there is no margin since the product does not exist.

Lastly, Ofcom have suggested that a result of increasing the price difference would be that "*consumers of WLR would have to pay higher prices as a result*" [55]. Part of the way of delivering a greater price difference could and should (for good reason) be delivered by reducing the MPF price. We have made clear to Ofcom on several occasions that by divorcing the decisions on MPF and WLR pricing they ran the risk of not being able to adjust MPF price downwards to deliver an appropriate price difference. To come back now and say effectively '*we cannot increase the price difference since it will result in increased WLR prices*' beggars belief.

[55] MPF/SMPF Statement § 4.21

5. Other

5.1 Creation of a new 'WLR core' product

Rather than set separate charges for WLR residential and WLR business, Ofcom has decided to set a single WLR charge for a 'core' product. We agree, in principle, that this is a reasonable approach.

One of the impacts of this change is that the core product includes business lines which are shorter (and therefore have a 8% cost reduction for shorter line length)[56].

It is not clear that this same approach has been consistently adopted for MPF lines and if it hasn't there is further risk of an inappropriate price difference and resulting inefficiencies.

In particular, does the MPF cost (and line length adjustment) reflect the fact that MPF lines are used for providing services to businesses and that these lines are shorter than MPF lines used for providing services to residential consumers? This issue is more pertinent since TTG expect that in time a greater proportion of MPF lines will be used for providing services to businesses – only recently have TTG begun to push sales to business customers through more aggressive pricing[57].

Further, it is not clear whether the LRIC difference calculation that Ofcom previously used to check (albeit incorrectly) that the price differences were not inefficient needs updating to reflect the changes in methodology/assumptions used to calculate the WLR charge (e.g. inclusion of business, inclusion of transfer costs).

5.2 Pricing of enhanced service component

One of the implications of creating this 'core' product is that the enhanced care component of the current business WLR services which is currently effectively regulated via a charge control will now not be charge controlled. Ofcom has posed the question of how this portion should be regulated in §§3.51 – 3.69 and question 3.4.

BT could have an incentive to excessively price the service to increase returns and/or margin squeeze with the retail product. Alternatively in different circumstances, they may also have an incentive to underprice the product in order to margin squeeze competitors using MPF to compete with the WLR business service. Whilst we recognise the benefit of some pricing flexibility for BT we see little benefit to consumers from allowing BT to price outside the very wide boundaries set by a cost orientation obligation (i.e. DLRIC and DSAC which typically allow price variations of FAC +/- 40%). Thus we suggest that at a minimum a cost orientation obligation be imposed.

[56] MPF/SMPF Statement §A6.235 "*… the average cost of an MPF line is 6% less than an average WLR Residential line. Openreach have also applied the methodology to all the copper based products, the impact on a WLR Business Line is that it costs 8% less than a WLR residential line.*"
[57] Reduced Office broadband price to £10, some 58% less than BT e.g. http://www.ispreview.co.uk/news/EkFFVyyyFZiWIDdBzJ.html

In addition we believe that there should be a clear obligation on BT to price the enhanced services components consistently as between WLR and MPF. Without this, BT are likely to increase the price of MPF enhanced care services relative to WLR thus distorting competition.

5.3 Length of WLR charge control

Ofcom has proposed a 3½ year charge control for WLR from 1 October 2009 to 31 March 2013.

Ofcom has correctly identified the risk that when the new charge for MPF/SMPF is set for 1 April 2011 onwards it may be inconsistent with the then prevailing price for WLR. Ofcom said:

> *4.32 The most significant risk with the proposed approach [a 3½ year charge control to 31 March 2013] is that if exogenous factors changed significantly between now and when the MPF charge was re-set in April 2011 (assuming it remains appropriate to retain a charge control for MPF), the differential between WLR and MPF charges might not fully reflect the changed circumstances because WLR charges would not have been re-set to reflect them … Such changes could mean that after April 2011 the [price] differential between MPF and WLR could be greater than or less than what would be implied by the costs.*
>
> *4.33 If the [price] differential between MPF and WLR/WLR+SMPF does not reflect costs, this could distort the choice of wholesale inputs for CPs.*
>
> *4.44 However, such a distortion would only arise if there were a material change in the forecasts of efficient costs between now and when the future MPF charge is set, by March 2011. Also, it would only last for the two remaining years of the WLR charge control, until March 2013*[58]

Though Ofcom has identified that there would be a problem it has failed in its consultation document to be transparent and suggest any solution. During the consultation process we asked Ofcom to provide their view on the approach / solution. They declined to provide any simply repeating that it is a 'consideration'[59].

The first point to note is that this problem has arisen in large part because Ofcom has decided to divorce the process for setting MPF/SMPF and WLR charge controls. As stated in CPW's Appeal at §§69 – 72, we believe the only lawful course is for Ofcom to realign the setting of MPF/SMPF and WLR prices so that they can be set consistently with one another over the same time-frame.

If Ofcom were to maintain its divorced and ill-sequenced approach to setting prices for MPF/SMPF and WLR, Ofcom would need to consider two things.

- Firstly, under what conditions would the inconsistency be material enough to warrant action being taken
- Secondly, what form of action should be taken

[58] WLR CC Consultation §§4.32 – 4.34
[59] Letter Sivak to Heaney. Answer to question titled '3½ year charge control period'

On the first issue of what level of inconsistency would warrant action, Ofcom has provided no guidance to what level of inconsistency that would be considered material.

We think that even a £1 or £2 inconsistency would warrant 're-opening' the WLR charge control using the same costs as for MPF. Ofcom themselves appear to have suggested that a £1 inconsistency is material.

In the Statement on LLU prices Ofcom decided to increase prices by about £1.00[60] above the smooth glidepath in 09/10 since they felt that without such a 'correction' it would result in inefficient investment[61]. Thus, it seems that this amount of £1 is Ofcom's test of materiality. Ofcom in its Statement must make clear what level of inconsistency it would consider sufficient to require it to take action and why.

On the second issue of what action to take Ofcom is again silent. We believe that in the case where the inconsistency is large, the most obvious (and possibly only) course of action at that point would be to reset the WLR price to be based on the same underlying cost assumptions as those being used for MPF.

Given the importance of ensuring the price differences between MPF and WLR are appropriate and the risk of exogenous factors that might cause inconsistent prices, we believe that the appropriate course of action would be to set the WLR charge control to end when the MPF/SMPF charge control ends (30 March 2011) thereby allowing the charge control periods for the two products to be synchronised.

5.4 MPF to WLR conversion charge

This is the charge that is payable to migrate customers from MPF to WLR and is analogous to a MPF connection which transfers a customer from WLR to MPF. Historically, these charges have been the same (£34.86) though recently the WLR to MPF connection charge has risen to £38.

Ofcom has proposed removing any charge control on MPF to WLR conversion but leave in place the cost orientation regulation. The only reason given for Ofcom's approach is that "*We are concerned that the relatively small volumes in this service*

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[60] Ofcom derived the price as follows "*First we considered what a four-year (real terms) glide path would look like based on our estimate of the 2012/13 costs and the expected rate of RPI inflation over the period. Informed by that glide path, we then determined the appropriate starting charge for MPF in 2009/10 giving weight to alternative methods for determining the start charge - including the case for full cost recovery in 2009/10, as set out in Annex 5. We adopt a value close to the middle of the range bounded by these alternative approaches*" (MPF/SMPF Statement §7.31.1-7.31.2). The smooth glidepath Ofcom assumed was about £85.41. Given it set the price at £86.40 the deviation was about £1

[61] For example: MPF/SMPF Statement §A5.34 "*We also consider there is a case for a price path with a larger increase in the MPF charge in the first year. In particular, we consider that the potential distortions to the choice between MPF and WLR+SMPF provides some justification for such an increase*". Ofcom decided to adopt a price half way between that implied by a glidepath and the FAC in 09/10 (see §7.31.2)

would make it difficult to determine a reliable and robust estimate of the underlying units costs."[62]

Ofcom then went on to explain that cost orientation would be a sufficient remedy.

> *We consider that reliance on cost orientation is proportionate, but we also consider that the existing relative level of charges for the WLR to MPF new connection and the MPF to WLR transfer is appropriate.*
>
> *We propose to rely on the support of Communications Provider to monitor the level of the WLR conversion charge relative to the MPF transfer charge. In the event that there emerges a significant differential between the charges then we may need to consider a review of the basis of the charges to see if the differential is justified.*[63]

Ofcom's approach is flawed in a number of respects.

Firstly, it is not difficult to reliably and robustly estimate the MPF to WLR conversion cost since (a) the volumes, though smaller than WLR to MPF connections are still significant (~400,000 pa in 2012/13[64]) and (b) the activities are very similar to the WLR to MPF connection cost (which Ofcom's believe can be reliably estimated).

Secondly, if Ofcom is not confident of its estimates the right approach is not to remove price regulation but rather to do some additional work to remedy the lack of reliability.

Thirdly, placing the onus on CPs to monitor the price relative to WLR to MPF connection seems an attempt to unnecessarily pass responsibility onto others – for Ofcom to monitor the price takes about 20 seconds to identify the two prices on the Openreach website. For Ofcom's convenience, we have provided the link in the footnote[65]

Fourth, Ofcom's suggested approach of saying it might review if a differential arose merely serves to create inclarity and uncertainty where none is required.

We believe that given BT's incentive and track record of anti-competitive behaviour[66] Ofcom must put in strict rules to prevent pricing abuse. As Ofcom has said prices that are the same are 'appropriate' [§5.41]. Thus it should put in place now a rule that reflects that principle and require that the MPF to WLR conversion charge is exactly the same as (or above[67]) the WLR to MPF connection charge unless BT

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[62] WLR CC Consultation §5.39
[63] WLR CC Consultation §§5.41– 5.42
[64] This is based on Ofcom's volume estimates (from MPF/SMPF Statement Annex 7) which show MPF growing faster than WLR in 2012/13 and assuming that in areas with LLU there is 25% churn. Using the assumption that gross additions are won in proportion to the starting base in the year then there will be 0.4m MPF to WLR (versus 1.6m WLR to MPF)
[65] MPF connection charge at:
http://www.openreach.co.uk/orpg/pricing/loadProductPriceDetails.do?data=hlVgHLlbSFZRGPYSk11mUb%2FuVhXjMR5hQz3DdrCHJqBVrWsgMC%2F4dy9qJJFTkna2
WLR conversion charge at:
http://www.openreach.co.uk/orpg/pricing/loadProductPriceDetails.do?data=09MCgxETXlb8ZvXUsCN9MVQ14hLhaQkFGHrP9FQAi3yZrG2CsSujUDvDlXyfMBml
[66] See further Appeal at §116
[67] There is a good reason to consider that the MPF to WLR charge should be higher than the WLR to MPF connection charge since more activities are involved such as numbering.

provide adequate and cogent reasoning otherwise. Without this requirement BT will likely use the flexibility in an anti-competitive manner.

5.5 Adjustment to WLR transfer charge

A WLR transfer is when there is a migration between service providers who both use WLR.

Ofcom proposes to exclude certain costs related to transfers (about £10.50 in 2012/13[68]) from the WLR transfer charge and recover them in the WLR rental charge (about £1.58 pa in 2012/13[69]) in order to reduce switching costs at the retail level. Though we concur with Ofcom's objective we have a number of issues.

Firstly, we believe that Ofcom should in general avoid 'meddling' with costs in this way too much. Obviously it is appropriate for Ofcom to adjust cost allocations where they are, for instance, anti-competitive, where they may result in inefficiency or where the underlying assumptions are incorrect. However, this type of adjustment where common cost allocation is significantly changed can have a number of damaging unintended consequences – for example:

- It could, if forecast volumes are inaccurate, result in under- or over-recovery
- It can distort behaviours resulting in, for instance, an inefficiently higher level of switching
- It could distort competition if the approach is not applied consistently across all migration products (which it is not)
- It means that the Regulatory Financial Statement will present a misleading high level of profitability (since the rental cost will exclude this cost but the price / revenue will effectively include it)
- It is administratively complex and burdensome

Whilst, these downsides may have been justifiable when there was no alternative to providing line rental except WLR and when competition was nascent, the benefits of this meddling is now much less. Furthermore, it is unlikely that such a reduction would have a huge impact on switching behaviour since the reduction in transfer charge net of higher rental charges is minimal.

We also have a number of other comments

- Has Ofcom considered whether / how the same principle could / should be applied for other transfers? For example:
    - WLR to MPF (i.e. MPF connection)
    - MPF to WLR (i.e. WLR conversion)
    - MPF to MPF (between different CPs)

  If the adjustment is only applied to WLR to WLR migrations it may distort competition.

[68] Cost £13.50 [§5.13] less price £3 [§7.30]
[69] Increase in rental charge due to reduction in transfer charge price is £107.93 [Table 6.7] less £106.25 [Table 6.6]

- Given the cost of the transfer is £13.50[70] and two-thirds[71] are systems costs which will be mostly (though not wholly) fixed and common this implies that the incremental costs are at least £4.50. Thus, it is not clear that the £3 charge proposed will cover incremental costs. If it didn't recover incremental costs then this approach would probably result in inefficiencies due to 'too many' WLR to WLR switches
- We are unsure how the £1.58 increase was derived given the £10.50 cost and the five year recovery[72]. Use of a flat annuity algorithm would suggest an annual recovery in the rental price of £2.68[73]

5.6 New provide charges

Ofcom claim that the estimated CCA FAC on a WLR new provide is £36[74] (in 2012/13) and the estimated CCA FAC on a MPF new provide is £46[75]. Given WLR involve more components and activity than MPF logically one would expect the MPF cost to be lower than the WLR one. No explanation or transparency is provided for this apparent discrepancy.

5.7 Network and calling features

We note that Ofcom has proposed to not increase the price regulation of calling and network features given that they understand that the recent significant trial reductions in prices were expected to be implemented on a permanent basis.

In fact Openreach has just increased then back to the previous level[76]. We presume that Ofcom will reconsider its proposals in this light.

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[70] WLR CC §5.13
[71] WLR CC §5.13
[72] WLR CC §6.29
[73] using a 10.1% interest / discount rate
[74] WLR CC §5.25
[75] MPF/SMPF Statement §7.53
[76] see http://www.openreach.co.uk/orpg/pricing/loadProductPriceDetails.do?data=61weAriLXAXIUQqb38BBAr%2FuVhXjMR5hQz3DdrCHJqBVrWsgMC%2F4dy9qJJFTkna2

6. Responses to Ofcom questions

Question 3.1 Do you agree with our preferred option to set a control on a WLR core rental service to be available both to residential and business customers with the option for number entry to residential and business directories? Or do you consider that the alternative use of a basket would be a more appropriate control?

As we describe in Section 5.1, we broadly agree with the use of a core WLR service. However, as we describe in §5.2 this is contingent on appropriate regulation of the enhanced care component that will now not be charge controlled.

Question 3.2 If we are setting the control on a core WLR rental service are there any other features of the WLR Premium service, other than entry in a business directory, that would be required in the revised core rental service so that it would be suitable as a basic business product?

There are a number of features of the business WLR service that would need to be provided within the core WLR service or otherwise be reasonably available. These include:

- Lines at temporary premises (e.g. events)
- Proactive-fault management (night time 'routining') – though this may be appropriate to include in the enhanced care service
- Ability to select terminal type e.g. NTE or NTTP (which is suitable for PABXs)

Question 3.3 Please provide you views on the requirement for and if necessary, duration of any transition period for the implementation of a core WLR service?

To implement this change would require both some limited Openreach system changes to their ordering interfaces (the timing of which would depend on Openreach schedules) as well as data modifications e.g. to reclassify lines. Once the changes have been implemented and made available by Openreach it would take 3-6 months for these to be adopted by CPs.

We are unclear how this would work for WLR2 since Openreach have said that they are doing no more developments on WLR2.

Question 3.4 What is your view on the appropriate basis of charges (cost orientation) regime for WLR Premium and other higher care level services? Do you consider that the other obligations on Openreach (perhaps supplemented by guidance on interpretation) are sufficient control on the WLR Premium charge without an addition basis of charge condition? (Responses to these question will be considered in conjunction to the basis of charges (question 13.3) proposed in the Wholesale Review consultation)

At a minimum a cost orientation obligation should be imposed on the additional care levels. A cost orientation obligation gives BT significant price flexibility and no reason has been provided as to why additional flexibility would provide any benefits to consumers (though BT and its shareholders would gain). In addition, the enhanced care level prices as between WLR and MPF/SMPF should be consistent.

Question 4.1 Do you agree that it is important to ensure consistency between the WLR and LLU charge controls? In this context, do you agree that we will need to consider consistency in considering the impact on any challenges to assumptions when we are setting the final controls?

To the first part of the question. Yes. It is absolutely critical to ensure that competitive is not distorted or made inefficient by ensuring that the prices are consistent inasmuch that the relative price differences are efficient. Unfortunately, Ofcom proposed price differences are extremely inefficient.

It is unclear what is meant by the second part of this question. Of course Ofcom will need to consider consistency. However, what is apparent is that Ofcom have not properly considered consistency. Rather than ensuring consistency from the outset Ofcom has ‘created’ a set of costs and then, in an obvious exercise in *ex-post* rationalisation, invented a set of LRIC cost differences that supported the proposed prices.

See §4 for further explanation.

Question 4.2 Do you agree with Ofcom’s analysis on the relative charges for WLR and MPF set out here, in Annex 5 of this document and in the Openreach Pricing Framework?

No. The relative price differences between WLR and MPF massively underestimate the LRIC costs differences and thus the prices will drive significant economic inefficiencies.

See §4 for further explanation.

Question 4.3 Do you agree with Ofcom's proposal to set a three and a half year period charge control for WLR?

No since it is likely to lead to material distortion unless Ofcom commit to re-open the WLR charge control in the case that there is a cost inconsistency of more than £1 to £2. Ofcom's proposal (if it could be called that) to handle the potential discrepancy is vague and unclear. (see §5.3)

Question 5.1 Do you agree that Ofcom should continue with its current approach to setting the transfer charge ceiling, recovering the transfer costs primarily through the line rental? If not, please explain why.

As we outline in §5.5 we generally believe that Ofcom should move away from 'meddling' in allocations unless there is a strong reason since it can have a number of negative unintended consequences.

Question 5.2 If we do continue with a low transfer charge do you agree that Ofcom should increase the transfer to £3 with an index? If not, please explain why.

The price may need to be higher than £3 to recover incremental costs and so avoid economic inefficiencies (see §5.5).

Question 5.3 Do you agree that Ofcom should continue to set a charge ceiling for new connections? Do you agree that it is appropriate to impose of one off adjustment in this case given the difference between existing charges and the CCA FAC cost? Do you agree it is appropriate to consider the relative charge of new line for LLU and WLR in making this adjustment?

Yes there should be a charge control. In terms of one-off adjustments and the path of prices it is critical that there should be consistency as between WLR new provide and MPF new provide. The current situation where a MPF new provide costs more than a WLR new provide even though they involve less resource and activity must be addressed. (see §5.6)

Question 5.4 Do you agree that Ofcom should exclude the remaining migration charges and calling and network features from the scope of the charge ceiling? If not, please explain why.

We have no comment on this issue.

Question 6.1 Do you agree with the approach we have taken to derive the core WLR rental? In particular do you consider the estimates for the cost of the WLR Premium care levels to be reasonable?

Question 6.2 Do you agree with an allocation of common costs to the WLR Premium care level service?.

Effectively Ofcom have used a FAC approach by including an allocation of common cost. This is we think appropriate since it prevents 'overloading' excessive costs onto the core WLR service and is also consistent with the treatment of non-regulated services in the Openreach Financial Framework.

We have no comment on the method or assumptions used to derive the (incremental) additional cost of WLR Premium.

Question 6.3 Do you have any comments on the likely change in transfer or connection volumes in the latter part of this charge control period?

No we do not have any comment on this point.

However, the fact that Ofcom is providing such detail and 'consulting' on such a small issue (the impact is less than £1m in one year) is extraordinary when compared to other areas. For example, on LLU Ancillary services which cost £400m a year Ofcom provided little more transparency than for this issue.

Question 7.1 Please set out your views on the proposals set out in Section 7, together with the potential implications of the those proposals for CPs and for consumers, and the factors you consider we should take into account when determining the final pricing regime.

It is unclear what precisely this question is trying to ask. However, regarding the particular issues within Section 7

- We agree with the approach to align prices to cost in 2012/13 (though we fundamentally disagree that the costs are correct)
- We agree with the use of the proposed glidepath
- We agree with the linking of the charge control to RPI

Question 7.2 Do you agree with our treatment of the first year RPI adjustment to ensure consistency with the LLU proposals?

Yes. (presuming that this refers to the use of a higher X in 2009/10 to reflect that the fact that the RPI figure used will be artificially low for 2009/10)

Question 7.3 Do you agree with the proposed 25 days implementation period? If not please state your reasons and a preferred period?

We presume that this question means 28 days not 25.

In this case 28 days is reasonable given the limited changes being made. However, Ofcom should maintain its 90 day standard approach. Ofcom must be clear that this will not set a precedent.

Question 7.4 Do you agree with our assessment that the proposed changes to conditions and directions meet the tests set out under the Act?

As §7.57 of the WLR consultation makes clear, the charge control should promote efficiency and sustainable competition.

> *In setting an appropriate control we need to ensure that it operates so that it*
>
> *i) promotes efficiency;*
>
> *ii) promotes sustainable competition; and*
>
> *iii) confers the greatest possible benefits on end users.*[77]

Unfortunately the proposed control will not do that. It will *inter alia* allow BT to make excessive profits (due to cost assumptions being too high) and not promote efficient or sustainable competition (since the price differences between WLR and MPF are too low).

Ofcom should properly take into account its duties as described in §7.57 in setting the WLR (and MPF/SMPF) prices. It has manifestly failed to do so to date.

Question 7.5 Please provide any other comments you may have in response to the proposals set out in this document.

Our comments are set forth in the remainder of this response.

– END –

[77] WLR CC §7.57