



Draft Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT's charges for partial private circuits

Draft Determinations and Explanatory Statement

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Section 1

Summary

Introduction

- 1.1 On 25 June 2008 Cable & Wireless UK ("C&W"), THUS plc ("THUS"), Global Crossing (UK) Telecommunications Limited ("Global Crossing"), Virgin Media Limited ("Virgin") and Verizon UK Limited ("Verizon") (collectively "the Altnets") submitted disputes against British Telecommunication plc ("BT") regarding BT's charges for services known as partial private circuits ("PPCs") ("the Altnet Disputes"). COLT Telecommunications ("COLT") submitted a similarly worded dispute on 20 October 2008 ("the COLT Dispute"). The Altnets and COLT alleged that BT had overcharged them approximately £180 million for PPC services.
- 1.2 PPCs are the wholesale inputs used to create leased lines, which are fixed permanent communications connections providing capacity between two points. There are two main parts to PPCs – terminating segments and trunk segments. PPCs are purchased as either a terminating segment or as a terminating segment combined with a trunk segment. Communications Providers ("CPs") are able to combine PPCs with their own networks to offer leased line services to their own customers.
- 1.3 On 25 July 2008, we decided that it was appropriate for Ofcom to handle the Altnet Disputes for resolution on the basis of section 186(3) of the Communications Act 2003 ("the Act"). On 27 August 2008, we published the finalised scope of the Altnet Disputes as whether, in the period from 24 June 2004 to 30 September 2008, BT had overcharged the Altnets for PPCs¹ and, if so, by how much the Altnets had been overcharged and whether and by how much BT should reimburse the Altnets.
- 1.4 On 2 December 2008, we decided that it was also appropriate for Ofcom to handle the COLT Dispute for resolution on the basis of section 186(3) of the Act. On 3 December 2008, we published the scope of the COLT Dispute that we proposed to resolve.² The wording was identical to that for the Altnet Disputes, apart from reference to the Altnets being replaced with references to COLT. No comments were received from BT or COLT as to the scope of the COLT Dispute.
- 1.5 This explanatory statement sets out our proposals and rationale for resolving the Altnet Disputes and the COLT Dispute (together "the Disputes") and outlines in summary the main arguments of the Parties.

Regulatory obligations

- 1.6 In its *Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets* (the "2004 LLMR Statement")³, Ofcom concluded that BT held significant market power ("SMP") in the markets for wholesale low

¹ Based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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.

² See http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ocases/open_all/cw_1002/.

³ A copy of the 2004 LLMR Statement is available from Ofcom's website at the following link: <http://www.ofcom.org.uk/consult/condocs/llmr/statement/>.

bandwidth traditional interface symmetric broadband origination ("TISBO"), for wholesale high bandwidth TISBO and for wholesale trunk segments at all bandwidths. As a result, Ofcom imposed a series of SMP conditions on BT under section 45 of the Act, including non-discrimination obligations and cost orientation obligations for all three markets and a charge control for the two TISBO markets.

- 1.7 In particular, Ofcom imposed on BT a cost orientation obligation (which is referred to in the 2004 LLMR Statement as a "basis of charges obligation") on each of the three markets above. The purpose of these obligations is to prevent BT from exploiting its market power by requiring BT to set each and every charge on the basis of its long run incremental costs whilst allowing an appropriate mark-up for the recovery of common costs.
- 1.8 In addition, Ofcom imposed on BT a charge control obligation in the markets for low bandwidth TISBO and high bandwidth TISBO.⁴ No charge control obligation was imposed in the market for trunk.
- 1.9 In December 2008, Ofcom published its second review of the markets for retail leased lines, symmetric broadband origination and wholesale trunks segments in the Business Connectivity Market Review statement ("the 2008 BCMR Statement").⁵ Ofcom concluded that BT continued to have SMP in the low bandwidth TISBO market, in the high bandwidth 34/45Mbit/s TISBO market (except for the Central and East London Area), in the very high bandwidth 140/155Mbit/s TISBO market (except for the Central and East London area) and in the market for trunk. On this basis, Ofcom imposed non-discrimination, cost orientation and charge control obligations for each of the four markets above.
- 1.10 Ofcom also published in its Leased Lines Charge Control consultation ("the 2008 LLCC Consultation") proposals as to the scope and form of the new charge controls that should apply to leased line services in light of the conclusions in the 2008 BCMR Statement.⁶ The 2008 LLCC Consultation included details of the charge controls proposed for the first time on PPC trunk segments.

Approach to resolving the Disputes

- 1.11 In resolving the Disputes, i.e. whether BT has been overcharging the Altnets and COLT (together "the Disputing CPs") for PPCs, we propose to assess whether BT's charges for PPCs were fair and reasonable. In order to determine what is a fair and reasonable charge, we have had regard primarily to the regulation described above that was imposed on BT in relation to PPCs.
- 1.12 The relevant regulatory obligations relate to BT's cost orientation obligations and the charge control on TISBOs⁷. Of these, we believe that the cost orientation obligation is most relevant to our assessment of whether overcharging has taken place. The Disputing CPs have alleged that BT's PPC charges are not cost oriented but have not made any representations that BT was charging over the level of the charge controls for TISBO services. On this basis, we have focused our assessment on

⁴ Details of the charge control imposed on PPC services can be found in Ofcom's 2004 Partial Private Circuits Charge Control Statement ("the 2004 LLCC Statement") available from Ofcom's website at the following link: http://www.ofcom.org.uk/consult/condocs/ppc_charge_control/statement/.

⁵ See <http://www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf>.

⁶ See <http://www.ofcom.org.uk/consult/condocs/llcc/leasedlines.pdf>.

⁷ There was no charge control obligation in relation to PPC trunk services during the period of the Disputes.

whether BT has been charging more than what is fair and reasonable taking account of BT's cost orientation obligations.

- 1.13 We have also explored whether it would be appropriate for Ofcom to take into account any other factors in determining whether BT's charges have been fair and reasonable. We identified two factors which may be relevant for consideration: BT's rates of return on PPC services and international benchmarking. After careful consideration, we propose to conclude that although both factors may be appropriate indicators of overcharging, we cannot place too much emphasis on them in this case. Setting a rate of return and only allowing BT to earn returns up to that rate would effectively mean the imposition of rate of return regulation, which would not create the right incentives for BT to reduce its costs and increase efficiency. International benchmarking can be a useful tool where the circumstances are as similarly defined as possible. However, we consider that, where there are significant underlying data difficulties (as in the case of PPC charges), it is not possible to draw reliable inferences from international benchmarking. On this basis, we propose to conclude that the most appropriate factor for our assessment is BT's cost orientation obligations. Rates of return and international benchmarking are also considered but are primarily used as means of complementing and cross checking our cost orientation assessment.
- 1.14 In establishing what is a fair and reasonable charge and in determining the right methodology for our assessment, we have taken into account our duties and obligations under sections 3 and 4 of the Act, in particular our principal duty to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets where appropriate by promoting competition.⁸ We have also taken into account our duties to have regard to the desirability of promoting competition in relevant markets, of encouraging investment and innovation in relevant markets and of encouraging the availability of use of high speed data transfer services throughout the UK.⁹
- 1.15 By ensuring that BT's charges are consistent with its obligations (including its obligation to provide network access on a cost oriented basis), we consider that the proposed determinations (set out in **Annexes 4 to 9**) (the "Determinations") also support the Community goal of encouraging the provision of network access.¹⁰ Further, we consider that this document clearly sets out the Parties'¹¹ arguments and Ofcom's reasoning that leads to these proposals. In addition, we believe that this document, on which the Parties will have an opportunity to comment, fits with Ofcom's duty to ensure that its regulatory activities are transparent, accountable, evidence-based and consistent.¹² Finally, we also consider that these draft Determinations are proportionate in that they strike a fair balance between the Parties.

Cost orientation assessment

Wording of the obligation

- 1.16 BT's cost orientation obligation requires that BT shall secure that "*each and every charge offered [...] is reasonably derived from the costs of provision based on a*

⁸ See section 3(1) of the Act.

⁹ These duties are set out in section 3(4) of the Act.

¹⁰ See section 4(7) of the Act.

¹¹ References to "Parties" are to BT, the Altnets and COLT.

¹² As required by section 3(3) of the Act.

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'. BT is required to ensure that its charges for each and every PPC service meet this condition.

Cost ceiling test

- 1.17 As a first order test, the maximum price that a firm can charge for a good or service in a contestable market (i.e. a market without entry barriers) is the stand alone cost ("SAC"). In the context of a multi-product firm such as BT, the setting of all prices at SAC would lead to over-recovery of common costs. Ofcom has therefore used the distributed stand alone cost ("DSAC") as the appropriate measure against which to assess whether BT's individual PPC charges were too high.
- 1.18 This position is consistent with that adopted by Ofcom in its 1997 and 2001 guidelines on the operation of the network charge controls ("the Guidelines"), where Ofcom stated that it will apply a first order test that charges for a service should not be above DSAC. The use of DSACs as a measure of the cost ceiling below which charges should be set so as not to be unduly high is also recognised by BT in its Primary Accounting Documents.
- 1.19 In conclusion, we believe that the DSAC test, applied over a period of years, is the appropriate benchmark against which to assess whether BT's charges are fair and reasonable, in light of BT's cost orientation obligation. Thus, where prices have been above DSAC for the majority of the period of the Disputes, we consider that it is reasonable to conclude that overcharging has occurred, unless the parties present evidence to rebut this.

Level of aggregation of services

- 1.20 The wording of the cost orientation obligation above states clearly that the obligation applies in relation to "*each and every charge offered*" (emphasis added).¹³ On this basis, we consider it appropriate to apply the DSAC test to each charge for PPC products on a disaggregated basis. In our view, this approach is consistent with BT's cost orientation obligation and does not undermine the charge control which is in place for TISBOs. In addition, a disaggregated approach promotes regulatory certainty and is reinforced by BT's own Primary Accounting Documents which also refer to "each service" and BT's regulatory financial statements where BT lists out the different services separately.
- 1.21 In looking at what is fair and reasonable in the context of disaggregated PPC services we have been mindful of the fact that low rates of returns may have been earned by BT on certain PPC services. Although there may be a variety of reasons for any low rates of return on individual PPC services, we do not believe that this would justify overcharging for other PPC services, particularly where the services are in separately defined markets.
- 1.22 BT argues that the cost orientation obligation on PPCs should be looked at on an aggregated basis. BT stresses that trunk services are never sold separately from terminating segments, that the costs of provision are shared and that the boundary between them is a regulatory construct. We do not agree with this interpretation of BT's cost orientation obligation for numerous reasons set out in the explanatory

¹³ The full wording of the cost orientation obligation is set out in Annex D of the 2004 Leased Lines Market Review (see http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf).

statement and consider that BT appears to have known that the obligation applied on “each and every charge”, rather than on aggregated PPC services.

Application of the DSAC test to PPCs

- 1.23 After establishing the most appropriate methodology for resolving the Disputes, we have applied that methodology to the relevant facts and data.

Appropriate base data set

- 1.24 In applying our methodology for assessing overcharging in these Disputes, we have had to identify what is the best available data on which to base our assessment. The Competition Appeal Tribunal (“the CAT”) has said that Ofcom must proceed on the basis of the best available evidence at the time of resolving a dispute.¹⁴
- 1.25 In June 2008, after the Altnets brought their disputes to Ofcom, we were informed by BT that the methodology it had used for calculating certain PPC volumes and revenues in its 2006/07 Regulatory Financial Statements was inappropriate. BT corrected this methodology when preparing its 2007/08 Regulatory Financial Statements and restated the data for 2006/07 when publishing these statements in September 2008 (“the Restated Data”). The Restated Data has been audited by PricewaterhouseCoopers (“PwC”). In addition, Ofcom commissioned consultants Analysys Mason to carry out an independent review of the restatement and supporting systems and processes that were used to prepare the restatement.
- 1.26 BT further advised us that on the basis of the above finding, certain of the PPC data published in BT's 2004/05 and 2005/06 financial statements were also based on the same inappropriate methodology. BT did not publish restated Regulatory Financial Statements for 2004/05 and 2005/06 but instead provided revised data for this period that had been prepared on the same basis as the Restated Data (“the Revised Data”).¹⁵ The Revised Data has not been audited by PwC and was not examined by Analysys Mason. However, the Revised Data has been subject to our internal review in order to satisfy ourselves that it appears reasonable and consistent with the Restated Data.
- 1.27 We therefore had a choice of two separate data sets on which to base our assessments: the PPC data in BT's originally published regulatory financial statements or the Restated and Revised Data. We propose to conclude that for the purposes of resolving the Disputes, the best available and therefore the most appropriate data set to use is the Restated and Revised Data. The use of the original BT data would have led to Ofcom knowingly resolving the Disputes on the basis of incorrect data and we consider this would not be in accordance with our duties.

Cost adjustments

- 1.28 The Restated and Revised Data contains certain costs that Ofcom does not believe should be attributed to certain PPC services. These costs might distort the general

¹⁴ See paragraph 183 of the CAT's judgment on the Core Issues in the Mobile Call Termination Rate Dispute appeal: *T-Mobile (UK) Limited and British Telecommunications plc and Hutchison 3G UK Limited and Cable & Wireless UK & Others and Vodafone Limited and Orange Personal Communications Services Ltd v Office of Communications, Judgment on the Core Issues* [2008] CAT 12: see www.catribunal.org.uk/files/Judgment_TRDs_200508.pdf.

¹⁵ This data was supplied by BT in response to a formal information request that was issued to BT by Ofcom on 1 October 2008.

profitability of PPC services. On this basis, we considered that it is appropriate for us to make adjustments to the base data in order to ensure that it better fits the purpose of resolving the Disputes. We then applied the DSAC test to the adjusted Restated and Revised Data, looking at the services on a disaggregated basis.

Conclusion

- 1.29 In summary, BT's charges for 2Mbit/s trunk services appear to have been significantly higher than the DSAC for the majority of the period of the Disputes. In addition, BT has not provided arguments to rebut the presumption of overcharging. Therefore, we propose to conclude that BT has overcharged the Disputing CPs for 2Mbit/s trunk services in the period 1 April 2005 to 30 September 2008, but not for the period 24 June 2004 to 31 March 2005. We propose to conclude that BT has not overcharged the Disputing CPs for other PPC services.
- 1.30 Based on the maximum level that we think BT should have charged for these services (i.e. the DSAC ceiling), we have calculated that the total level of this overcharge to the Disputing CPs is approximately £43 million. On the facts of this case, we consider that it is appropriate and proportionate for Ofcom to exercise its power under section 190(2)(d) of the Act to require the payment of the above amount by way of adjustment of the overpayment by the Disputing CPs to BT on PPCs, with interest.
- 1.31 We believe that resolving the Disputes in this manner would represent a fair balance between the interests of the Disputing CPs and BT and would be consistent with Ofcom's duties under sections 3 and 4 of the Act.

Next steps

- 1.32 Interested parties have until 29 May 2009 to comment on these proposals, after which Ofcom will issue final determinations to resolve these disputes. Details of how to respond to this consultation are set out in **Annexes 1 to 3**.

Section 2

Relevant regulatory provisions and issues under dispute

Partial Private Circuits

- 2.1 Leased lines, also known as private circuits, provide dedicated symmetric transmission capacity between customer sites and can be used to carry voice and data traffic. They are a key building block in the communications networks on which UK businesses depend, and which are central to the effective functioning of the economy. CPs compete to provide retail leased line services to business customers.
- 2.2 Wholesale leased lines are used by CPs as inputs to their retail leased lines services. These may take the form of complete circuits connecting two or more end-user sites, or PPCs connecting customer sites to points in the purchasing CP's network.
- 2.3 PPCs are the most widely used wholesale leased line in the UK. In simple terms, PPCs are comprised of terminating segments (which run between the customer's premises and the core network) and trunk segments (which run across the core network). A more detailed explanation of the constituent parts of a PPC is set out in **Annex 10** below.

The legal and regulatory framework

- 2.4 In accordance with our obligations as a national regulatory authority ("NRA") under the European Common Regulatory Framework for electronic communications networks and services ("the CRF")¹⁶, Ofcom has carried out reviews of the leased lines markets and imposed regulation where appropriate.

Regulatory obligations for the relevant markets during the period of the Disputes

The 2004 Leased Lines Market Review

- 2.5 On 24 June 2004, Ofcom published the 2004 LLMR Statement¹⁷, which set out its analysis and conclusions in relation to leased lines markets.
- 2.6 Amongst its findings in the 2004 LLMR Statement, Ofcom concluded that BT held SMP in the markets for:
 - a) wholesale low bandwidth TISBO (which includes circuits of bandwidths up to and including 8Mbit/s);
 - b) wholesale high bandwidth TISBO (which includes circuits of bandwidths above 8Mbit/s and up to and including 155Mbit/s); and
 - c) wholesale trunk segments at all bandwidths.

¹⁶ Details of the CRF and the Directives that comprise it are set out in **Annex 11** below.

¹⁷ *Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*: <http://www.ofcom.org.uk/consult/condocs/llmr/statement/>.

- 2.7 As a result of these conclusions, Ofcom imposed a series of SMP conditions on BT under section 45 of the Act, including:
- a) a basis of charges obligation (covering cost orientation and a cost accounting system) in each of the markets (a)-(c) identified in **paragraph 2.6** above;
 - b) a price control obligation in the two TISBO markets (a) and (b) identified in **paragraph 2.6** above; and
 - c) a requirement not to unduly discriminate in each of the markets (a)-(c) identified in **paragraph 2.6** above.

The basis of charges obligation (i.e. cost orientation obligation)

- 2.8 Cost orientation obligations were imposed on BT in each of the markets for low bandwidth TISBO (SMP Condition G3), high bandwidth TISBO (SMP Condition GG3) and trunk (SMP Condition H3). The purpose of these obligations is to prevent BT from exploiting its market power by overcharging its customers. The cost orientation obligations do this by requiring BT to set its charges on the basis of its long run incremental costs (whilst allowing a mark-up for the recovery of common costs).
- 2.9 SMP Condition G3 states as follows:

“Condition G3 – Basis of charges

G3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition G1 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.

G3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by Condition G1 is for a service which is subject to a charge control under Condition G4, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition G3.1.

G3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”¹⁸

- 2.10 The wording of SMP Condition GG3 (which applies to high bandwidth TISBO) is identical to that of SMP Condition G3 (with references to ‘G’ being replaced with those for ‘GG’). SMP Condition H3 (which applies to trunk) is similarly worded, though the wording set out in SMP Condition G3.2 is not included as there was no charge control imposed on trunk charges (and again, references are to ‘H’ rather than ‘G’).

¹⁸ The term “Network Access” is defined in section 151 of the Act, the text of which is set out in **paragraphs A11.9 to A11.13 of Annex 11** below.

- 2.11 In setting the cost orientation obligations, Ofcom had specific regard to its duties and Community obligations under sections 3 and 4 of the Act. Ofcom considered that the cost orientation obligations helped to ensure that BT is unable to charge excessive prices, thereby facilitating the promotion of competition and the interests of end users.¹⁹

The charge control obligation

- 2.12 Charge control obligations were imposed on BT in the markets for low bandwidth TISBO (SMP Condition G4) and high bandwidth TISBO (SMP Condition GG4). The charge control obligations set out in the 2004 LLMR Statement were intended as interim measures while a more detailed analysis of how BT's costs of providing PPC TISBO services would change over the coming years was carried out.²⁰ Subsequently, on 30 September 2004, Ofcom published its analysis of BT's PPC TISBO costs and its revisions to the charge control SMP Conditions in the 2004 LLCC Statement.²¹ These revised SMP Conditions are set out in **Annex 11** below.

- 2.13 In setting the charge control obligations, Ofcom had specific regard to its duties and Community obligations under sections 3 and 4 of the Act. Ofcom considered that the charge control obligations helped to encourage BT to be more efficient whilst enabling other CPs to compete with BT, thereby resulting in the availability of a wider range of services at lower prices to the benefit of end users.²²

Requirement not to discriminate unduly

- 2.14 A requirement not to discriminate unduly was imposed on BT in the markets for low bandwidth TISBO (SMP Condition G2), high bandwidth TISBO (SMP Condition GG2) and trunk (SMP Condition H2). The text of these SMP Conditions is set out in **Annex 11** below.
- 2.15 In setting the non-discrimination obligations, Ofcom had specific regard to its duties and Community obligations under sections 3 and 4 of the Act. Ofcom considered that the non-discrimination obligations helped to ensure that other CPs were able to make effective use of wholesale inputs to provide retail services in competition with BT, thereby promoting competition.²³

The future regulatory obligations

- 2.16 The EU Directives require Ofcom to ensure that regulation remains appropriate in light of changing market conditions. Over the last few years, Ofcom has been reviewing the leased lines markets and has recently published its conclusions on the future regulation of these markets, including a consultation on a new charge control.

¹⁹ See paragraphs 6.87-6.90 and 7.65-7.68 of the 2004 LLMR Statement.

²⁰ The charge control effectively took the form of an indexation of the charges set in the PPC Phase 2 Direction, updated to take account of a further year's cost changes.

²¹ *Partial Private Circuits Charge Control*:

www.ofcom.org.uk/consult/condocs/ppc_charge_control/statement

²² See paragraphs 6.127-6.130 of the 2004 LLMR Statement.

²³ See paragraphs 6.64-6.68 and 7.48-7.51 of the 2004 LLMR Statement.

The 2008 Business Connectivity Market Review

- 2.17 On 8 December 2008, Ofcom published its second review of the markets for retail leased lines, symmetric broadband origination and wholesale trunks segments, publishing its conclusions in the 2008 BCMR Statement.²⁴
- 2.18 Ofcom identified in the 2008 BCMR Statement that:
- “The current regulatory framework has worked well in promoting competition in some markets, but in Ofcom’s view has failed to deliver improved competitive conditions in others.”²⁵*
- 2.19 Ofcom concluded that BT continued to have SMP in the low bandwidth TISBO market (which was defined on the same basis as in the 2004 LLMR Statement), and again imposed cost orientation, charge control and non-discrimination obligations (amongst others).
- 2.20 In relation to high bandwidth TISBO market, Ofcom identified that a separate geographic market exists for the Central and East London Area (“CELA”)²⁶ and the rest of the UK (excluding the Hull area as before). Ofcom concluded that BT does not have SMP in the CELA. This differs from the conclusions in the 2004 LLMR Statement, where we did not distinguish between the CELA and the rest of the UK and concluded that BT had SMP in the whole of the UK.
- 2.21 Ofcom additionally identified that the high bandwidth TISBO market should only comprise 34/45Mbit/s circuits as 140/155Mbit/s circuits now fall within a separate very high bandwidth TISBO market. A second very high bandwidth TISBO market for circuits with bandwidths above 155Mbit/s was also identified. Previously, we had concluded that the high bandwidth TISBO market comprised 34/45Mbit/s and 140/155Mbit/s circuits, with the very high bandwidth TISBO market comprising circuits of above 155Mbit/s.
- 2.22 In the high bandwidth TISBO and the very high bandwidth 140/155Mbit/s TISBO markets outside the CELA, Ofcom concluded that BT has SMP and imposed cost orientation, charge control and non-discrimination obligations (amongst others). No SMP obligations were imposed in relation to the very high bandwidth above 155Mbit/s TISBO market.
- 2.23 In relation to trunk, Ofcom concluded that BT continues to have SMP in the market for wholesale trunk segments at all bandwidths in the whole of the UK. We again imposed cost orientation and non-discrimination obligations, but additionally concluded that it was appropriate to impose a charge control as well (a departure from our previous approach in the 2004 LLMR Statement).
- 2.24 In imposing the SMP conditions in the 2008 BCMR Statement, Ofcom took account of its duties and Community obligations in sections 3 and 4 of the Act.²⁷

²⁴ *Business Connectivity Market Review*: www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf.

²⁵ See paragraph 2.38 of the 2008 BCMR Statement.

²⁶ CELA corresponds broadly to the London congestion charging zone and Docklands.

²⁷ See, in particular, the discussion at paragraphs 8.105-8.123 (low bandwidth TISBO), 8.175-8.185 (high bandwidth TISBO), 8.224-8.237 (very high bandwidth 155Mbit/s TISBO) and 8.345-8.357 (trunk segments) of the 2008 BCMR Statement.

The 2008 Leased Lines Charge Control

- 2.25 Ofcom has also published proposals as to the new charge control that should apply to leased line services in the period April 2009 to September 2012. These proposals are set out in the 2008 LLCC Consultation, which is currently the subject of public consultation.²⁸
- 2.26 The 2008 LLCC Consultation proposes six charge control baskets, of which the traditional interface ("TI") basket is of particular relevance to the issues under consideration in these disputes. The TI basket contains all BT low bandwidth TISBO, high bandwidth TISBO (outside the CELA), very high bandwidth 155Mbit/s TISBO (outside the CELA) and trunk services. A charge cap of RPI-0% to RPI-7% is proposed on this basket.
- 2.27 Ofcom expects to publish a Final Statement on the charge controls in May/June 2009, such that they will formally come into effect shortly thereafter. In view of the delay resulting from the restatement of BT's regulatory accounts, BT Wholesale ("BTW") and Openreach have stated publicly that for the period from 1 October 2008 until the introduction of the new control, the prices of TISBO and PPC trunk services will not be increased in nominal terms; and that it will apply the new charge control from 1 October 2008.²⁹

Issues under dispute

The submissions of the Disputing CPs

- 2.28 The Disputing CPs have brought disputes against BT in which they assert that, since the imposition of the PPC SMP obligations on BT on 24 June 2004, requiring BT to secure that its PPC charges are cost oriented, BT's charges for PPCs have not been in compliance with that condition because they have not been cost orientated. As a result, the Disputing CPs claim that they have been overcharged for PPCs that they have purchased since that date. The Disputing CPs argue that BT should be required to reimburse them for the amounts that they have been overcharged, which they estimate to be in the region of £180 million in total.
- 2.29 When submitting their disputes, the Altnets summarised the issues in dispute as being:
- "whether BT has overcharged the Operators in Dispute for PPCs provided to them from 24 June 2004 to date (which will depend on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost-oriented during that time) and, if so:*
- by how much have the Operators in Dispute been overcharged and should therefore be reimbursed."*³⁰
- 2.30 In the submissions that it made when bringing the COLT Dispute³¹, COLT outlined the scope of its dispute with BT and advised that:

²⁸ *Leased Lines Charge Control*: <http://www.ofcom.org.uk/consult/condocs/llcc/leasedlines.pdf>.

²⁹ See paragraphs 7.7 to 7.12 of the 2008 LLCC Consultation: www.ofcom.org.uk/consult/condocs/llcc/leasedlines.pdf

³⁰ See paragraph 2.1 of the dispute submission made by Olswang (on behalf of the Altnets) on 25 June 2008 ("the Altnet Dispute Submission").

"We are aware that Ofcom has already accepted a dispute regarding this matter from a consortium of industry operators and it would make economic and practical sense to deal with COLT's dispute as part of this existing action.

...

*COLT had no specific evidence or unique issues in its dispute with BT that would warrant any different treatment of its case to that of other operators."*³²

- 2.31 In support of their claims to Ofcom that BT has overcharged for PPCs, the Disputing CPs rely on a report by forensic accountants RGL ("the RGL Report"). The RGL Report was originally prepared for THUS and C&W in the context of their negotiations with BT on the PPC charges to support their position that BT's charges were such as to allow the over-recovery of PPC costs. A copy of the RGL Report was first provided to BT in December 2007.
- 2.32 The RGL Report is based on PPC volumes, costs and revenues that were published in BT's regulatory financial statements for 2004/05, 2005/06 and 2006/07. The RGL Report calculates BT's cost recovery in the low bandwidth TISBO, high bandwidth TISBO and wholesale trunk segments markets, using information published in BT's regulatory financial statements as well as documents published by Ofcom and BT in relation to PPCs.
- 2.33 Using BT's regulatory financial statements as a starting point, RGL makes a number of adjustments to some of the PPC data contained within the financial statements to correct for what they believe to be errors in the way in which the financial statements were prepared. These adjustments are based on statements made by Ofcom in its June 2007 review of BT's PPC charging model³³ and by BT in its PPC internal reference offer³⁴.
- 2.34 After making these adjustments, RGL calculated what it believed to be BT's true return on capital employed for PPC services. RGL compared these rates of return to

³¹ COLT made an initial submission to Ofcom on 3 October 2008. This was supported by further information submitted by COLT on 20 October 2008 (together "the COLT Dispute Submission"). We have taken the 20 October 2008 as the date that the full dispute submission was submitted to Ofcom.

³² Submission of 20 October 2008 from Nikkan Woodhouse (Senior Regulatory Advisor, COLT) to Martin Hill (Ofcom).

³³ During Ofcom's review of the replicability of BT's regulated retail business services in 2006 (see www.ofcom.org.uk/consult/condocs/busretail/statement/), a number of CPs expressed concern that the operation of the PPC pricing model gave BT's downstream business a competitive advantage. As part of a follow-up review of the PPC pricing model, Ofcom identified that BT's regulatory accounting practices did not appear to provide for equivalent treatment of PPC inputs provided to internal and external customers (see *Replicability and the PPC Charging Model*, Ofcom note, 15 June 2007. A non-confidential version of the note was published in Annex 13 of the Business Connectivity Market Review consultation: <http://www.ofcom.org.uk/consult/condocs/bcmr/>). RGL used the differences highlighted by Ofcom in the 2007 review to make adjustments to BT's published PPC data to better reflect their view of BT's actual costs of providing PPCs.

³⁴

http://www.btwholesale.com/pages/downloads/service_and_support/contractual_information/docs/ppc_offer/ppciro_080606.doc

BT's weighted average cost of capital ("WACC")³⁵ and concluded that the difference between the two represented the extent of over-recovery of costs by BT.

Table 2.1: Comparison of BT's rate of return (as calculated by RGL) with its WACC

Market	Estimated rate of return			BT's WACC		
	2004/05	2005/06	2006/07	2004/05	2005/06	2006/07
Low bandwidth TISBO	22%	21%	21%	13.25%	12.01%	11.40%
High bandwidth TISBO	21%	33%	50%	13.25%	12.01%	11.40%
Trunk	44%	56%	56%	13.25%	12.01%	11.40%
PPCs overall	27%	31%	33%	13.25%	12.01%	11.40%

Source: RGL Report, Tables 1 and 2

2.35 The RGL Report additionally expresses the difference between the rates of return and BT's WACC as a percentage of PPC revenues (see **Table 2.2**). The Disputing CPs have used this to derive an estimate of the amount by which they believe they have been overcharged by BT (see **Table 2.3**). In their submission, the Altnets argue that Ofcom should determine the amount of over-charge at a more granular level, on a service by service basis by reference to the fully allocated cost ("FAC") for those services.

Table 2.2: RGL estimate of BT's over-recovery as percentage of PPC revenue

Market	2004/05	2005/06	2006/07
Low bandwidth TISBO	14%	12%	12%
High bandwidth TISBO	16%	26%	43%
Trunk	45%	50%	46%
Total PPCs (weighted average)	22%	24%	26%

Source: RGL Report, Table 3

Table 2.3: Estimates from the Disputing CPs of BT's over-charging

Complainant	2004/05	2005/06	2006/07	2007/08 ³⁶	Total
THUS	[X]	[X]	[X]	[X]	[X]
C&W	[X]	[X]	[X]	[X]	[X]

³⁵ A company's WACC measures the rate of return that a firm needs to earn in order to reward its investors. It is an average representing the expected return on all of its securities, including both equity and debt.

³⁶ Over-recovery estimates for 2007/08 have been estimated by the Altnets as data for 2007/08 was not available at the time that the disputes were submitted. The Altnets are also claiming for the period April 2008 to the end of September 2008.

Global Crossing	[X]	[X]	[X]	[X]	[X]
Virgin	[X]	[X]	[X]	[X]	[X]
Verizon	[X]	[X]	[X]	[X]	[X]
COLT	[X]	[X]	[X]	[X]	[X] ³⁷

Source: Annex 9 of the Altnet Dispute Submission and Annex A of the COLT Dispute Submission

- 2.36 We understand that during negotiations with the Altnets on its PPC charges, BT maintained the position that its PPC charges were compliant with its cost orientation obligations. BT additionally argued that it was not appropriate to discuss the issues further as Ofcom was in the process of undertaking a review of the leased lines markets (which resulted in the publications of the 2008 BCMR Statement and the 2008 LLCC Consultation). BT suggested that further discussions should be postponed until after Ofcom had reached its conclusions. Therefore, on the basis of what they believed to be a refusal by BT to negotiate further, the Altnets submitted their disputes to Ofcom on 25 June 2008.³⁸
- 2.37 On the basis of the COLT Dispute Submission, it would appear that COLT did not seek to begin negotiations with BT in relation to the level of PPC charges until after Ofcom had received the Altnet Dispute Submission. As part of the COLT Submission, COLT provided evidence that BT informed COLT that it took the position that it was not appropriate for it to discuss PPC charges while those charges were the subject of a dispute to Ofcom (i.e. the Altnet Dispute). On the basis that BT was unwilling to discuss the level of PPC charges with it, COLT submitted its dispute to Ofcom in October 2008.

BT's initial comments on the submissions from the Disputing CPs

The Altnet Dispute Submission

- 2.38 Ofcom provided BT with a copy of the Altnet Dispute Submission on 27 June 2008 and invited comments on whether BT believed that Ofcom should accept the Altnets' Disputes. BT responded to Ofcom on 4 July 2008, questioning whether a dispute existed.³⁹
- 2.39 BT argued that commercial negotiations had not been exhausted and that it was therefore not appropriate for Ofcom to accept the Altnet Disputes for resolution. BT based its arguments on its understanding that the main disagreement between it and the Altnets was based on the adjustments proposed by RGL and that it was merely awaiting clarification from Ofcom on the proposed adjustments (which it was expecting through Ofcom's work on the 2008 BCMR Statement and the 2008 LLCC Consultation) before recommencing discussions with the Altnets.
- 2.40 BT accepted that there had been some discussion between it and THUS and C&W in relation to the issues raised in the Altnet Dispute Submission but argued that there had been "virtually none" with Verizon, Global Crossing or Virgin Media. BT

³⁷ [X]

³⁸ The combined dispute submission prepared by Olswang on behalf of the Altnets that was submitted to Ofcom on 25 June 2008.

³⁹ Letter from Neena Rupani (BT) to Martin Hill (Ofcom) dated 4 July 2008.

questioned how there could be a dispute with respect to these three companies, given Ofcom's guidance that evidence of prior negotiation was required before a dispute could be accepted.

The COLT Dispute Submission

- 2.41 On 8 October 2008, Ofcom provided BT with a copy of COLT's initial submission of 3 October 2008 and invited BT to provide comments.
- 2.42 BT responded to Ofcom on 10 October 2008, advising that:
- COLT's approach was too far into the four-month period of the Altnets' Dispute to enable BT to "*consider their case in any meaningful way*";
 - It was "*arguable*" whether BT was in dispute with COLT; and
 - The most pragmatic way to deal with COLT's request would be to postpone consideration of any submission by COLT until "*a) it is properly defined and evidenced and b) the current dispute is resolved*".⁴⁰
- 2.43 On 20 November 2008, Ofcom provided BT with a copy of COLT's further submission of 20 October and invited comments on the matters raised in COLT's submission, including on the proposed scope.
- 2.44 BT argued in its response of 24 November 2008 that as COLT had failed to update its evidence in light of BT's restatement of its 2006/07 regulatory financial statements, COLT had "*made no attempt to consider their claim in light of this new information and that the basis of their claim is now out of date and flawed*".⁴¹

BT's additional comments on handling the Disputes

- 2.45 BT made further substantive submissions to Ofcom on 14 October 2008 in relation to the points raised by the Disputes ("the BT Submission"). In the BT Submission, BT essentially argues that (a) Ofcom should not consider the Disputes; and (b) that it should, as BT describes it, "summarily dismiss" them.
- 2.46 In particular, BT argues that it is not jurisdictionally or procedurally appropriate for Ofcom to consider the claims of the Disputing CPs using our dispute handling powers. BT suggests that the claims would be better considered as allegations that BT has failed to comply with its regulatory obligations.
- 2.47 BT has further argued that we should "summarily dismiss" the Disputes on the grounds that BT has a legitimate expectation that we would not address these issues on a historical basis and/or that we are estopped from considering the issues, and that the dispute submissions are based on incorrect financial data and methodology.

Assessment of whether to accept the Disputes

- 2.48 We have carefully considered BT's arguments summarised above in light of our statutory duties and powers.

⁴⁰ See letter of 10 October 2008 from Theresa Brown (Director of Regulatory Affairs, BT Wholesale) to Martin Hill (Ofcom).

⁴¹ Letter from Neena Rupani (Head of Broadband and Data Connectivity Regulation, BT) to Ian Vaughan (Ofcom) dated 24 November 2008.

- 2.49 Section 186 of the Act requires Ofcom to handle a dispute referred to it under and in accordance with section 185 (as is the current case), unless Ofcom considers (amongst other matters) that there are alternative means available for resolving the dispute. Further, Ofcom has issued guidelines for the handling of disputes (“the Dispute Resolution Guidelines”) ⁴² which set out the evidence that Ofcom requires before it will accept a dispute. Our Dispute Resolution Guidelines⁴³ make clear that the information that a complainant is required to provide when submitting a dispute is details of the relevant *ex ante* conditions, a clear statement of the scope of the dispute, details of the preferred remedy (with reasons), evidence of commercial negotiations and a statement of an officer of the company that best endeavours have been used to resolve the dispute through commercial negotiation.
- 2.50 If Ofcom has decided that it is appropriate for it to handle the Disputes, then Ofcom, under section 188 of the Act, must consider the Disputes and make a determination for resolving them.
- 2.51 Having considered the Altnet Dispute Submission, the COLT Dispute Submission and BT’s initial comments, Ofcom is satisfied that the Disputes are disputes between CPs relating to network access. In particular, Ofcom considers that these disputes in relation to the price paid by the Disputing CPs for PPCs relate to the terms or conditions on which network access is provided by BT to each of the Disputing CPs, in accordance with section 185(8)(a) of the Act.
- 2.52 Further, Ofcom is satisfied that the Disputes meet the requirements set out in the Dispute Resolution Guidelines as to the evidence that must be provided before Ofcom will accept a dispute. First, we do not accept BT’s argument that we should dismiss the Disputes because the Altnets’ and COLT’s Submissions were based on incorrect financial data and contained methodological errors. We consider that the evidence provided by the Disputing CPs is sufficient in accordance with our Dispute Resolution Guidelines for us to accept the Disputes. Secondly, on the basis of the history of negotiations set out in **Annex 12** below, Ofcom is satisfied that BT had suspended commercial discussions both in relation to the Altnets and to COLT and that the matters in dispute would not be resolved through further negotiation between the Parties.
- 2.53 Ofcom has considered whether there are alternative means available for resolving the Disputes. Ofcom’s Dispute Resolution Guidelines make clear that where the market power of the Parties is unequal, alternative forms of dispute resolution are unlikely to be effective and that regulatory intervention to resolve disputes is appropriate.⁴⁴ We consider that this is the case in relation to the Disputes.
- 2.54 As set out above, BT has submitted that we should “summarily dismiss” the Disputes on the grounds that BT has a legitimate expectation that we would not address these issues on a historical basis and/or that we are estopped from considering the issues.
- 2.55 Ofcom has a number of different powers under the Act. Ofcom’s dispute resolution power is a free standing power, which can be exercised alongside any other powers, such as its compliance enforcement power. Thus, Ofcom is not restricted from

⁴² Ofcom’s *Guidelines for the handling of competition complaints, and complaints and disputes about breaches of conditions imposed under the EU Directives*, July 2004:
http://www.ofcom.org.uk/bulletins/eu_directives/guidelines.pdf.

⁴³ See paragraph 44.

⁴⁴ See paragraphs 66 to 71 of Ofcom’s *Guidelines for the handling of competition complaints, and complaints and disputes about breaches of conditions imposed under the EU Directives* (www.ofcom.org.uk/bulletins/eu_directives/guidelines.pdf).

accepting disputes in cases where Ofcom might also have the power to investigate a breach of an SMP condition. As the CAT affirmed in the TRD decision⁴⁵, dispute resolution is a third potential regulatory restraint that operates *in addition to* other *ex ante* obligations and *ex post* competition law (emphasis added). To the extent that the BT's submission that we "summarily dismiss" the Disputes is intended to be to the effect that because Ofcom has separate statutory powers relating to contravention of conditions, Ofcom cannot accept the Disputes under section 186, we do not consider it to be correct as a matter of law. Further, to the extent that BT's submission is intended to be to the effect that Ofcom should not decide that it is appropriate to handle the Disputes under section 186, because there are alternative means available for resolving the Disputes, we do not consider in relation to these Disputes involving a number of separate bilateral disputes and on the facts of these disputes that it would be appropriate for Ofcom not to handle the Disputes on this basis.

- 2.56 Moreover, Ofcom does not accept BT's argument that Ofcom's conduct in relation to previous investigations and consultations had created a legitimate expectation to BT that PPC charges would only be looked at on a forward-looking basis and that Ofcom would not consider a dispute as to whether BT had been overcharging for PPCs for a prior period. Ofcom has a statutory duty to resolve disputes and cannot therefore fetter its discretion in this regard. In any event, we have examined our overall public statements, notices and correspondences with BT in relation to the PPC charges and concluded that there is no basis on which to argue that our conduct has given rise to a legitimate expectation by BT that its charges were approved by Ofcom or that Ofcom would not accept a dispute in relation to whether BT has overcharged for PPCs. Most importantly, contrary to BT's reliance on it, we do not consider that our decision to close our investigation into BT's PPC trunk charges in December 2005⁴⁶ and any comments made in that context can somehow be relied upon by BT in this way.⁴⁷
- 2.57 Similarly, we do not consider that Ofcom is estopped from exercising its duty in resolving the Disputes, as we cannot see how the criteria of estoppel by convention are met.⁴⁸ Ofcom is not a party to any transaction with BT; it is a sectoral regulator acting in accordance with its duties, powers and obligations under the Act. Moreover, it is not clear to us what BT considers to be the assumption that has led to the creation of the estoppel in this case, nor why it would be unfair or unjust to allow the parties to go back on their transaction if there has been overcharging.
- 2.58 On the basis of the above considerations, on 25 July 2008 and 2 December 2008 respectively, Ofcom decided that it was appropriate for it to handle the Altnet Dispute and the COLT Dispute for resolution on the basis of section 186(3) of the 2003 Act.

⁴⁵ *T-Mobile (UK) Limited and British Telecommunications plc and Hutchison 3G UK Limited and Cable & Wireless UK & Others and Vodafone Limited and Orange Personal Communications Services Ltd v Office of Communications, Judgment on the Core Issues* [2008] CAT 12, from paragraph 88: see www.catribunal.org.uk/files/Judgment_TRDs_200508.pdf.

⁴⁶ See http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_841/

⁴⁷ For more details, please see paragraphs 3.83 onwards.

⁴⁸ The criteria for estoppel were succinctly summarised by Birmingham LJ in *The Vistafjord* (1988 2 Lloyd's Law Rep 343 at 352), namely that it applies where: (i) parties have established by their construction of their agreement or their apprehension of its legal effect a conventional basis; (ii) on that basis they have regulated their subsequent dealings, to which Birmingham LJ added; (iii) it would be unjust or unconscionable if one of the parties resiled from that convention.

Scope of the Disputes

- 2.59 Ofcom informed the Parties of this decision and published details of the Disputes on its website on 28 July 2008 and 3 December 2008. After a period for comments on the proposed scope of the Disputes, Ofcom published the finalised scope of the Altnet Disputes on 27 August 2008:

“The finalised scope is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:

- i. BT has or will have overcharged the Parties for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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) and, if so;*
- ii. by how much the Parties will have been overcharged; and*
- iii. whether and by how much BT should reimburse the Parties.”⁴⁹*

- 2.60 BT proposed that the period of the Disputes be amended to end on 30 September 2008 on the basis that it had committed to implement the 2008 LLCC Consultation proposals from 1 October 2008. Ofcom agreed with the proposal to change the end date of the Disputes and amended the scope accordingly.
- 2.61 Although the COLT Dispute Submission included a request that BT be required to pay “relevant costs” as well as repay any overcharge with interest, COLT provided no qualification or quantification of what these “relevant costs” were. COLT also confirmed⁵⁰ that the scope of its dispute is identical to the Altnet Disputes (this view was not contested by BT). Ofcom did not, therefore, include the question of “relevant costs” in the proposed scope of the COLT Dispute that it published for comment. COLT raised no objection to this so the payment of “relevant costs” has not been considered when resolving the COLT Dispute.
- 2.62 At the time, Ofcom did not consider it would be possible to join COLT to the Altnets' disputes without causing delays to Ofcom's process of resolving the Altnet Disputes. For this reason Ofcom considered it appropriate to handle COLT's submission as a separate dispute, though with an identical scope.⁵¹ In light of the time that it has taken to address all the issues raised in the Altnet Disputes, we have now been able to publish our proposals to resolve the disputes brought by the Altnets and COLT in the same document.

Proposed conclusions on our use of the dispute resolution powers and the scope of the Disputes

- 2.63 Having considered the submissions made by all the Parties, Ofcom remains of the view that the Disputes were properly made under and in accordance with section 185

⁴⁹ The scope was published in Ofcom's Competition and Consumer Bulletin - see http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ocases/open_all/cw_992/

⁵⁰ Submissions from Nikkan Woodhouse to Martin Hill dated 3 October 2008 and from Ann Francis (Head of UK Regulatory and Business Development, COLT) to Martin Hill dated 10 November 2008.

⁵¹ See http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ocases/open_all/cw_1002/.

of the Act and Ofcom's Dispute Resolution Guidelines, that it is appropriate for it to handle the Disputes under section 186 of the Act and accordingly that it must consider the Disputes and make determinations for resolving them under section 189 of the Act. Therefore, Ofcom now sets out, having regard to the facts of the case and our duties and Community obligations under sections 3 and 4 of the Act, its proposals for resolving the Disputes.

Section 3

Proposed methodology for resolution

Overview

- 3.1 As identified in **paragraph 2.59** above, the scope of the Disputes is whether BT has overcharged the Disputing CPs for PPC services in the period 24 June 2004 to 30 September 2008.
- 3.2 For the purposes of resolving the Disputes, we are equating the Disputing CPs' concern that BT has overcharged them for PPCs with whether BT's charges for PPCs over the period were fair and reasonable.⁵² To test whether BT's charges were fair and reasonable, we have first looked at the consistency of BT's PPC charges with BT's cost orientation obligations, and then cross-checked our findings with the rates of return that BT has earned on PPCs and international benchmarking comparisons.
- 3.3 In carrying out our analysis of BT's charges, we believe that it is appropriate to do so at the individual PPC service level, rather than by considering all PPC services in aggregate as proposed by BT.
- 3.4 Our reasoning for reaching these proposed conclusions is set out in the rest of this section.

Assessing overcharging

Relevant factors to consider when assessing overcharging

- 3.5 BT and the Altnets disagree in their submissions as to how Ofcom should consider cost orientation, rate of return and international benchmarking. They reach different conclusions as to whether overcharging has taken place when applying them to PPC charges.

Cost orientation

- 3.6 Both BT and the Altnets have suggested that Ofcom should consider the cost orientation obligations imposed on BT in relation to PPC services when assessing whether overcharging has taken place. We believe that BT's cost orientation obligations should be the main factor in determining what charges are fair and reasonable.
- 3.7 The basis of charges (cost orientation) obligations imposed on BT in the PPC markets require that BT *"secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network*

⁵² The CAT has provided guidance as to the test that should be applied when assessing disputed transactions, emphasising that Ofcom should decide on the basis of what is fair and reasonable as between the parties. In paragraph 101 of its TRD judgment, the CAT stated: *"That test can be expressed as requiring OFCOM to determine what are reasonable terms and conditions as between the parties. The word "reasonable" in this context means two things. First it requires a fair balance to be struck between the interests of the parties [to the agreement in question]...But secondly, because OFCOM is a regulator bound by its statutory duties and the Community requirements it also means reasonable for the purposes of ensuring that those objectives and requirements are achieved."*

Access covered by Condition G1 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".

- 3.8 Accordingly, when it sets charges for PPC services, BT is required to do so in accordance with this condition. In assessing whether BT has set its charges for PPC services in accordance with this condition, we have considered in particular:
- (i) whether BT has allowed an appropriate mark-up for the recovery of common costs; and
 - (ii) taking each of the charges, whether BT should have ensured that this was the case on an individual service basis.
- 3.9 Our starting point is that the reasonable position for BT to take in ensuring its compliance with the cost orientation obligation was to allow an appropriate mark-up for the recovery of common costs. The charge for each service should be bound by the long run incremental cost ("LRIC") floor and the DSAC ceiling for that service unless BT had exceptional reasons for not doing so.⁵³
- 3.10 As a first order test, the maximum price that a firm can charge for a good or service in a contestable market (i.e. a market without entry barriers) is the SAC as any price above this level would attract entry into the market and result in the price being competed down to the SAC level. In the context of a multi-product firm such as BT, the setting of all prices at SAC would lead to over-recovery of common costs. It is therefore insufficient to simply assess whether an individual charge is below SAC and it becomes necessary to compare charges to cost ceilings for all relevant combinations of services (the so-called "combinatorial tests"). However, due to the number of services supplied by BT, carrying out combinatorial tests would be very complicated. Instead, a more practical test has been developed and applied by Of tel/Ofcom, which is that charges should not be above DSAC. This allows for the distribution of certain common costs amongst all the products bearing such costs (although other patterns of common cost recovery might also avoid over-recovery).
- 3.11 Of tel and Ofcom have consistently regarded the DSAC as being the appropriate cost ceiling against which to test BT's charges. For example, as early as 1997⁵⁴, and then again in 2001⁵⁵, Of tel published guidance (which remains in operation) as to how it would operate charge controls imposed on various of BT's network services and assess whether charges were "*unreasonable or otherwise anti-competitive*" in the context of its work on the network charge controls.⁵⁶
- 3.12 The Guidelines set out Of tel's intended application of floors and ceilings for testing BT's charges, including explaining in some detail Of tel's interpretation of LRIC and SAC for the purposes of network charge controls – i.e. the distributed LRIC ("DLRIC") and DSAC.⁵⁷ These cost measures differ from the individual service LRIC or SAC by

⁵³ The economic theory of cost orientation is discussed in more detail in **Annex 13** below.

⁵⁴ See http://www.ofcom.org.uk/static/archive/oftel/publications/1995_98/pricing/ncc1097.htm.

⁵⁵ See *Guidelines on the Operation of the Network Charge Controls* from October 2001 http://www.ofcom.org.uk/static/archive/oftel/publications/ind_guidelines/pcr1201.htm#b

⁵⁶ The Guidelines predate the introduction of PPCs as a product so the PPC charge control is not specifically referred to, though the guidance is of general application to network products and mention is made of the disputes that Of tel was addressing at the time in relation to PPCs.

⁵⁷ We note that the names "distributed LRIC" and "distributed SAC" originate from BT's LRIC Financial Statements.

taking account of the combinatorial tests (in a simplified fashion). Preceding its explanation of how BT should interpret and calculate the SAC ceiling charge (i.e. the DSAC), Oftel states that:

"In general, Oftel would consider a good first order test of whether a charge is unreasonable or otherwise anti-competitive to be whether the charge in question falls within a floor of long run incremental cost and a ceiling of stand-alone cost...A charge at the service level set below the floor could mean that BT was not recovering sufficient of the incremental cost of conveyance from the service and might indicate the possibility of anti-competitive behaviour. A charge at the service level set above the ceiling might mean that BT was recovering more than an appropriate share of the full (or stand-alone) costs in providing conveyance, which would indicate possible abuse of a dominant position in the market for the service.

*In investigating complaints about charges, Oftel would not apply the floors and ceilings test mechanistically. The floors and ceilings tests are an effective first order test for the likelihood of anti-competitive or exploitative charging. However, there may be circumstances in which charges set outside the band of floors and ceilings are not abusive, or charges set within the band are abusive. If asked to investigate charges, Oftel will seek to analyse the effect of the charge in the relevant market and will take a view on this based on the individual circumstances of each case."*⁵⁸ [Emphasis added]

3.13 As explained above, the Guidelines clearly explain that for the purposes of network charge controls, Oftel (and now Ofcom) would expect charges to fall between the DLRIC and DSAC, as a first order test. The Guidelines make clear that this test should not be applied mechanistically to individual services and that other factors need to be taken into consideration before it can be concluded that charges are abusive. Our consideration of BT's PPC charges against their DSACs and other relevant factors are set out in **Sections 5 and 6** below.

3.14 Whilst the Guidelines refer only to interconnection services covered by the network charge control, this reflects the fact that PPC services were not subject to a charge control at the time that the Guidelines were drafted. The Guidelines do however make reference to an investigation that Oftel was undertaking at the time into whether BT's PPC charges were cost oriented. Oftel explained that:

*"Once Oftel has resolved this dispute, it will consider whether it needs to place charge controls on PPCs. If Oftel decides to impose charge controls on PPCs, it will consult on the most appropriate way to incorporate these controls within the Network Charge Controls."*⁵⁹

3.15 Oftel and Ofcom have subsequently made clear that the cost orientation of PPC charges would also be assessed against whether the charges fell between the LRIC floor and the SAC ceiling:

⁵⁸ The Guidelines refer to the test applying to charges "at the service level". Although this phrase is not defined in the Guidelines, they do make clear that when assessing abusive charging, the test should be applied to interconnection services (see paragraph B.5 of the Guidelines) and that the appropriate floors and ceilings are those set out in BT's financial statements (see paragraph B.15).

⁵⁹ See paragraph 2.63 of the Guidelines.

- In March 2001, Ofcom published a Direction requiring BT to enter into agreement with a number of other providers of telecommunications services for the interconnection of PPC services ("the PPC Direction").⁶⁰ At paragraph 1.33 of this decision, Ofcom stated that it "would interpret the requirement for cost orientation as meaning any price between the long run incremental cost (LRIC) floor and stand alone cost (SAC) ceiling, subject to any relevant combinatorial and non discrimination tests also being satisfied." Ofcom confirmed this position in 2002 when resolving further disputes on PPCs, referring back to its comments in the PPC Direction.⁶¹
- In the 2004 LLCC Statement Ofcom explained that it "would interpret cost orientation of an individual service as being based on its long run incremental costs plus an appropriate mark up for common costs. In particular any individual price would be expected to typically fall between its long run incremental cost and its standalone cost ceiling."⁶²

3.16 Further, Ofcom notes that for the entire period under dispute, BT has included statements on the use of DLRIC and DSAC in its relevant accounting documents. In section 5.3.3 (*Network Components, Combinatorial Tests and DLRICs*) of its 2005 *Primary Accounting Documents*⁶³ BT notes:

"A way of ensuring that fixed common costs are recovered in the revenues is to conduct combinatorial tests whereby the aggregate revenue of services straddling the fixed common costs are required to equal or exceed the LRIC of these services measured as a single increment.

Combinatorial test have not been specified in the case of the Core increment. Instead, the recovery of the Intra Core Fixed Common Costs has been prescribed by Ofcom through the use of distributed LRICs ("DLRICs") in determining cost floors. This restricts pricing flexibility by setting a price floor for components in excess of the actual LRICs. Ofcom uses this restriction in order to avoid complex combinatorial tests."

3.17 Furthermore in section 5.3.5 (*Distributed Stand Alone Cost (DSAC) of Network Components*) BT goes on to note:

"A similar approach is taken with Stand Alone Costs in order to derive ceilings for individual components. The economic test for an unduly high price is that each service should be priced below its Stand Alone Cost. As with price floors this principle also applies to combinations of services. Complex combinatorial tests are avoided through the use of DSACs, which reduce pricing freedom by lowering the maximum price that can be charged. This results in ceilings for individual components that are below their actual SACs."

⁶⁰ See <http://www.ofcom.org.uk/static/archive/ofcom/publications/licensing/2001/ppcs0301.htm>.

⁶¹ See paragraphs 3.127 and 3.128 of *Partial Private Circuits, Phase Two – a Direction to resolve a dispute concerning partial private circuits*, 23 December 2002:

www.ofcom.org.uk/static/archive/ofcom/publications/broadband/leased_lines/ppc1202/ch3.htm.

⁶² See paragraph 5.24 of the 2004 LLCC Statement:

http://www.ofcom.org.uk/consult/condocs/ppc_charge_control/statement/ppc_stmnt.pdf

⁶³ See:

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2005/PrimaryAccountingDocument2005.pdf>

Equivalent text appears in BT's *Primary Accounting Documents* for all the years of the Disputes.

- 3.18 For the purposes of BT's LRIC model, BT's wholesale network is divided into five increments.⁶⁴ PPC services fall within the Core increment of BT's LRIC modelling. They are therefore covered by BT's statements above.
- 3.19 Further, BT uses the DLRIC and DSAC floors and ceilings in its Regulatory Financial Statements, under the heading of "Cost orientation".⁶⁵
- 3.20 It is our view that the use of cost ceilings (and the DSACs that underlie them) as a benchmark for overcharging is both compatible with our duties and Community obligations, and conceptually straightforward to implement. It is therefore our proposed primary mechanism for assessing whether overcharging has taken place when resolving the disputes. Specifically, we believe that using cost ceilings to assess overcharging:
- a) applies a methodology known by and apparently accepted by the Parties in advance of the period of the Disputes and therefore accords with any expectations that the Parties might have had as to the approach Ofcom might take to overcharging disputes taking into account BT's SMP obligations and in particular its cost orientation obligations;
 - b) restricts BT's ability to price in a way that exploits its significant market power, thereby protecting those who purchase the services and the consumers of retail leased lines;
 - c) avoids distortions in downstream competition;
 - d) allows BT reasonable flexibility to efficiently recover its common costs;
 - e) minimises any distortions in BT's incentives to improve efficiency;
 - f) promotes efficient investment and entry decisions;
 - g) provides regulatory consistency over time as the guidelines were published, and so known to BT and its customers (including the Disputing CPs), before the period covered by the Disputes; and
 - h) avoids reliance solely on actual rates of return (on a FAC basis) which potentially could harm incentives for efficiency.

Accounting rate of return assessment

- 3.21 As discussed in **paragraphs 2.31 to 2.35** above, the Disputing CPs have suggested that the overcharging assessment should be based on a comparison of the ROCE that BT has earned on its PPC services with BT's WACC. Where BT has earned a ROCE that is higher than its WACC, the Disputing CPs argue that overcharging has occurred.

⁶⁴ See section 5.3.1 of BT's 2005 Primary Accounting Documents.

⁶⁵ See, for example, page 30 of BT's regulatory financial statements for 2008, which relates to services in the low bandwidth TISBO markets. The DSAC ceiling is referred to as the 'LRIC Ceiling': www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2008/Currentcostfinancialstatements2008.pdf

- 3.22 BT agrees that a rate of return assessment is one indicator of whether overcharging is occurring, though it argues that this assessment should be carried out over a period of time rather than just one year. BT suggests that only in instances where its average ROCE for PPC services consistently and seriously exceeded an acceptable level over the medium to long term could it be argued that it had overcharged. BT further noted that it is unreasonable to expect it to set charges so precisely as to make a ROCE exactly equal to WACC, given that charges are set in advance.
- 3.23 Clarifying this further, BT suggests that returns over the duration of an entire charge control should be considered and that it would be perverse for cost orientation to be interpreted in such a way as to permit lower returns than might be made under a price cap. The ROCE for PPCs as a whole ought to be considered cost oriented as long as it is not materially above the cost of capital for the years in question.
- 3.24 We agree with the Parties that rate of return assessments are one appropriate indicator of whether overcharging has taken and/or is taking place. However, we have concerns about placing too much emphasis on this factor for our assessment of overcharging. We agree that the assessment of accounting rates of return on the basis of fully allocated costs (as allocated by BT) is a useful tool in considering whether overcharging may have occurred, and the potential scale of any such overcharging. But we disagree that it should be the central element of any overcharging analysis and that it needs to be viewed in conjunction with other types of assessment.
- 3.25 Setting a rate of return and only allowing BT to earn returns up to that level would effectively mean the imposition of rate of return regulation. We do not believe that such a regulatory regime creates the right incentives for BT to reduce its costs and increase efficiency, and thereby achieve the best outcome for consumers. We therefore believe that to resolve the Disputes by setting a charge which allowed BT no more than its WACC would be inconsistent with Ofcom's duties and Community obligations and so not fair and reasonable.
- 3.26 In the 2004 LLCC Statement we explicitly stated that we did not intend to introduce rate of return regulation for these very reasons, and instead opted for cost orientation obligations supported by an RPI-x charge control.⁶⁶ By separating the level of prices from the firm's incurred costs for a period of time, a RPI-x price cap creates an incentive for the regulated firm to increase its cost efficiency over and above that forecast when the cap was set. The firm benefits from these unanticipated efficiency gains through increased profits within the price control period. RPI-x charge controls are generally only set where there is little prospect of competition forcing down prices. Where a market is considered to be prospectively competitive (as the PPC trunk market was considered in 2004), charge controls would not generally be imposed as competition is expected to force down charges in the medium term. A cost orientation obligation is imposed to prevent charges from increasing unjustifiably in the short term.
- 3.27 The efficiency incentives created by RPI-x regulation mean that it is used widely by many economic regulators in the UK (e.g. the Office of Rail Regulation, Ofwat and the Civil Aviation Authority).
- 3.28 Moreover, beyond the conceptual concerns over the appropriateness of a rate of return assessment and its impact on BT's incentives, there are practical difficulties in

⁶⁶ See paragraph 2.13 of the 2004 LLCC Statement:
<http://www.ofcom.org.uk/consult/condocs/llcc/leasedlines.pdf>.

implementing such an assessment. These difficulties arise from the fact that it is insufficient for the purposes of identifying overcharging to merely demonstrate that BT has earned returns in excess of its cost of capital. There are a number of reasons for this, including:

- **regulatory regime** – TISBO services are covered by a RPI-x charge control. The key feature of such a control is that it creates incentives for the firm to increase efficiency so as to increase its profitability. Therefore, the existence of returns in excess of the cost of capital is entirely consistent with the existence of a charge control on TISBO;
- **shocks** – firms do not operate under conditions of perfect certainty, as a consequence they are subject to both demand and supply side shocks. For example, if demand for the service increases relative to expectations, this may result in a temporary increase in profitability. Alternatively, if consumer demand declines due to a slowing of economic growth then profitability may also decline;
- **common cost allocation** – the rate of return assessments adopted by the Parties are accounting rates of return that are based on BT's fully allocated costs. BT's view of fully allocated costs represents only one view of common cost allocation. As discussed in **Annex 13** (and in **paragraphs 3.9 to 3.20**), the view of common cost allocation embodied in BT's FAC measures may not necessarily be the only reasonable pattern; and
- **other measurement difficulties** – it is difficult to estimate accurately the ROCE for a firm. While accounting information may allow the calculation of an accounting ROCE, this may not accurately reflect the 'true' or underlying profitability for a range of possible reasons (such as if there is significant leasing activity by the firm or substantial intangible assets).

3.29 In Ofcom's view, a rate of return assessment is therefore a useful indicator of potential overcharging for individual services. However, given the concerns highlighted above, we do not believe that it is a sufficiently robust or appropriate assessment to form the main basis of our resolution of this case. Therefore, while we do not propose to rely on an assessment based solely on BT's rates of return, we agree with the Parties that it could provide some useful additional insight when used in combination with other approaches. See **paragraphs 5.17 to 5.22** below, where we set out our analysis of the rates of return that BT has earned on PPCs.

International price benchmarking

- 3.30 As part of its submission of 14 October 2008 in relation to the issues raised by the Disputing CPs, BT included a report that it had commissioned from Deloitte ("the Deloitte Report").⁶⁷ In addition to discussing (and in many cases, rebutting) the adjustments to BT's PPC data proposed by the RGL Report (which is discussed in **Section 4** below), the Deloitte Report also provided details of benchmarking work that Deloitte had carried out on the level of PPC charges in other EU Member States.
- 3.31 BT argued that a comparison of its PPC charges with those set by incumbent operators in other EU Member States, which face similar regulation to that imposed on BT in the UK, should help inform our thinking as to whether BT has overcharged for PPCs. BT noted that the Deloitte Report suggests that BT's PPC charges are in

⁶⁷ See Annex 15.

line with or lower than those of other EU incumbent operators and that this suggested that BT was not overcharging for PPC services.

- 3.32 As we noted in the 2008 BCMR Consultation⁶⁸, in order for benchmarking data to be meaningful, it is important to ensure that, as far as possible, the circumstances being compared are as similarly defined as possible.
- 3.33 In the case of PPCs, this would mean comparing products across incumbents that are:
- similarly defined; and
 - subject to similar levels and types of regulation.
- 3.34 Although Deloitte has sought to derive comparable price data using the information available to it, in our view the services being compared are differently defined and face different levels of regulation.
- 3.35 Despite Deloitte having selected European countries that operate under the same EU regulatory framework, there are clear differences in the level of competition in those countries and the regulation that has been imposed.
- 3.36 Deloitte itself appears to acknowledge the difficulties in carrying out meaningful benchmarking analysis of PPCs in the 'Methodology' section of its report. It noted that the "*structure of PPCs and tariffs differ widely across the benchmark sample making it difficult to make an exact like-for-like comparison across a wide range of countries*".⁶⁹ Deloitte went on to add that: "*Prices across countries may differ for a number of reasons, including but not limited to different geographies and effectiveness of regulation*".⁷⁰
- 3.37 As discussed in **Section 2** above, BT has had regulation imposed in the terminating segment and trunk markets – including cost orientation obligations in all these markets. Of the nine incumbents⁷¹ that Deloitte has chosen to compare against BT, only four have had regulation imposed on them in the trunk market and of these only two had a cost orientation obligation imposed on trunk charges.⁷²
- 3.38 The regulatory basis under which these incumbents are operating and setting charges is therefore clearly different.
- 3.39 Deloitte does not specifically consider trunk charges. Rather it provides an analysis of:
- PPC terminating segments (including local end access); and
 - PPC terminating and trunk segments combined.

⁶⁸ See paragraphs 7.69 to 7.79 of the 2008 BCMR consultation:
www.ofcom.org.uk/consult/condocs/bcmr/bcmr_pt3.pdf

⁶⁹ Paragraph 48 of the Deloitte Report.

⁷⁰ Paragraph 48 of the Deloitte Report.

⁷¹ The Deloitte Report does not contain details of the regulation imposed in Portugal. The figures provided relate to the eight countries for which Deloitte has provided information.

⁷² Of these latter two, Ireland is currently considering the removal of the SMP designation in the trunk market.

- 3.40 The absence of specific information on trunk charges in itself makes it difficult to draw any useful insights from the benchmarking in relation to trunk charges. Theoretically it is possible that considering the two service groups identified above in combination could allow some information on trunk charges to be inferred. However, while this is conceptually possible, reflecting the international differences in competition and regulations, Deloitte's analysis with respect to terminating and trunk segments combined suffers from some very important limitations which undermine any such analysis.
- 3.41 The principal difficulty with the terminating and trunk segment analysis is that in a number of cases (four out of nine countries), trunk charges are not disclosed by incumbents as the trunk markets have been found to be competitive. As a consequence, Deloitte has used the terminating segment charges as a proxy for trunk charges. This is clearly unsatisfactory when it is the trunk charges that are of specific interest.
- 3.42 For the remaining countries it is not clear that the boundary between the terminating segment services and the trunk services is consistently defined across the countries, a factor that Deloitte noted in its report.

"The boundary between what constitutes a PPC terminating segment and a PPC trunk segment is not clear-cut. The European Commission acknowledges that the appropriate boundary will differ across different markets according to the specific network topology."⁷³

- 3.43 Therefore, whilst the international benchmarking data may provide some assistance in assessing whether BT has overcharged for PPC terminating segments, we consider that the scope and underlying data difficulties highlighted above mean that it is not possible to draw any reliable inferences from it in relation to BT's trunk charges. We consider the extent to which the international benchmarking data affects our analysis of overcharging in **Section 5**.

Conclusion

- 3.44 On the basis of the analysis set out above, we believe that all three factors, i.e. cost orientation, rates of return, and international price benchmarking, may be useful tools in resolving the Disputes. Of these, we consider that the primary weight should be given to the cost orientation assessment. None of the Parties to the Disputes have suggested that other factors are relevant and we have not identified any other factors that we should consider as part of our methodology for resolving the Disputes.
- 3.45 We propose to assess whether BT's charges were fair and reasonable by first assessing whether BT set its charges at or below the DSAC ceiling, in line with the Guidelines. We will also use rates of return and benchmarking as a means of checking the sense of the results of our cost orientation assessment.

Which services should the methodology be applied to?

- 3.46 Having identified the appropriate factors by which to assess whether BT has overcharged for PPC services, we need to identify what services this assessment should be carried out against. Essentially the key issue is to establish the appropriate level of service aggregation or disaggregation for resolving the Disputes.

⁷³ Paragraph 58 of the Deloitte Report.

- 3.47 This question is relevant to all three factors that we intend to use to assess whether BT has overcharged for PPC services, but is of particular importance to the cost orientation ceiling assessment. As explained in more detail in **Section 5**, the decision on whether to look at individual services or aggregated services is crucial in determining whether the cost ceiling assessment suggests that BT has overcharged.
- 3.48 The BT Submission put forward a number of arguments as to why PPC charges should be considered in aggregate (i.e. across TISBO and trunk combined), rather than on an individual service basis.
- 3.49 Firstly, BT argued that trunk is never purchased separately by CPs but is always purchased together with terminating segments. As such the charge for trunk is merely notional and should not be looked at in isolation from terminating segments charges.
- 3.50 BT further suggested that the Altnets have recognised the need to look at PPCs as a whole in their dispute submission, quoting:

“For the purposes of this dispute referral, we request that Ofcom award compensation based on trunk and terminating segments in aggregate i.e. based on BT’s over-recovery across PPCs as a whole.”⁷⁴ [BT’s emphasis]

- 3.51 BT commissioned a report by Tim Keyworth⁷⁵ for the purposes of responding to the Disputes (“the Keyworth Paper”). The Keyworth Paper makes four main points as to why it is appropriate to consider PPC charges on an aggregated basis:
- (i) BT supplies only PPCs, rather than separate trunk and terminating services;
 - (ii) The distinction between the trunk and terminating segments is blurred;
 - (iii) Ofcom has, in the past, clearly recognised uncertainties over the allocation of costs between trunk and terminating segments; and
 - (iv) The nature of the alleged economic harm relies on BT having raised the overall costs of provision of leased line services in downstream markets.
- 3.52 The Keyworth Paper notes that BT never sells trunk services in isolation and suggests that BT’s PPCs provide “*end-to-end connectivity products*”, which are sub-divided for charging purposes into trunk and terminating segments.⁷⁶
- 3.53 BT recognised in its submission that the cost orientation obligation requires that each and every charge be cost oriented and therefore seeks to argue that Ofcom’s assessment is not based on an assessment of each and every charge but on the basis of “*sub-portions or components of charges*”.⁷⁷ BT then argues that the cost orientation applies to ‘network access’ and argued that network access is only possible if trunk is sold with terminating segments.
- 3.54 The Keyworth Paper argues that the distinction between trunk and terminating segments is effectively “*a regulatory construct*” and notes that Ofcom is proposing an

⁷⁴ Paragraph 2.90 of the dispute submission of 25 July 2008.

⁷⁵ Tim Keyworth is an economist specialising in the assessment of regulatory and competition policy issues.

⁷⁶ Paragraph 10 of the Keyworth Paper, dated 13 October 2008.

⁷⁷ Paragraph 12 of BT’s submission of 14 October 2008.

alternative definition to trunk in the 2008 BCMR Statement than that which it defined in the 2004 LLMR Statement. BT estimates that this change in definition would result in 50% of trunk segments being reclassified as terminating segments. The Keyworth Paper concludes that the split between trunk and terminating segments is therefore inexact and that this is further evidenced by the lack of consistency across EU member states as to the definition of trunk services.

3.55 The Keyworth Paper also claims that Ofcom has previously recognised uncertainties between trunk and terminating segment costs. In particular, the Keyworth Paper makes reference to Ofcom's decision to close its own-initiative investigation into BT's PPC trunk prices in 2005, drawing attention to Ofcom's statement that the "*concerns raised in the investigation transcend two markets*".⁷⁸ The Keyworth Paper interprets this to mean that concerns in relation to trunk charges require the assessment of both trunk and terminating segment charges.

3.56 BT additionally made reference to Ofcom's comments in relation to trunk returns in the 2008 BCMR Consultation:

*"The results need to be assessed against the background of the quality of data which form the basis to this analysis. It is somewhat counterintuitive for trunk returns to be above the returns associated with origination/termination markets and it is therefore important to consider whether the recorded cost data are sufficiently robust and accurately reflect 'true' costs of provision."*⁷⁹

3.57 The Keyworth Paper also seeks to argue that there is arbitrariness in terms of the definition of trunk and terminating segments for pricing purposes, noting that a pricing algorithm is used to calculate trunk and terminating segment charges. This algorithm is based on a notional routing of a PPC, and does not necessarily reflect the actual routing of that PPC.

3.58 Reference is also made in the Keyworth Paper to the fact that common costs need to be allocated between trunk and terminating segments. The Keyworth Paper suggests that there is uncertainty over this allocation and quotes from statements made by Ofcom in the 2004 LLMR Statement⁸⁰, the 2008 BCMR Statement and the closing Competition Bulletin entry for Ofcom's own-initiative investigation into BT's PPC trunk prices to support this view.⁸¹ In light of these uncertainties, BT suggested that PPC costs and charges should be looked at on an aggregated basis.

Ofcom's view on the appropriate level of service aggregation

3.59 In carrying out our analysis, we do not accept BT's arguments set out above that we should only consider PPC charges on an aggregated basis (i.e. across trunk and terminating segment services combined), rather than the charges for individual PPC services.

3.60 We have looked at the PPC charges and returns on an aggregated basis but do not think that this can be the only relevant assessment. Indeed, we do not believe that such an assessment would be consistent with the regulation that we have imposed

⁷⁸ See http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_841/.

⁷⁹ See paragraph 7.378 of the 2008 BCMR Consultation at:
http://www.ofcom.org.uk/consult/condocs/bcmr/bcmr_pt3.pdf

⁸⁰ Paragraphs 2.189 and 2.190 of the 2004 LLMR Statement.

⁸¹ Paragraphs 15 to 17 of the Keyworth Paper.

on BT in relation to PPCs which is applied to the different services that make up a PPC. It is therefore Ofcom's view that the appropriate level of aggregation to apply our assessment mechanisms is at the individual service level. As we go on to explain in this Section, our view is based on an assessment of the obligations imposed on BT and the economic principles and duties that underlie those obligations. The key points are:

- a) **Separate markets and regulation** – trunk and terminating segments are treated as separate markets in the 2004 LLMR Statement, with regulation being applied to each market separately. As BT successfully argued in the TRD appeal, this treatment renders it illogical not to consider the distinct services separately⁸² (see **paragraphs 3.61 to 3.91** for further details);
- b) **Regulatory certainty** – like Ofcom, the Parties all appear to have understood that the SMP obligations relate to individual services. It would therefore introduce regulatory uncertainty (through regulatory inconsistency) if Ofcom was to deviate from this interpretation (see **paragraphs 3.92 to 3.97**);
- c) **Charge control incentives** – allowing BT to combine some markets which have RPI-x charge controls imposed with those that do not, would act to reduce BT's incentives to improve efficiency and grow volumes, and therefore undermine the entire rationale for implementing charge controls. These efficiency gains benefit consumers through lower prices in future control periods. This therefore appears inconsistent with our duties and Community obligations (see **paragraphs 3.98 to 3.104**); and
- d) **Economic harm** – we do not accept BT's rejection of the potential for economic harm arising from imbalanced prices for trunk and terminating segments. Not only could price imbalances have affected consumption patterns, but they could also give rise to inefficient investment decisions by BT's competitors in the trunk segment market. This in turn could have negative impacts for consumers (see **paragraphs 3.105 to 3.110**).

a) Trunk and terminating segments are in separate markets and face separate regulation

- 3.61 As set out in **Section 2**, Ofcom concluded in both the 2004 LLMR Statement and the 2008 BCMR Statement that PPC trunk and terminating segments comprised separate markets. SMP regulation was imposed in each of the following three markets: low bandwidth TISBO (terminating segments), high bandwidth TISBO and trunk. BT recognises in the BT Dispute Submission that it was appropriate for Ofcom to adopt these markets.⁸³
- 3.62 In Ofcom's view the wording of the cost orientation obligations imposed in each of the three PPC markets in the 2004 LLMR Statement very clearly supports the use of a disaggregated approach.
- 3.63 The wording of the obligations clearly states that:

“Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the

⁸² See the witness statement of Richard Budd, Regulatory Economics Manager at BT, as set out in **paragraph 3.65** below.

⁸³ See paragraph 10 of the BT Dispute Submission.

satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition G1 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.” [Emphasis added]

In our view the scope of this obligation is not ambiguous. BT must ensure that each and every one of its charges in each of the three markets are individually cost oriented.

3.64 In the determinations to resolve the Mobile Call Termination Rates disputes published by Ofcom in July 2007, we adopted a methodology that was based on considering the appropriateness of 2G and 3G termination rates through a blended version of the underlying rates.⁸⁴ In its appeal of these determinations to the CAT, BT successfully argued that 2G and 3G termination rates should be considered on a disaggregated basis on the grounds that they were treated as being separate services by the regulatory regime.⁸⁵

3.65 In his witness statement dated 4 September 2007, Richard Budd (Regulatory Economics Manager at BT) argued for BT that;

“2G and 3G termination services were accorded different regulatory treatment i.e. they were considered to be two separate services for regulatory pricing purposes. It is wholly illogical to ignore the fact that Ofcom itself had recognised the services to be distinct in this specific and relevant sense and then assessed the disputes as if they were not.”⁸⁶

3.66 We consider that, as with 2G and 3G termination services, PPC trunk and terminating segments are separate services that have been accorded different regulatory treatment. In the 2004 LLMR Statement trunk and terminating segments were clearly defined as separate markets for regulatory pricing purposes. Not only was an RPI-x charge control imposed on the two terminating segment markets, but all three markets separately had cost orientation obligations imposed upon them. Therefore, the separation between trunk and terminating segments is even clearer than for mobile termination. Different regulatory treatment was applied to each of 2G and 3G termination, but they were defined in the same relevant market. For trunk and terminating segments, not only were distinct regulatory obligations put in place but they were also determined to be in separate markets.

3.67 BT has sought to distinguish the facts in the Disputes from those in the TRD appeal, arguing that CPs were terminating calls on a mobile network operator's 2G or 3G networks, whereas the Disputing CPs are purchasing both trunk and terminating segments.⁸⁷ However, BT's argument ignores the fact that it is possible to purchase terminating segments on their own and secondly that, even if purchased together, the ratio of trunk / terminating segments is not fixed. Therefore, in both cases CPs are

⁸⁴ See www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_942/.

⁸⁵ *T-Mobile (UK) Limited and British Telecommunications plc and Hutchison 3G UK Limited and Cable & Wireless UK & Others and Vodafone Limited and Orange Personal Communications Services Ltd v Office of Communications, Judgment on the Core Issues* [2008] CAT 12. See www.catribunal.org.uk/files/Judgment_TRDs_200508.pdf.

⁸⁶ See paragraph 46 of the Witness Statement of Richard Martin Budd, dated 4 September 2007.

⁸⁷ See footnote 12 of BT's submission of 14 October 2008.

purchasing combinations of services that have different prices and that different CPs will purchase in different proportions and quantities.

- 3.68 Furthermore, in our view the distinctions between the circumstances of mobile termination and PPCs tend to strengthen the case for treating trunk and terminating segments separately. In the case of the TRD appeal the purchasing operator did not have the choice between buying 2G or 3G termination – the combination of 2G and 3G termination sold to the purchasing operator was under the control of the terminating mobile operator. In the case of PPCs, however, it is the purchasing operator that has the choice of whether to purchase terminating segments alone or to purchase both trunk and terminating segments. This strengthens the significance of separate consideration of trunk and terminating segments prices.
- 3.69 BT has also sought to argue that trunk segments are not, in themselves, network access and that they only become network access when combined with terminating segments. We do not agree with this argument.
- 3.70 The market for trunk segments is not confined to products offered over BT's network (albeit that the trunk was defined on the basis of points in BT's network in the 2004 LLMR Statement). Trunk is a separately defined service, being transmission capacity across a core network, and BT is not the only wholesale provider of trunk segments. CPs are able to use their own networks to self-supply PPC trunk services in a number of instances. On some occasions, CPs are purchasing PPC trunk services from CPs other than BT. It was estimated in the 2008 BCMR consultation that non-BT supply of PPC trunk services accounted for around 14% of the total PPC trunk market.⁸⁸
- 3.71 Ofcom also made clear in the 2004 LLMR Statement that although BT only provides trunk segments in combination with terminating segments, it did not rule out the possibility of BT being required to provide standalone trunk segments if requested.
- “As BT correctly points out, it was under no obligation to provide standalone trunk segments under the previous regulatory regime. However, standalone trunk segments are identical to those trunk segments provided with terminating segments and so would appear to fall within the scope of the market for trunk segments identified by Ofcom. Were Ofcom to receive a dispute in future regarding any refusal by BT to provide standalone trunk segments, it would have to consider the dispute on its merits and whether it would be reasonable to require the provision of such a product. ... However, Ofcom is not currently aware of any reason why such provision should be considered unreasonable.”⁸⁹*
- 3.72 The provision of trunk services enables CPs to link their own network with the access network connections (terminating segments) that they have purchased to link them with their customers. Regardless of whether the terminating segment is provided by the same CP that is supplying the trunk segment or by a different CP, the trunk segment still provides network access.

⁸⁸ See paragraph 7.370 of the 2008 BCMR consultation at: http://www.ofcom.org.uk/consult/condocs/bcmr/bcmr_pt3.pdf.

⁸⁹ Paragraph 8.18 of the 2004 LLMR Statement.

- 3.73 BT provides trunk segments as a result of an SMP obligation imposed in the trunk market that requires BT to provide network access on reasonable request.⁹⁰ It levies separate charges for trunk segments as compared to those for terminating segments (these trunk charges being as much as four and a half times the level of the terminating segment charge on a per kilometre basis for some bandwidths). It is therefore clear that trunk services are more than just a 'notional' service that should be considered as an increment to the terminating segment.
- 3.74 We also disagree with BT's view that the definition of trunk and terminating segments and the allocation of costs between these services is sufficiently unclear that we cannot look at PPC services separately but must instead look at them on an aggregated basis.
- 3.75 The distinction between trunk and terminating segments is not a purely regulatory construct, as is suggested by the Keyworth Paper. The trunk market was defined on the basis of standard approaches to market definition, as explained in detail in the 2004 LLMR Statement and the 2008 BCMR Statement. As discussed in **paragraph 3.70** above, the trunk market is not limited to products offered over BT's network but also includes trunk services provided by other CPs. The trunk market would exist independently of any regulation.
- 3.76 The precise dividing line between BT's trunk and terminating services is not an arbitrary regulatory decision, it reflects the constraints of BT's network architecture and the nature of the different services requested by BT's customers (some of which purchase trunk and some of which do not, or may buy terminating and trunk segments in differing proportions).
- 3.77 The fact that Ofcom has redefined the boundaries of trunk in the 2008 BCMR Statement does not mean that terminating segments and trunk do not have clear definitions. They do and are set out explicitly following each market review. Any alterations have been consulted on and represent Ofcom's response to issues raised by stakeholders and a decision to reflect more closely the principles underlying the definition of the trunk market. These definitions can and do change following market reviews as the markets (and Ofcom's understanding of them) develop, but the services were clearly defined in the 2004 LLMR Statement for the period of the Disputes and are clearly defined going forward in the 2008 BCMR Statement. For the period that the market review findings were in force, BT was bound by the definitions set out in the 2004 LLMR Statement as this formed the basis of the regulation for that period.
- 3.78 The Keyworth Paper argues that arbitrariness in the definition of trunk and terminating segments can further be seen in the pricing structure for PPCs. Reference is made to the fact that an algorithm is used to calculate trunk and terminating segment charges and that this algorithm is based on the notional routing of a PPC, rather than its actual routing.
- 3.79 As the Keyworth Paper acknowledges, this algorithm is used to avoid BT's actual routing of the PPC impacting on the price charged to a customer. It also encourages BT to route PPCs in the most efficient manner possible. The fact that it might not reflect the actual routing of the PPC does not create any ambiguity as to the definition of trunk and how its costs and charges should be calculated.

⁹⁰ SMP Condition H1 (set out in **Section 2** above).

- 3.80 We also do not believe that the issues raised by BT about the potential lack of clarity and precision as to the distinction between trunk and terminating segment costs are relevant to our consideration of the appropriate level of service aggregation.
- 3.81 In particular, we do not believe that BT's reference to paragraph 7.378 of the 2008 BCMR Consultation supports its argument. Although Ofcom suggested that it was necessary to consider whether the recorded cost data in relation to trunk returns was sufficiently robust, Ofcom concluded that there was no suggestion that BT's trunk costs had been understated but that instead it appeared that the high returns resulted from a lack of competitive pressure on BT:

*"We are however not aware of any reason to believe BT's costs to be understated here. It appears that BT has been able to sustain such high levels of profitability because trunk services, unlike most origination services, have not been subject to a price control. Since the 2003/04 Review was carried out, it appears that competitive forces in the trunk market have not constrained BT's pricing."*⁹¹

- 3.82 Similarly, BT's reference to paragraphs 2.189 and 2.190 of the 2004 LLMR Statement does not appear to support its argument. The discussion in paragraphs 2.189 and 2.190 of the 2004 LLMR Statement relates to Ofcom's attempts to identify the proportion of the total cost of providing an end to end leased line that is accounted for by trunk segments, rather than how costs should be allocated between trunk and terminating segments. Although Ofcom did identify that it did not have full visibility of BT's cost allocation methodologies, it did not identify that this was a specific problem or that the data that resulted was unreliable.
- 3.83 BT also seeks to take comfort from some of the statements made by Ofcom in an own-initiative investigation into BT's PPC trunk charges that was carried out between June and December 2005.⁹² In fact, Ofcom closed that investigation without reaching any conclusions on whether BT was complying with its cost orientation obligation in relation to its PPC trunk charges. The financial information available at the time was insufficient to allow Ofcom to make meaningful conclusions. Rather Ofcom agreed an action plan with BT to ensure that appropriate financial information would be available in future.⁹³
- 3.84 In particular, BT has placed emphasis on comments made by Ofcom in its closing statement on the own-initiative investigation that:

"Ofcom has decided to close this own initiative investigation into BT's prices for its wholesale trunk segments because the concerns raised in the investigation transcend two markets and would be better dealt with on a forward looking basis within the next Leased Lines Market Review (LLMR) which encompasses both markets."

⁹¹ See paragraph 7.378 of the 2008 BCMR Consultation at: http://www.ofcom.org.uk/consult/condocs/bcmr/bcmr_pt3.pdf.

⁹² Details of the own-initiative investigation, which was opened as a result of concerns raised by CPs, can be found on Ofcom's Competition Bulletin at: http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_841/.

⁹³ In line with the agreed action plan, new data was published by BT in its 2006/07 regulatory financial statements. This data helped inform Ofcom's assessment of the PPC markets in the 2008 BCMR Consultation but needed to be restated in the 2007/08 regulatory financial statements (see **paragraph 4.7** below). This Restated Data was used in our 2008 LLCC Consultation proposals and is used in resolving these disputes.

...

Any adjustment to PPC wholesale segments costs could lead to an adjustment of costs reported in the low and high bandwidth TISBO markets and may therefore have an impact on the assumptions used in determining the PPC terminating segments charge control.”⁹⁴

- 3.85 BT has sought to interpret this statement as Ofcom concluding that concerns in relation to trunk charges require the assessment of both trunk and terminating segment charges. We do not accept this interpretation. The ‘concerns’ referred to in the case closure statement were not whether or not BT’s charges for trunk services were cost oriented but instead related to the accounting treatment of certain costs. Ofcom stated in the case closure statement that:

“During the course of the investigation Ofcom identified a number of concerns relating to the accounting treatment of PPC trunk segments. These concerns primarily relate to the way that core transmission costs are split between PPC wholesale trunk segments (which fall into the Wholesale Trunk Segments Market and are regulated through basis of charges Condition H3), and PPC terminating segments (which fall into the Traditional Interface Symmetric Broadband Origination (TISBO) Markets, and are regulated through the PPC terminating segments charge control for low and high bandwidths). Additionally the derivation of reported revenues for PPC wholesale trunk segments may not be consistent with the methodology used by BT for third party billing.”

- 3.86 In the investigation, Ofcom had sought to carry out an analysis of BT’s trunk costs. This involved examining the costs that BT was seeking to recover through trunk charges and assessing whether it was appropriate for BT to include those costs (and the level of those costs) in the PPC trunk cost stack. This is a similar exercise to which Ofcom has carried out in resolving these Disputes and which is described in more detail in **Section 4**.
- 3.87 During the investigation, issues were raised as to the extent to which certain core transmission costs should be allocated between PPC trunk and PPC terminating segments. We had concerns that these core transmission costs were disproportionately allocated to terminating segments and that more costs should be allocated to trunk. The impact of this would have been to reduce the profitability of trunk. We were unable to identify whether the allocation of core transmission costs was appropriate and if not what the appropriate allocation should have been due to BT’s inability to provide us with the necessary data at that time.
- 3.88 Ofcom’s caution in relation to drawing conclusions on BT’s compliance with the trunk cost orientation obligations in 2005 has proved justified in light of the conclusions below. Although the data published in BT’s 2004/05 regulatory financial statements suggests that BT’s charges may have been above the cost ceiling in relation to trunk services as the average charge is above the published DSAC, once adjustments have been made to the financial data (including the adjustment identified by Ofcom in the 2005 investigation) the situation is far less clear cut.
- 3.89 Reallocating core transmission costs would also have led to us altering the level of costs that could be recovered through PPC terminating segment charges. This in turn

⁹⁴ See http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_841/

could have had an impact on the assumptions that we used when reaching our conclusions in the 2004 LLCC Statement. Given the potential for changes and the fact that the existing financial reporting data was insufficient to enable us to reach conclusions on this matter, we chose not to continue with the investigation. Instead, we required BT to prepare the data needed to quantify and correct the accounting problems identified (which BT has subsequently done). We reached no conclusion as to whether BT was complying with its cost orientation obligation or not.

- 3.90 In the current Disputes, we are not looking to carry out an assessment of the reallocation of costs between trunk and terminating segments. Instead, we are assessing whether, in light of our understanding of the allocation of core transmission costs (and other trunk and terminating segment costs) over the period of the Disputes, BT's PPC charges have been fair and reasonable.
- 3.91 We would additionally note that the decision we took to close the investigation in 2005 is consistent with our view that PPC charges should be looked at on a disaggregated basis. In 2005, we were unable to identify how certain costs should be apportioned between trunk and terminating segment services. Had we been of the view that aggregation was the appropriate approach to adopt it would not have mattered that we could not identify the appropriate apportionment as we would have looked at the cost as a whole.

b) Regulatory certainty

- 3.92 As explained above, we believe that the wording of the regulation imposed on BT is clear that compliance with the regulation requires the setting of charges with reference to individual services and therefore that the overcharging assessment should be made in relation to individual PPC services and not in relation to trunk and terminating services in aggregate.
- 3.93 We consider that BT has been operating under the assumption that this is the case. Although BT argues that the interpretation of its cost orientation obligation is not clear, BT's Primary Accounting Documents set out its view that the "*economic test for an unduly high price is that each service should be priced below its Stand Alone Cost*" [emphasis added].⁹⁵
- 3.94 Furthermore, in its regulatory financial statements, BT lists out the separate bandwidths of PPC trunk services under the heading "Services"⁹⁶ and separately lists in a separate section of the statements the individual connection, main link, distribution and local end PPC services (at different bandwidths), again under the heading "Services".⁹⁷ As explained previously, each service then has a DSAC ceiling associated with it under the heading of "Cost orientation".
- 3.95 The Altnets set out in their dispute submission that "*BT should not be allowed to offset losses on terminating segments against over-recovery on trunk*".⁹⁸ Basing a cost assessment on trunk and terminating segments combined could lead to this occurring. COLT additionally noted that although its submission was based on an aggregated assessment of PPC charges, it would expect Ofcom "*to be able to obtain*

⁹⁵ See the documents at www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/.

⁹⁶ See Section 4.8 – Wholesale Trunk Segments of BT's 2008 Regulatory Financial Statements: <http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2008/Currentcostfinancialstatements2008.pdf>.

⁹⁷ See Section 3.8 – TISBO (up to and including 8Mbit/s) and Section 3.9 – TISBO (above 8Mbit/s up to and including 155Mbit/s) of BT's 2008 Regulatory Financial Statements.

⁹⁸ Paragraph 2.82.2 of the Altnets' Dispute Submission.

a clearer overview of the detailed and disaggregated costs for PPC's" [emphasis added].⁹⁹

- 3.96 The Altnets also highlighted the effect of off-setting on the PPC charge control, noting that allowing off-setting "*would effectively de-risk the charge control from BT's perspective, since any shortfall in RoMCE due to failure to achieve efficiency savings in terminating segments could be clawed back by increasing charges in the trunk segment market*".¹⁰⁰
- 3.97 We therefore consider that it is not the case that the Disputing CPs argue solely for an assessment on an aggregated approach in their dispute submissions as the appropriate methodology to use for resolving the Disputes. Although the Altnets use an aggregated methodology to estimate the extent of overcharging they allege, it is important to note:
- the purpose of the submission was to demonstrate that there was a case to answer. The Altnets acknowledged in their submission that it is up to Ofcom to decide which methodology it believes is the most appropriate to use to resolve the Disputes;
 - the methodology used in the Disputing CPs' submissions was based on a belief that BT is overcharging across all PPC services and that, as such, the simplest way to assess this and calculate the level of overcharge was to assess the services in aggregate; and
 - the Altnets made clear in their submission to Ofcom of 5 September 2008 that, while they did have published information in relation to PPCs, they had proposed the methodology in their dispute submission due to the need for adjustments to be made to the published PPC data in relation to individual PPC services.

c) Aggregation risks damaging the incentive properties of the terminating segment charge control

- 3.98 As we have explained in **Section 2**, the 2004 LLMR Statement imposed a different regulatory regime on BT's terminating segment services as compared to the trunk services. Specifically, two terminating segment markets (i.e. low bandwidth and high bandwidth TISBO) were subject to separate RPI-x price cap charge controls. On the other hand, the market for trunk segments was not subject to a charge control.
- 3.99 The principal objective of imposing RPI-x price caps is to prevent prices from significantly deviating from costs in the absence of a competitive constraint. However, the benefit of using RPI-x as opposed to other forms of charge controls is that it encourages the regulated firm to pursue efficiency targets and volume growth. The maximum charges that the firm is allowed to charge under such regimes are determined by the value of X which reflects the regulator's view of what the efficient level of costs should be over the control period on a forecast basis. If the firm is able to outperform the assumed level of efficiency it benefits through higher profits over the remaining period of the control.

⁹⁹ See COLT's Dispute Submission of 20 October 2008.

¹⁰⁰ Paragraph 2.84.1 of the Altnet Dispute Submission. In this context, 'RoMCE' means return on mean capital employed.

- 3.100 The treatment of unexpected changes in efficiency is, however, symmetric. If the regulated firm under-performs against the efficiency targets embodied in the charge control it will earn lower profits than assumed in the charge control.
- 3.101 The direct and explicit link between the firm's performance and its profitability provides the efficiency incentives that are central to the RPI-x regime.
- 3.102 Allowing BT to aggregate across the three PPC markets (i.e. trunk, low bandwidth TISBO and high bandwidth TISBO) for the purposes of assessing overcharging would have significant implications for BT's incentives in the two terminating segment markets in which there are price cap controls.
- 3.103 Adopting BT's proposed aggregated approach would effectively allow it to compensate for failing to achieve efficiency savings or volume growth in the charge controlled terminating market(s) by exploiting its SMP position in the provision of non-charge controlled trunk services. This would act to reduce BT's incentives to improve efficiency and grow volumes, and therefore undermine the entire rationale for implementing RPI-x charge controls. In light of our duties and Community obligations, and taking into account our public statements in relation to BT's charge control and cost orientation obligations, it seems appropriate to us that the cost orientation obligations should be considered separately in relation to trunk and terminating segments
- 3.104 It is also instructive to consider the alternative situation, i.e. if BT were substantially outperforming the RPI-x control in the charge controlled terminating market(s) by achieving larger cost savings than anticipated. In such circumstances, aggregating the assessment across both terminating segments and trunk would increase the chances of finding overcharging. This would be so, even if trunk charges were not too high relative to trunk costs and BT was complying with the charge caps on terminating segments. In our view a finding of overcharging on such a basis would not be fair or reasonable, but could arise if BT's proposed aggregated approach was adopted.

d) BT's behaviour could give rise to economic harm

- 3.105 In its submission of 14 October 2008, BT argues that if economic harm was to arise from any overcharging, it would relate to the total level of charges for all PPC products, and not the mix of individual service charges. The implication of this view is that it would be consistent with our duties and Community obligations to consider the Disputes at an aggregated level as it is at this level that any harm would arise.
- 3.106 We disagree with BT on this point. In our view economic harm may arise from overcharging not only as a consequence of any elevation in the total level of charges, but also as a consequence of any distortions that may occur in the relative prices of the individual services. We explain this in detail from **paragraphs 6.10 to 6.22**. It is Ofcom's view that the prices of the underlying services are important in giving rise to distortions in both consumption and investment behaviours.
- 3.107 BT emphasises that trunk is not (currently) purchased separately, but is always purchased in conjunction with terminating segments. However, CPs do have choices in their purchasing decisions, which we expect to be affected by the relative prices for trunk and terminating segments. CPs can choose to purchase terminating segments alone from BT and self-provide trunk services (or purchase trunk services from another operator), or they can choose to purchase both terminating segments and

trunk services from BT. We expect the price of BT's trunk services to affect these choices.

- 3.108 It is clear from the data provided by BT that different CPs have different purchasing patterns in relation to PPC trunk services. **Figure 3.1** shows the percentage of each of the Altnets' PPC spend, split between trunk and terminating segments. It indicates that some CPs purchase proportionately less trunk than others.

Figure 3.1: Comparison of the relative spending patterns of the Altnets¹⁰¹

[X]

Source: Ofcom – based on data supplied by BT

- 3.109 If BT is undercharging for some services but overcharging for others such that the overall effect on the level of charges is neutral, BT's argument is that there would be no resulting economic harm. However, such pricing behaviour could distort decisions for rivals competing downstream over the relative consumption of the products (i.e. they would over-consume the relatively cheap services and under-consume the relatively expensive services). If applied generally it could, for example, allow anti-competitively low prices to be offset by excessive prices elsewhere, a practice sometimes referred to as "unfair cross-subsidy" and a form of exclusionary behaviour. This would reduce overall economic welfare. In addition, if by overcharging for a service BT inefficiently distorts the incentives for firms to enter the market, the pricing behaviour may lead to inefficient investment (entry by firms with inefficiently high costs) which would reduce economic welfare further.
- 3.110 It is therefore Ofcom's view that economic welfare could be reduced by allowing BT to balance its charges across different product markets. We therefore believe it is consistent with our duties and Community obligations to consider overcharging on an individual service level.

Proposed conclusions

- 3.111 For the reasons set out above we propose to reject BT's arguments as regards aggregation and consider that it is appropriate to consider the extent to which BT may have overcharged the Disputing CPs on the basis of an assessment of the charges levied for the individual services within the three markets defined in the 2004 LLMR Statement.
- 3.112 Although of particular importance in terms of our cost ceiling assessment, the question of whether to use aggregated or disaggregated services is also important to the rate of return and benchmarking assessments as it determines what comparisons should be made.
- 3.113 We believe that not only is such an approach consistent with the regulations (and their economic underpinning) that applied to BT during the period of the Disputes, but it is also consistent with our duties and Community obligations.

Consistency of the proposed approach with our duties and Community obligations

- 3.114 Ofcom believes that the proposed methodology outlined above for resolving the Disputes (i.e. considering the rates of return that BT has earned on distinct PPC

¹⁰¹ Data for COLT has not been included as comparable information was not requested from BT.

services, the cost ceiling benchmarks that arise from the cost orientation obligations that apply to those services and international benchmarking comparisons) is consistent with our statutory duties and Community obligations.

- 3.115 In light of the requirements of section 3(6) of the Act, we consider that when resolving the Disputes Ofcom must have regard to its duty to promote competition which is key to promoting the interests of consumers and delivering benefits to them. We must also have regard to the desirability of encouraging investment and the availability of high speed data transfer services.
- 3.116 Resolving the Disputes using the three factors set out in **paragraph 3.2** above would be consistent with our duties and Community obligations. The SMP conditions imposed on BT in the PPC markets are designed to help promote competition in the leased lines markets by providing CPs with the wholesale inputs they need to compete with BT's retail divisions. Considering BT's cost orientation obligations (and other relevant SMP conditions) and using these as a benchmark for resolving the Disputes will therefore help promote competition. Given that leased lines are high speed data transfer services, promoting competition will also encourage the availability of such services.
- 3.117 In considering the three factors we will need to ensure that we do so in a manner that is transparent, accountable, proportionate, consistent and that is targeted only where action is necessary. We do this in **Sections 5 and 6**. Before doing so, however, we first need to identify what data should be used as the basis for these assessments and this is discussed in **Section 4**.

Section 4

BT's costs of providing PPCs

Overview

- 4.1 In order to carry out the cost ceiling and rate of return assessments discussed in **paragraph 3.2** above, we require detailed data on BT's costs of providing PPCs and the revenue that it has generated from the provision of these services.
- 4.2 We propose to start by using information from BT's published regulatory financial statements (or the revised version of that data that we obtained from BT in the case of 2004/05 and 2005/06) and the underlying reporting system.
- 4.3 We then propose to apply adjustments to the PPC cost data and capital employed to allow us to calculate rates of return that are more relevant to the Disputes.
- 4.4 Finally, because the published DSACs are related to the unadjusted cost data, we propose to adjust the DSACs to reflect the changes in costs following the adjustments. The adjusted DSACs are used as the cost ceiling, as one of the factors for assessing overcharging.
- 4.5 We recognise that the determination of costs in a network business is not an exact science. In making the adjustments we propose to BT's financial data (to determine PPC costs) we are conscious that arguments could be made in favour of different levels of adjustments or the inclusion of additional adjustments. However, in line with the CAT's guidance that we should use the best information available to us when resolving disputes¹⁰², we propose to make what we believe to be the most reasonable and appropriate adjustments to BT's data for the purposes of resolving the Disputes.

The relevant base data for our calculations

- 4.6 The starting point for our analysis is the information set out in BT's regulatory financial statements. It was this data that formed the basis of the Disputes.
- 4.7 In June 2008, BT advised us of its intention to restate certain PPC data within its 2006/07 published regulatory financial statements as it had overstated the volume of internal PPCs sold and the revenue attributable to those services.¹⁰³ In particular, BT had identified that when calculating the volume of circuits used by its internal businesses, it had used the working system size ("WSS"),¹⁰⁴ as opposed to the revenue system size ("RSS")¹⁰⁵, which it used when calculating volumes sold to external customers. This had resulted in BT overstating both the volume of internal PPCs sold and the revenue attributable to those services (which is calculated on the basis of a transfer charge).

¹⁰² See *T-Mobile (UK) Limited and British Telecommunications plc and Hutchison 3G UK Limited and Cable & Wireless UK & Others and Vodafone Limited and Orange Personal Communications Services Ltd v Office of Communications, Judgment on the Core Issues* [2008] CAT 12, available at: www.catribunal.org.uk/files/Judgment_TRDs_200508.pdf.

¹⁰³ BT informed the AInets of the amendments to its 2006/07 regulatory financial statements in July 2008.

¹⁰⁴ Working system size is a term used by BT to describe the total number of circuits in existence.

¹⁰⁵ Revenue system size is a term used by BT to describe the total number of circuits that generate revenue.

- 4.8 BT corrected its preparation methodology when preparing its 2007/08 regulatory financial statements, including restating certain PPC data for 2006/07, and published the Restated Data in September 2008. BT did not publish restated financial statements for 2004/05 and 2005/06, though it did confirm to us that certain of the PPC data contained in these statements had also been inappropriately prepared.
- 4.9 In order to ensure that we had comparable data covering the whole period of the Disputes, we issued BT with a notice under section 191 of the Act on 1 October 2008 ("the Notice").¹⁰⁶ The Notice required BT to provide internal and external revenue and volume data for each PPC service (aggregating the n*64kbit/s services) and to calculate the respective DLRICs, FACs and DSACs for these services. BT was required to provide this data for each of the years in dispute (i.e. 2004/05 to 2007/08) and prepare it on the same basis as the 2007/08 regulatory financial statements. BT completed the provision of this Revised Data on 17 October 2008.¹⁰⁷

BT's views on the relevant data set

- 4.10 BT has argued strongly that we should use the Restated and Revised Data. In a letter to Ofcom of 8 August 2008, BT noted that the reason for the restatement was that the original data was found to have contained inaccuracies. BT argued that it would be inconsistent with our duties under section 3 of the Act for us to use data that we know to be incorrect.

Altnets' views on the relevant data set

- 4.11 In their letter to Ofcom of 8 August 2008, the Altnets argued that Ofcom should use the best available information to resolve the Disputes. At this time, the Altnets had not had visibility of the Restated Data, which was not published until September 2008.
- 4.12 Having had an opportunity to review the Restated Data, the Altnets made a further submission to Ofcom on 10 October 2008 in which they argued that Ofcom should not use this data when resolving the Disputes. They argued that there were fundamental and systematic problems with the Restated Data which made it unreliable. The Altnets' arguments were based on a second report prepared for them by RGL ("the Second RGL Report").
- 4.13 The Second RGL Report identified five main concerns with the Restated Data:
- (i) the lack of adjustment to PPC costs despite changes in PPC volumes and revenues;
 - (ii) obvious errors and inaccuracies in the restated accounts, including unit costs and volumes for PPCs not reconciling to the total costs shown in the accounts and the restated accounts not applying the revised PPC volumes in a consistent manner;
 - (iii) the absence of a clean audit opinion on the restated accounts in relation to the PPC markets;

¹⁰⁶ We had previously indicated to BT at the start of the Disputes that we would be requiring this data but did not request it at the time as BT had advised that it would not be able to begin preparing this data until after it had finalised and published the restated 2006/07 data.

¹⁰⁷ Details of the originally published data and the data provided in response to the information request are included in **Annex 14** below.

- (iv) the fact Ofcom had required BT to include a statement in the published regulatory financial statements in relation to Ofcom's concerns about the restatement of PPC volumes and revenues; and
 - (v) that BT had provided no clarity as to why it had needed to restate the accounts.
- 4.14 On the basis of the Second RGL Report, the Altnets argued that Ofcom should not use the Restated and Revised Data. The Altnets noted that they had previously provided Ofcom with a methodology that could be used to resolve the Disputes. They further suggested that as an alternative Ofcom could adjust the 2007/08 PPC data published by BT and then use the resulting unit costs, in conjunction with the revenue and volume data from previous years, to assess whether overcharging had taken place. The Altnets argued that the unit costs for 2007/08 were likely to be more reliable than those for previous years and that as PPCs are mature products, they should not differ significantly over the period of the Disputes.

Ofcom's assessment of the relevant data set

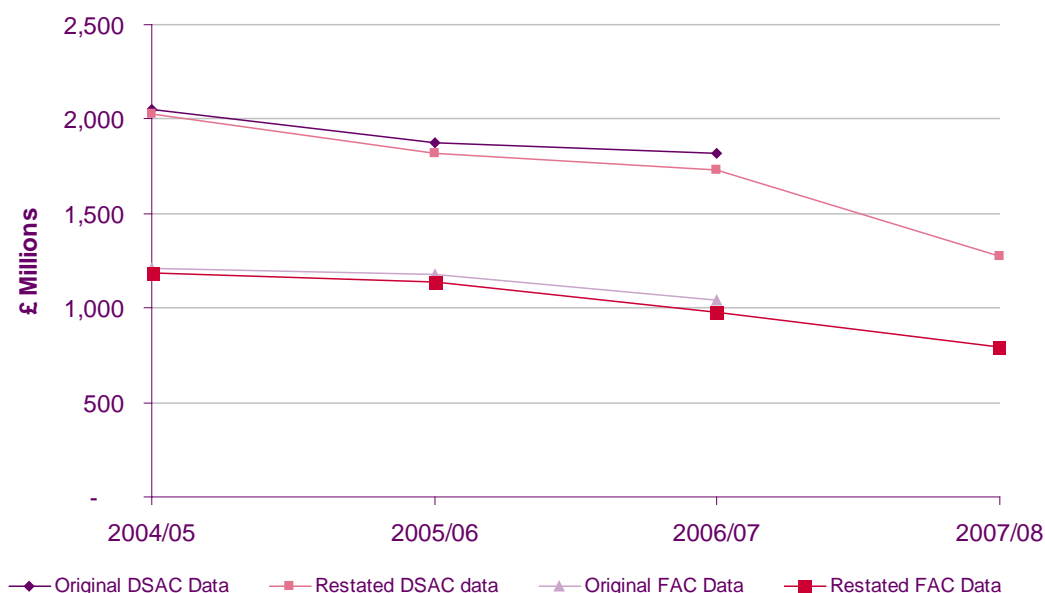
- 4.15 In order to help us assess the accuracy of the Restated Data, which has been audited by PwC, we commissioned consultants Analysys Mason to carry out an independent review of the restatement and supporting systems and processes that were used to prepare the restatement.¹⁰⁸ Analysys Mason concluded that the approach adopted by BT for calculating the revised turnover and volumes "*appears to be reasonable*" and that the restated data formed an appropriate basis on which to base the charge control. Analysys Mason were able to "*identify the cause of the vast majority of changes made in the 2006/07 restatement*" however they identified certain action points for Ofcom to follow up on. Most of the follow-up work has been completed and we have not identified any factors that would necessitate us amending the Restated Data. Further work is ongoing and should be completed before we publish our final conclusions in the Disputes. We are sufficiently comfortable with the checking of the Restated Data for us to propose to conclude that the Restated Data (along with the amended unit costs published by BT on 9 April 2009)¹⁰⁹ is the best available PPC information for 2006/07 and 2007/08 and for us to use it to reach our preliminary conclusions in these draft determinations.
- 4.16 As discussed in **paragraph 4.9** above, BT did not publish restated regulatory financial statements for 2004/05 or 2005/06, but instead supplied us, in response to a formal information request under our statutory powers, with revised data for this period that had been prepared on the same basis as the restated 2006/07 data. This Revised Data has not been audited by BT's auditors, PricewaterhouseCoopers ("PwC"), and was not examined by Analysys Mason during its review as it was not available at the time that the review was carried out. We have not, however, taken the data provided by BT at face value but have carried out work to satisfy ourselves that it appears reasonable.
- 4.17 We have required BT to reconcile the Revised Data back to the published financial statements for 2004/05 and 2005/06 and have reviewed BT's reconciliations. We have compared the aggregate total FACs and DSACs (in £million) of the two sets of data to ensure that they show similar trends (see **Table 4.1**, which compares published and restated/revised FAC and DSAC data). A significant portion of the

¹⁰⁸ A copy of the Analysys Mason study was published with the 2008 LLCC Consultation on Ofcom's website, see: <http://www.ofcom.org.uk/consult/condocs/llcc/>.

¹⁰⁹ See **paragraph 4.20** for details.

costs are fixed with respect to volumes and therefore we would not expect the volume restatement to significantly change total costs in £million.

Figure 4.1: Comparison of published DSACs with restated DSACs



Source: Ofcom – the individual DSACs and FACs for each PPC service have been aggregated to enable an overall comparison of the revised/restated data to the original data.

- 4.18 On this basis, we consider that despite the fact that the Revised Data has not been audited, this data constitutes the best available information in relation to 2004/05 and 2005/06 for resolving the Disputes.

Issues raised by the Altnets

- 4.19 Turning to the issues raised by the Altnets and the Second RGL Report, BT's restatement does not have a material impact on the total costs reported in the financial statements. As a result of the changes in some of the PPC volumes, the unit costs of some PPC services have increased or reduced as a result of the restatement.
- 4.20 As the Altnets have identified, the unit costs in the restated financial statements have not altered from those originally published. BT has advised us that this was an error on their part and that the original unit costs had been included rather than the restated unit costs. BT has supplied us with the revised unit costs and these have been used in our assessment. BT republished the corrected restated unit costs on 9 April 2009.
- 4.21 The Altnets have additionally called into question whether a 'clean' audit opinion has been provided to the restated financial statements, noting the statement in the audit opinion that:

"...the Re-stated Market Financial Statements for the year ended 31 March 2007 are fairly presented in accordance with the Primary Accounting Documents dated 21 August 2007, except where

*restated as explained in Notes 2 and 3 on pages 101 and 102 and comply with the requirements of the Final Statements and Notification.*¹¹⁰

Note 3 relates to the restated PPC revenues.

- 4.22 We have spoken to PwC and they have advised us that the “except where restated” comment set out above relates to the fact that the basis of preparation for the data has changed from that set out in the 2007 Primary Accounting Documents and that it should not be read so as to exclude the restated numbers from PwC’s unqualified opinion for the year. PwC have confirmed to us that they have provided an unqualified opinion in relation to the restated 2006/07 data.

Proposed conclusions on the relevant data set

- 4.23 Given that the Revised Data was obtained from BT using our formal information gathering powers and can be reconciled back to the data originally published by BT in its regulatory financial statements, we believe that it is the best available data from which to start our assessment of whether BT has overcharged the Disputing CPs for PPCs.

Removing non-PPC costs and revenues

- 4.24 The PPC data in BT’s regulatory financial statements has been prepared for the purposes of financial reporting. PPC terminating and trunk segments fall within the TISBO and trunk markets, but are not the only services that fall within these markets.
- 4.25 The Disputes we are considering relate solely to PPCs. Services such as Radio Backhaul Service (“RBS”), Site Connect, enhanced maintenance, resilient services and ancillary services, which also fall within the TISBO markets, are therefore out of scope of the Disputes. As a result, the costs and revenues associated with these services need to be excluded from our assessment. Some of these costs were individually included in the published accounts (e.g. RBS), others were included within the reported services and had to be separately extracted either by Ofcom through our adjustments described later in this Section or by BT when submitting the data in response to our section 191 information request (e.g. Site Connect).
- 4.26 In order to estimate some of the adjustments described below, we needed data at a more granular level than BT’s published accounts. We therefore used information from BT’s Additional Financial Statements (“AFS”), which give a breakdown of the published accounts information by service. BT does not publish these statements but provides them to Ofcom on a confidential basis.
- 4.27 In using data from the AFSs, we mirrored the changes that BT had made when restating the data in order to arrive at our own base data.
- 4.28 We performed two reconciliations around our base data. Firstly, we added the original AFSs and compared them to BT’s published accounts to ensure that they were consistent. Secondly, we reconciled our base data to the data BT provided in

¹¹⁰ See paragraph 18[d] of the audit Opinion on page 113 of BT’s 2008 Regulatory Financial Statements:

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2008/Currentcostfinancialstatements2008.pdf>.

response to the section 191 Notice. In both cases only minor differences remained, such as roundings up and down.

- 4.29 We additionally asked BT to reconcile their section 191 data to their published accounts.¹¹¹ We reviewed the reconciliations. Although some differences remained we are satisfied that, in the context and timeframe of a dispute, they were not significant enough to prevent us from relying on the data to resolve the Disputes.
- 4.30 **Table 4.2** below shows the percentage change (change in data as a percentage of the original data) in the overall revenues, FACs and DSACs that resulted from BT revising the way in which it prepared the financial data (negative percentages mean that the revised data is less than the original data). The absolute costs and revenues are set out in **Tables A14.1** and **A14.2** in **Annex 14** below.

Table 4.2: Change in data resulting from the revision, expressed as a percentage of the original data

PPC Service	2004/05			2005/06			2006/07		
	Revenue	FAC	DSAC	Revenue	FAC	DSAC	Revenue	FAC	DSAC
TISBO									
64kbit/s	-	1%	1%	(2%)	0%	0%	(19%)	4%	2%
2Mbit/s	-	(5%)	(4%)	(27%)	(7%)	(6%)	(32%)	(13%)	(11%)
Low Bandwidth TISBO	(29%)	(3%)	(2%)	(19%)	(5%)	(4%)	(29%)	(8%)	(6%)
TISBO									
34/45Mbit/s	-	0%	0%	(16%)	0%	0%	(19%)	0%	0%
140/155Mbit/s	-	0%	0%	(19%)	0%	0%	(31%)	(3%)	(3%)
High Bandwidth TISBO	(27%)	0%	0%	(18%)	0%	0%	(27%)	(1%)	(1%)
Trunk									
2Mbit/s	-	-	-	(14%)	0%	0%	(18%)	(4%)	(5%)
34/45Mbit/s	-	-	-	(15%)	0%	0%	(7%)	0%	0%
140/155Mbit/s	-	-	-	(16%)	0%	0%	(27%)	(2%)	(2%)
All Trunk	(25%)	0%	0%	(14%)	0%	0%	(17%)	(3%)	(3%)

Source: Ofcom – based on information in BT's regulatory financial statements and from its response to the section 191 Notice.

Proposed adjustments to the PPC base data

- 4.31 The data in BT's financial statements also contain certain costs and revenues that we do not believe should be attributed to certain PPC services and one-off gains or losses that might distort the general profitability of PPC services in general. We therefore consider that it is appropriate for us to make adjustments to this base data in order to ensure that it better fits our purposes.¹¹²
- 4.32 These proposed adjustments are in line with those that we are proposing to make in the 2008 LLCC Consultation, which are explained in detail in Annex 8 of that consultation document.¹¹³ The 2008 LLCC Statement will, however, set forward looking policy. We therefore started by considering all the adjustments in the 2008

¹¹¹ In the case of 04/05 and 05/06 this was to the original published accounts on the old basis, whereas for 06/07 and 07/08 the published accounts were on the new basis.

¹¹² This is not the first time that Ofcom has adjusted BT's published accounting data when resolving disputes or carrying out investigations. Previous examples include the own-initiative investigation and subsequent disputes into BT's charges for WLR ISDN2 in 2004/05: see

http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_797/

¹¹³ See Annex 8 of the 2008 LLCC Consultation:

<http://www.ofcom.org.uk/consult/condocs/llcc/leasedlines.pdf>.

LLCC Consultation and then excluded or amended those adjustments that we considered were not relevant to the Disputes.

- 4.33 The proposed adjustments generally reduce the level of PPC costs and therefore increase the rate of return being earned on PPC services. They also impact on the level of the DSAC and therefore potentially affect the level of any charges that we might determine.
- 4.34 For the purposes of resolving the Disputes we have modelled all the adjustments as individual stand alone changes to the base data.

Proposed adjustments

1. Third party customer local end equipment and infrastructure costs

- 4.35 BT's rental costs for PPC local end rental services include the costs associated with the equipment, fibre and copper used to provide the physical link between the local serving exchange and the third party customer premises. BT, however, recovers an element of these costs through its PPC equipment and infrastructure connection charges.
- 4.36 We have therefore removed this element of costs from the PPC rental costs and moved them to be matched against the revenue from PPC equipment and infrastructure connection charges, which is outside the scope of these Disputes.
- 4.37 We believe that this adjustment is justified because it avoids potential over-recovery of the costs through PPC rental charges. This helps prevent overcharging from occurring, which fits with our principal duty in section 3(1) of the Act to further the interests of citizens and consumers in communications matters.

2. Payment terms

- 4.38 This adjustment changes the estimate of the costs of financing working capital, related to debtors, so as to reflect the payment terms for CPs that are purchasing PPCs.
- 4.39 In its regulated accounts, BT estimates its working capital related to its debtors for all its services based on 59 days (being the time period between when the costs are incurred and the receipt of the revenue). In the case of PPCs, Ofcom determined the payment terms following a dispute in January 2007 ("the 2007 Dispute").¹¹⁴ We have therefore replaced the estimate based on 59 days with one reflecting the regulated payment terms determined by that dispute. Given that the payment terms were applied historically in the 2007 Dispute, we have also applied them historically for the purposes of resolving these Disputes. This had the effect of slightly reducing PPC costs because the working capital was reduced and therefore the financing costs were less.
- 4.40 We believe that this adjustment is justified that on the basis that it reflects the reality of PPC payments terms and maintains consistency with our previous decisions, in line with our duties under section 3(3) of the Act.

¹¹⁴

http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_916/thusbt.pdf

3. Resilient circuit costs

- 4.41 This adjustment relates to the removal of the costs for resilient circuit and protected path services from BT's data.
- 4.42 For BT's 2007/08 and restated 2006/07 regulatory financial statements, the revenues for resilient and protected path services have been separately identified but not the costs, which are included with the other circuit costs. Given that resilient and protected path services are not within the scope of the Disputes, we propose to eliminate an estimate of the costs of these services from the data provided by BT.
- 4.43 We believe that this adjustment is justified as it avoids potential over-recovery of the costs through PPC rental charges. This helps prevent overcharging from occurring, which fits with our principal duty in section 3(1) of the Act to further the interests of citizens and consumers in communications matters.

4. Trunk/distribution rebalancing

- 4.44 This adjustment flows from concerns that we identified when carrying out our own-initiative investigation into BT's prices for PPC trunk services in 2005. As explained in the closing Competition Bulletin for that investigation, we identified concerns relating to the way that *"core transmission costs are split between PPC wholesale trunk segments (which fall into the Wholesale Trunk Segments Market and are regulated through basis of charges Condition H3), and PPC terminating segments (which fall into the Traditional Interface Symmetric Broadband Origination (TISBO) Markets, and are regulated through the PPC terminating segments charge control for low and high bandwidths)"*.
- 4.45 As a result, we obtained a clear commitment from BT and agreed a project plan and timetable that would see BT prepare the data needed to quantify and correct the accounting problems identified. We explained that this analysis might lead to restated costs and revenues for PPC trunk services and a revised methodology for recovery of core transmission costs between trunk and terminating segments on a forward looking basis. BT revised its cost allocation methodology in 2007 and reflected this in the 2006/07 and 2007/08 regulatory financial statements. Data for prior years was not however restated.
- 4.46 Given that the 2004/05 and 2005/06 data incorrectly allocates costs between trunk and distribution we believe that it is appropriate to make an adjustment to the data for those two years. This approach is supported by the Disputing CPs and does not appear to be opposed by BT as it is an adjustment that RGL proposed in their report and is one that is not objected to in the Deloitte Report submitted by BT.
- 4.47 In making the adjustment, we have based our reallocation of costs on the 2007/08 data. This is because we believe that 2007/08 represents the most reliable data for the new allocation method, as it has been operated by BT for two years. We have therefore looked at the ratio of TISBO to trunk costs for 2007/08 and applied this to the two earlier years 2004/05 and 2005/06.
- 4.48 The adjustment has the effect of shifting costs from TISBO to trunk and thereby increasing the rate of return on TISBO and decreasing the rate of return on trunk. For PPCs as a whole, there is no overall effect on the rate of return as the adjustment is simply moving costs between markets rather than changing total costs.

5. Next generation network costs

- 4.49 The capital and operating costs incurred by BT in relation to its next generation network ("21CN network") during 2005/06, 2006/07 and 2007/08 are currently attributed to legacy services. Of the total costs, a proportion is apportioned to both PPC terminating and trunk services. BT has not, however, used its 21CN network to provide PPCs during the period of the Disputes. It therefore could be argued that as PPCs do not use the 21CN network, these costs should not be recovered through PPC charges.
- 4.50 However, the costs attributed to the 21CN network fall into two categories, namely direct costs and indirect costs. In the context of the 2008 LLCC Consultation, BT argued that the indirect costs would have been incurred even in the absence of 21CN, and that PPCs should therefore make a contribution to their recovery. Ofcom accepted this argument in developing its leased line charge control proposals, and we consider it appropriate to adopt a similar approach here. Adjusting BT's costs in this manner ensures that BT is allowed to recover a level of cost that it would have incurred through providing PPCs whilst preventing it from recovering costs that are not currently related to the provision of PPCs, thereby balancing the interests of BT and the Disputing CPs.

6. Residual accounting adjustments

- 4.51 **Table 4.3** below lists all the other adjustments we propose to make to BT's data, in line with Annex 8 of the 2008 LLCC Consultation.

Table 4.3: Other accounting adjustments to BT's data

Adjustment	Summary of adjustment
a Ancillary services (e.g. excess construction charges)	BT includes the cost of providing these services within the base data for PPC services. Ancillary services are not within the scope of the Disputes. We therefore propose to eliminate an estimate of the cost of these services.
b Third party customer local end equipment and infrastructure selling costs	BT incurs costs in selling third party customer local end equipment. We do not believe these costs are relevant to the Disputes and propose to eliminate them. As BT does not separately report these services from local end rental we assume these selling costs are also reflected in the local end rental cost base. These costs therefore needed to be removed.

7. Current cost normalisation

- 4.52 In the 2008 LLCC Consultation we proposed an adjustment to forecast the changes to asset values that might arise from the current cost accounting ("CCA") treatment of assets over the period of the charge control. A forecast value was included in the charge control model as historic CCA holding gains and losses are unlikely to provide a robust forecast for future years.
- 4.53 We have considered whether a similar (or any other adjustment) is required for our assessment of whether BT has overcharged the Disputing CPs. The situation for the Disputes, however, differs from the 2008 LLCC Consultation. In resolving the Disputes, we are looking backwards at events during past periods whereas the 2008

LLCC Consultation is forward looking to future periods. An adjustment to forecast future changes in asset values is therefore not relevant.

- 4.54 For the purposes of resolving the Disputes, we could therefore use the holding gains and losses reported in BT's regulatory financial statements or seek to replace these with a forecast of the anticipated holding gains and losses that were used by BT when setting its PPC charges. Were we to have a reasonable estimate of what BT anticipated the holding gains and losses would be at the time that it set its PPC charges, we might consider using these estimates for the purposes of resolving the Disputes. However, there is no reliable means of identifying the asset price changes that BT anticipated when it set its PPC charges, therefore we are unable to adopt this approach.
- 4.55 We have used the actual holding gains and losses reported by BT in its regulatory financial statements when resolving the Disputes. Absent information that these actual gains and losses would not have been foreseen by BT, we have not made adjustments to the reported holding gains and losses. We do not, therefore, propose to make an adjustment for current cost normalisation when resolving the Disputes.

8. Regulatory Asset Valuation

- 4.56 The Regulatory Asset Value ("RAV") was created by Ofcom in 2005 as part of Ofcom's cost of copper review.¹¹⁵ It flowed from Oftel's decision in 1997 to require BT to value its assets on a CCA basis.¹¹⁶ The effect of this decision was that BT would recover more costs than it had actually incurred on copper access network assets held prior to the accounting policy change in August 1997. To prevent this over-recovery, the RAV was introduced to represent the remaining value (i.e. costs to be recovered) of the pre-August 1997 assets.
- 4.57 Exceptionally, when introducing the RAV in 2005, Ofcom decided not to apply the RAV to PPCs at that time, stating:
- "Some Partial Private Circuits (PPCs) also use metallic pairs in the final drop to the customer. Ofcom does not intend currently, however, to re-examine the existing PPC price controls as a result of this statement as to do so given that the price controls were imposed quite recently (in September 2004) would seem disproportionate. However, Ofcom will take account of this statement when the PPC price controls are next examined."*¹¹⁷
- 4.58 Given our statement in the cost of copper review that it would be disproportionate to reopen the PPC charge controls to take account of the RAV adjustment, we do not consider that it is appropriate to take account of the RAV adjustment for the purposes of assessing whether BT has been overcharging the Disputing CPs. To do otherwise would interfere with our duty to ensure regulatory certainty. Ofcom had not devised the RAV adjustment at the time that charges were set in the 2004 LLCC Statement

¹¹⁵ See Ofcom's *Statement on Valuing Copper Access*, available on our website at <http://www.ofcom.org.uk/consult/condocs/copper/value2/statement/>

¹¹⁶ See http://www.ofcom.org.uk/static/archive/oftel/publications/1995_98/pricing/ncc1097.htm.

¹¹⁷ See footnote 18 to paragraph 3.2 of the cost of copper statement:

<http://www.ofcom.org.uk/consult/condocs/copper/value2/statement/statement.pdf>

and did not factor it in our assessment of BT's costs at the time and the setting of the RPI-x glidepath.¹¹⁸

Adjustments proposed by RGL

- 4.59 The RGL Report, discussed in **Section 2**, uses BT's regulatory financial statements and applies a number of adjustments to some of the PPC data to correct for what they believe to be errors in the way in which the financial statements were prepared.
- 4.60 **Table 4.4** below summarises each adjustment from the RGL report and either sets out our proposed conclusion that the adjustments we have made above go further than those made by RGL due to, for example more detailed data requested from BT, or it explains why we do not propose to agree that a particular adjustment should be made.

Table 4.4: Analysis of the adjustments proposed in the RGL Report

RGL adjustment	Summary of adjustment	Our proposed conclusion
1. Trunk – distribution rebalancing.	In 2007 BT revised its cost allocation methodology for costs of private circuits between distribution and trunk segments to be more closely aligned with pricing methodology. This was implemented in the 2006/07 regulatory accounts and apportions the costs between distribution and trunk components using a circuit's route length, split by the radial trunk to distribution ratio. Prior years were not restated and therefore RGL's adjustment proposes to reapportion costs from TISBO to trunk markets for 2004/05 and 2005/06.	We agree with the principle of this adjustment. But rather than using the method of estimation suggested by RGL, we have based our reallocation of costs on the 2007/08 data (which was not available to RGL at the time that they prepared their report). The adjustment has the effect of shifting costs from TISBO to trunk and thereby increasing the rate of return on TISBO and decreasing the rate of return on trunk. The adjustment is described in more detail in paragraphs 4.44 to 4.48 above.
2. Internal revenue adjustment	Revenues for 3 rd party equipment charges, other single payments (OSPs') and resilience had not been reported by BT in the regulatory financial statements for 2004/05 to 2007/08. This adjustment estimates and includes these revenues within the existing services (within TISBO). It therefore increases the rates of return for TISBO.	We agree with the principle of this adjustment i.e. ensuring that the revenues and costs of a service are reported together. However, rather than inflating revenues, we have removed the costs, as these services are outside the scope of the Disputes. This has the effect of reducing costs and increasing the ROCE for TISBO. There is no effect on trunk. Our adjustment to reflect this is included in the 'Third party customer local end equipment and infrastructure costs' adjustment described in paragraphs 4.35 to 4.37 above.
3. External revenue	As per the internal revenue	As per the internal revenue

¹¹⁸ We note that in the forward-looking 2008 LLCC Consultation we have proposed to make an adjustment for RAV (in line with our statement set out above in the 2005 cost of copper review) because we are setting a new forward looking charge control. The impact of the RAV adjustment (if it were to be made) would be to lower costs (and therefore DSACs), leading to higher rates of return.

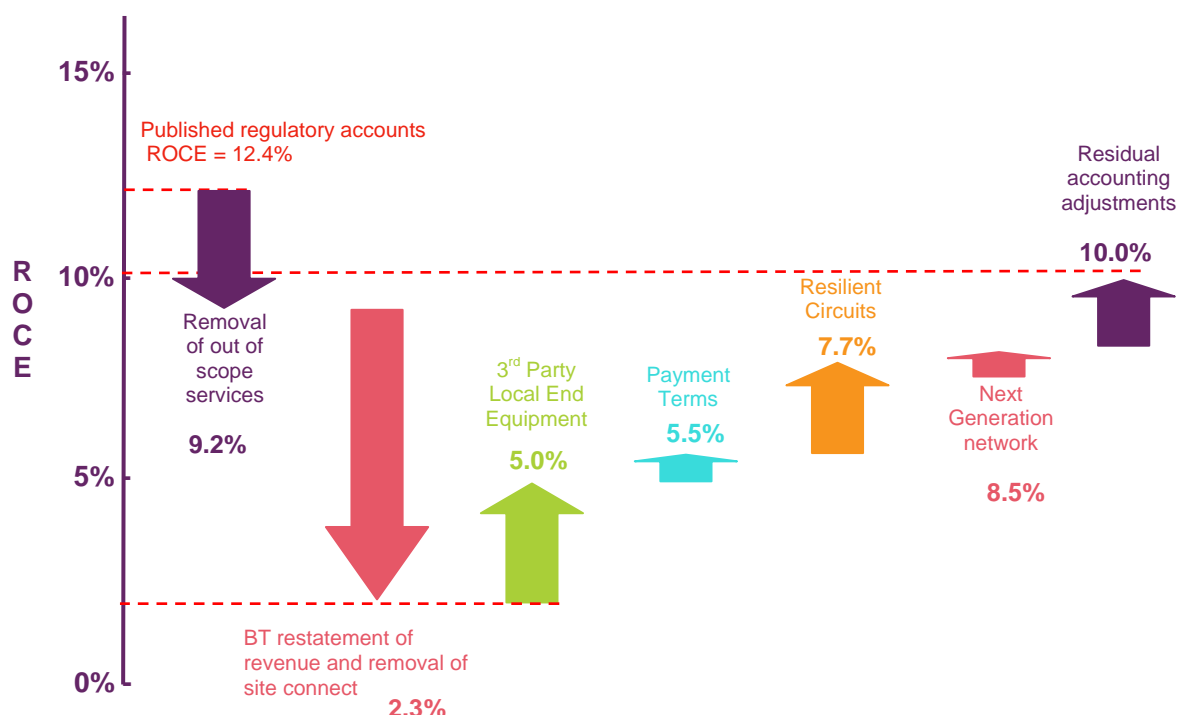
RGL adjustment	Summary of adjustment	Our proposed conclusion
adjustment	adjustment, RGL has increased external revenues by 10% in order to reflect the exclusion by BT of the products.	adjustment above, we have removed the costs therefore revenues should not be included. Our adjustment to reflect this is also included in the 'Third party customer local end equipment and infrastructure costs' adjustment described in paragraphs 4.35 to 4.37 above.
4. Working Capital adjustment	Adjustments have been made to both internal and external debtors to reflect the payment terms available to customers and ensure that prices for external services are not calculated in a way that discriminates against external customers.	We have proposed an adjustment to internal and external debtors using actual contractual payment terms. This is detailed in the 'payment terms' adjustment described in paragraphs 4.38 to 4.40 above.
5. Sales and general administration (SGA) cost adjustment	The adjustment aims to provide consistent SGA costs between internal and external circuits for the 2004/05 regulatory financial statements. BT reported SGA costs for internal sales significantly less than those for external sales. Similarly, BT's internal revenue was less than its external revenue by a similar amount. RGL argue that to avoid discrimination against external customers, BT's charges for internal sales should be uplifted by the difference in SGA costs.	<p>RGL's proposed adjustment is an increase to internal revenues for trunk and terminating segments, leading to an increase in BT's overall ROCE for PPC services.</p> <p>The difference in SGA costs for internal and external customers was recognised by OfTel when first setting PPC charges in 2001/02 and was accepted as a legitimate difference. We do not, therefore believe that it is appropriate to make any adjustment to BT's internal revenues to reflect this difference. The differences in the level of costs between internal and external customers do, however, mean that it is appropriate for us to identify separate DSACs for internal and external customers when assessing overcharging in 2004/05 (see paragraphs 4.82 and 4.83 below).</p>
6. Central London Zone (CLZ) adjustment	BT offers a reduced price for PPCs of some bandwidths where they are provided within central London. These reduced prices were not reported separately until 2008. RGL has reduced revenues on the basis that external customers buy fewer circuits as a proportion of total circuits than BT as BT's largest external customers will have their own networks in that area.	<p>We agree in principle with this adjustment. In the 2006/07 (restated) and 2007/08 accounts BT has reported separate revenues for CLZ and non-CLZ reflecting the difference in prices. Therefore no adjustment is required for these two years.</p> <p>The financial statements for 2004/05 and 2005/06 did not separate out revenues for CLZ and non-CLZ. Whilst we could estimate an adjustment for the years 2004/05 and 2005/06, the overall impact on the</p>

RGL adjustment	Summary of adjustment	Our proposed conclusion
		<p>ROCE would be minimal. In addition, given that the CLZ discount only affects prices and revenues, there will be no impact on the DSAC. The adjustment would therefore not impact on our overall conclusions that BT has not overcharged for TISBO services. We have not, therefore attempted to calculate this adjustment.</p>
<p>7. Local end price adjustment</p>	<p>This adjustment relates to point of handover (POH) costs. Other operators interconnect to BT's network at places called points of handover. Additional equipment is necessary at the POH. Since BT does not need to interconnect with itself, this equipment and the related costs would generally only be needed for external sales rather than internal sales.</p> <p>RGL made two claims regarding the treatment of POH costs by BT and its internal pricing:</p> <ol style="list-style-type: none"> 1) For VPN circuits, BT was in fact using POH equipment and had therefore incorrectly reduced its internal price; and 2) For leased lines, BT had overestimated the POH costs and had deducted too much in calculating its internal price. <p>RGL claimed that the lower internal prices were discriminating against external operators. RGL suggested correcting for this by increasing internal revenues. This had the effect of increasing the overall ROCE in their analysis, which they argue strengthens the case that there was overcharging.</p> <p>RGL's adjustment relates only to the TISBO markets.</p>	<p>The scope of these Disputes is to assess whether BT has overcharged the Disputing CPs for PPC services. As such, the question of whether BT has undercharged its own internal divisions for POH equipment is not relevant to our assessment. Any potential issues of discrimination would need to be considered separately.</p> <p>Although it could be argued that because of the differences in internal and external POH costs we should calculate separate internal and external DSACs for TISBO services for all years, we have concluded that it is unnecessary to do this. Our analysis in Section 5 shows that BT's charges for TISBO services were below the averaged internal/external DSAC. Given that the external costs are higher than the internal costs, calculating and using external DSACs would result in external TISBO charges being even further below DSAC.</p> <p>We therefore do not propose any adjustment for the issues raised by RGL.</p>
<p>8. Reallocation of 64kbit/s services</p>	<p>The regulatory accounts do not separately report revenue or costs for the trunk element of 64kbit/s services within the wholesale trunk market. Rather, these costs and revenues are included in the 64kbit/s transmission</p>	<p>Ofcom's approach to testing for overcharging differs from RGL. Rather than looking at the overall ROCE across PPCs, we compare DSACs by service to the revenues by service.</p>

RGL adjustment	Summary of adjustment	Our proposed conclusion
	service. RGL has reallocated costs and revenue from 64kbit/s transmission services to the trunk market in a similar proportion to 2Mbit/s circuits.	<p>Since BT does not separately report revenues and costs for the trunk element of 64kbit/s PPCs, it does not report a DSAC for 64kbit/s trunk services. Therefore, even if we were able to reallocate revenues and costs to 64kbit/s trunk, we would not have a DSAC against which to test the revenues.</p> <p>Having identified that the overall ROCE for 64kbit/s PPCs (trunk and TISBO combined) is negative, we do not believe that BT has overcharged for either 64kbit/s transmission or trunk services. This view is supported by the check that we have carried out by substituting the 64kbit/s transmission prices with the higher 64kbit/s trunk prices in our analysis (i.e. assuming that all the reported 64kbit/s transmission was in fact trunk). The outcome shows that BT did not overcharge for this service over the period of the Disputes.</p>

Results and impact

- 4.61 An indication of the impact of these proposed adjustments is provided in **Figure 4.5** below, which shows how the adjustments affect BT's ROCE across its entire PPC product range. The data from BT's published regulatory financial statements (and the ROCE that this indicates) is used as the starting point. Each arrow reflects one of the adjustments that we are proposing to make, with the impact of this adjustment being reflected in the revised ROCE figure.

Figure 4.5: Impact of the proposed adjustments on ROCE

Source: Ofcom – relates to all services in the scope of the disputes over the period 2004/05 to 2007/08. The starting point of 12.4% is an average based on the Restated and Revised Data for the four years.

- 4.62 The level of the adjustments varies from year to year and the adjustments affect the individual PPC services differently. The individual adjustments, as a percentage decrease to FAC, are set out in **Table 4.6** and the impact of these adjustments on the base data for the individual trunk and terminating services is set out in **Table A14.3** in **Annex 14** below. Negative percentages indicate a decrease in FAC as a result of the adjustment.

Table 4.6: Summary of the adjustments made to BT's Restated/Revised Data as a percentage of total unadjusted FAC

	2004/05	2005/06	2006/07	2007/08
3 rd Party local end equipment	(6%)	(6%)	(7%)	(7%)
Payment terms	(3%)	(2%)	(2%)	(1%)
Resilient circuits	(3%)	(4%)	(4%)	(4%)
Trunk/distribution rebalancing	0%	0%	0%	0%
Residual accounting adjustments	(3%)	(3%)	(3%)	(3%)
Next generation network costs	0%	(1%)	(2%)	(3%)

Source: Ofcom, based on BT's regulatory financial statements

- 4.63 It should be noted that there is no exact science to determining costs for network based services and, therefore, the appropriate adjustments to BT's published cost and revenue data for PPCs (and then reflecting these adjustments in the DSACs). Arguments can be made in favour (and against) a variety of different adjustments to the data with a view to making it more 'accurate' for the purposes of assessing overcharging.
- 4.64 Ofcom has given consideration to a range of different adjustments to the PPC data published by BT in its regulatory financial statements. On the basis of the information available to us at the time of resolving the Disputes, we believe that the adjustments proposed above are the most appropriate and that they result in the most appropriate PPC data for resolving the Disputes.

Adjusting BT's DSACs

- 4.65 As discussed in **Section 3** above, the key factor of those that we are proposing to use to assess whether BT has overcharged the Disputing CPs for PPCs is the assessment of whether BT's PPC charges were above their DSACs.
- 4.66 We explain the theory behind the construction of the DSAC in **Annex 13**, but in simple terms DSACs consist of two elements:
- the LRIC for the service; and
 - an allocation of common costs to the service.

In the case of BT's LRIC model, these two elements are calculated on a component level, and then converted to service estimates using usage factors. The allocation of common costs is based on an equal proportionate mark-up over incremental cost.

- 4.67 The DSAC estimates provided by BT as part of its response to our section 191 information request were generated by BT using its LRIC model. Ofcom has previously established with BT the principles upon which the calculations are based.
- 4.68 Although the modelling principles have been established with Ofcom, decisions on the details of how they are actually implemented are made by BT. As a consequence, the DSAC estimates, like BT's FAC estimates, will reflect BT's overall view of its PPC costs. The adjustments which Ofcom has made to BT's FAC data to remove irrelevant or inappropriate items will therefore also be necessary in order to derive an appropriate measure of DSAC from BT's estimates.
- 4.69 Converting Ofcom's FAC adjustments into consistent adjustments for BT's DSACs is, however, not a straightforward exercise.
- 4.70 In theory BT could produce revised DSAC estimates by re-running its LRIC model using the Ofcom-adjusted regulatory accounting information. However, such an exercise would involve a significant amount of work and would be complicated by the existence of a number of important methodological and practical difficulties, including:
- the model would need to be re-run for the whole of BT, not just for PPCs – this reflects BT's definition of the increments (e.g. core and access), the use of

components as the basis for modelling (rather than services) and the fact that some costs are common across increments;

- the model would need to be re-run separately for four years (reflecting the time period for the Disputes);
- the model is continually refined and updated and BT may no longer have the data or the parameter information needed to re-estimate the DSACs over the entire period. It would therefore be necessary for Ofcom and BT to agree how the modelling should be configured to estimate values for each of the years;
- each individual FAC adjustment would need to be assessed separately and modelled to estimate the impact on common cost allocation; and
- interactions between the FAC adjustments would need to be modelled carefully to capture accurately their collective impact on common cost allocation.

We discussed making adjustments to DSAC with BT and BT confirmed the difficulty in re-running its LRIC model to reflect the effect of the adjustments to FAC.

- 4.71 We do not believe that it would be proportionate or consistent with our obligations under the Act when resolving these Disputes to require BT to undertake such a work programme. It would take a significant amount of time to complete, on top of that already taken to generate the FAC adjustments that form an input into any DSAC recalculation, and could not be done within a reasonable timeframe for resolving the Disputes. We have therefore had to make an assessment as to what an appropriate adjustment is for resolving these Disputes.
- 4.72 To inform our assessment, we considered the specifics of how BT's LRIC model works and the different ways in which adjustments to FAC might influence the output of the model. We also met with BT to discuss in detail how DSACs may respond to FAC changes.
- 4.73 Both the analysis of the modelling methodology and our discussions with BT suggest that each FAC adjustment could impact in a different way on the LRICs and DSACs, and that estimating these impacts (and their interactions) accurately outside of the modelling framework is not possible.
- 4.74 Given the complex interactions between the variables that determine DSAC estimates it is therefore difficult (absent of remodelling) to generate precise estimates of the relevant adjustments. We have therefore considered other options for making broad based adjustments, which although inevitably approximate appear reasonable, proportionate and unbiased.
- 4.75 We believe that it is reasonable to consider that the range within which an appropriate DSAC adjustment is likely to fall is bound by no adjustment at one end, and by the same percentage adjustment as was applied to the FAC at the other end.
- 4.76 If we were to apply no adjustment to the DSAC, this might imply that it would in effect be reasonable for BT to recover costs which we have found to be not relevant to PPCs or which have been recovered through other charges. This would be inappropriate.
- 4.77 However, if we were to apply the same proportionate adjustment as adopted for the FAC (i.e. the other end of range from no adjustment), this would imply that the

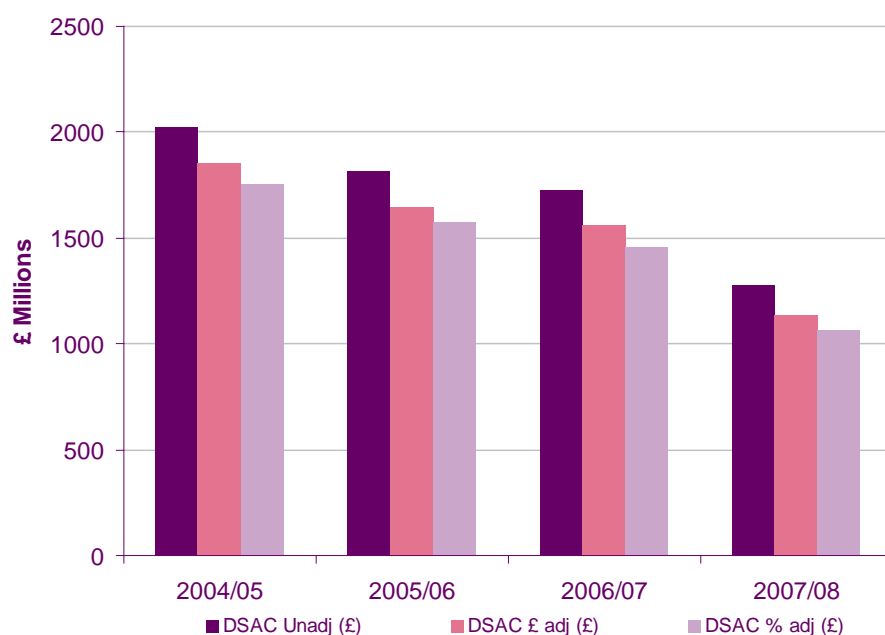
amount (in £) of the DSAC adjustment would be larger than that of the corresponding FAC adjustment. The effect of this would be to remove both the costs which Ofcom deemed should not be recovered and, in addition, a further share of BT's common costs from the DSAC figure.

- 4.78 Under normal circumstances, it might be reasonable for this additional share of common costs to be recovered through other charges. However, because the Disputes are backward looking and BT has already charged for its services, BT would not now be able to recover the common cost element unless other prices were also adjusted on a backwards looking basis. As an analysis of whether such adjustments would have been necessary or appropriate is beyond the scope of these Disputes, we do not think that adopting this approach would strike a fair balance between the Parties, as it would be unfair to BT to deny it the opportunity to recover legitimately incurred costs.
- 4.79 We therefore do not propose to use either of the two range extremes (i.e. no adjustment or the same percentage adjustment). Rather, we believe a value that lies between these two values strikes a fairer balance of the interests of the Parties. We have therefore chosen to use the same absolute adjustment applied to the FAC (i.e. the actual cash adjustment) as the appropriate adjustment to make to the DSAC. These adjustments are applied on an individual service basis. The formula for our proposed adjusted DSAC is therefore:

Adjusted DSAC = Increase or (decrease) in Original FAC + Original DSAC

- 4.80 In **Figure 4.7** below we set out data on the DSACs for the aggregated PPC terminating segment and trunk services for the four completed financial years relevant to the Disputes. For each year there are three values shown:
- the unadjusted DSACs, as provided by BT in the section 191 request;
 - the Ofcom-adjusted DSACs using the absolute cash adjustment (i.e. our proposed approach for resolving the disputes); and
 - the Ofcom-adjusted DSACs using the same percentage adjustment factor as applied to the FAC estimates.

Figure 4.7: Comparison of DSACs under different adjustment methods



Source: Ofcom

- 4.81 As is shown in **Figure 4.7**, the absolute cash adjustment that we propose to use results in DSAC values that lie broadly in the middle of what we consider to be a feasible range. This supports our view that the absolute adjustment balances the interests of the Parties.
- 4.82 In light of the fact that there is minimal difference between the costs for PPC services that BT supplies internally and externally, we propose to use the DSAC calculated in its regulatory financial statements (as adjusted in light of the discussions above) when assessing overcharging. The published DSAC is an average of the costs of providing PPC services to internal and external customers.
- 4.83 We have, however, adopted a slightly different position in relation to PPC services purchased in 2004/05, as the costs were significantly different (lower) for internal customers in this year than for external customers.¹¹⁹ This difference in costs was expressly recognised by the regulation applicable at the time.¹²⁰ We have therefore estimated separate DSACs for internal and external circuits (based on the difference in SGA costs) and carried out our assessment of overcharging in relation to the DSAC for external circuits.

¹¹⁹ There appear to be two reasons why internal costs were lower than external costs. First, as explained at item 5 in **Table 4.4**, SGA costs were lower for internal circuits than external circuits. Second, as explained at item 7 in **Table 4.4**, BT may report lower internal costs where it does not need to interconnect with itself. As explained in **Table 4.4**, we have not felt it necessary to estimate external DSACs for this for the second item as it would result in external TISBO charges being even further below DSAC.

¹²⁰ See

www.ofcom.org.uk/static/archive/oftel/publications/broadband/leased_lines/ppc1202/direction.htm

Proposed conclusion on adjusting BT's DSACs

- 4.84 The nature of the adjustments that we need to make to BT's FAC cost base means that it is unlikely that BT's DSAC estimates are an accurate reflection of the 'true' underlying cost ceiling. We therefore believe that adjustments to BT's DSACs are also required to ensure consistency with our FAC estimates.
- 4.85 To understand fully the impact on the DSACs of changes in the underlying regulatory accounting information, it would be necessary to re-run BT's LRIC model for each year of the dispute. This could be a highly complex and time-consuming exercise. Given the time constraints of a dispute and the likelihood that the data required to run the LRIC model for the earlier years of the Disputes is no longer available, we do not believe that it would be appropriate or proportionate to require BT to re-run the model in the context of resolving these Disputes.
- 4.86 We therefore propose to assess what a reasonable adjustment would be, given both the nature of the FAC adjustments and how DSACs are estimated. Having taken account of what a reasonable range of such DSAC adjustments might be, we propose to adjust the DSACs by the same absolute (or cash) amount that we have used to adjust BT's FAC data. We believe that this results in a fair balance of the interests of the parties.

Section 5

Proposed assessment of overcharging claims

5.1 In line with our proposed methodology set out in Section 3, Ofcom proposes to start its analysis of whether BT has overcharged for PPCs by considering whether BT's PPC charges have been cost oriented over the period of the Disputes. We will then cross check these results by reference to the rates of return that BT has earned on PPC services and the international benchmarking findings.

Cost ceiling assessment

5.2 Following the outputs of our rate of return assessment, we propose to assess BT's charges for PPC services in the trunk segment market using the cost ceiling test.

Comparison of PPC charges with DSAC

5.3 **Table 5.1** compares BT's PPC charges with the DSACs for those services. The PPC charges are reflected as a percentage of their DSAC, with 100% reflecting a charge that is set at its DSAC. Any figure above 100% indicates that the charge is set above DSAC. If BT set cost oriented charges, we would expect the charges to be 100% or less of the DSAC for each of the services listed in **Table 5.1**. Comparing our calculated DSACs with BT's PPC charges we can see that a number of BT's PPC trunk charges are above their DSACs during the period of the Disputes.

Table 5.1: Comparison of BT's external PPC revenues with our estimate of the external DSACs

PPC service	2004/05	2005/06	2006/07	2007/08	All Years
TISBO					
64kbit/s	25.6%	44.9%	26.7%	24.0%	29.6%
2Mbit/s	43.0%	56.6%	51.0%	71.4%	55.1%
Low Bandwidth TISBO	35.9%	52.3%	41.6%	55.9%	45.5%
TISBO					
34/45Mbit/s	28.3%	38.1%	55.0%	57.5%	44.8%
140/155Mbit/s	37.2%	77.5%	92.9%	79.8%	74.8%
High Bandwidth TISBO	28.9%	40.5%	58.2%	60.7%	47.5%
Trunk					
2Mbit/s	100.6%	169.4%	130.5%	227.7%	148.9%
34/45Mbit/s	23.4%	64.6%	64.5%	107.9%	67.7%
140/155Mbit/s	46.0%	37.9%	24.8%	56.0%	40.4%
All Trunk	84.0%	134.4%	107.7%	179.9%	123.0%
Total PPC	39.7%	59.5%	49.2%	67.0%	53.0%

Source: Ofcom

5.4 **Table 5.2** makes a similar comparison to that in **Table 5.1** but uses the DSACs originally published in BT's regulatory financial statements, rather than the adjusted DSACs that we have calculated based on the Restated and Revised Data. Although we do not propose to use these DSACs in our analysis, the data in **Table 5.2** does serve to indicate that the choice of base data makes little difference to which services are found to be priced above DSAC. This data also shows similar levels of volatility in

the DSACs over the period, indicating that it is not BT's restatement or Ofcom's adjustments that have caused the DSAC variability.

Table 5.2: Comparison of BT's PPC revenues with original DSACs¹²¹

PPC service	2004/05	2005/06	2006/07	2007/08	All Years
TISBO					
64kbit/s	n/a	40.8%	30.1%	22.5%	32.1%
2Mbit/s	n/a	54.1%	54.2%	57.1%	54.9%
Low Bandwidth TISBO	45.0%	49.4%	45.2%	44.9%	46.2%
TISBO					
34/45Mbit/s	n/a	32.6%	52.9%	46.3%	42.3%
140/155Mbit/s	n/a	71.5%	98.8%	56.8%	74.0%
High Bandwidth TISBO	38.5%	52.2%	76.5%	52.4%	53.3%
Trunk					
2Mbit/s	n/a	190.7%	138.8%	213.5%	174.4%
34/45Mbit/s	n/a	132.1%	65.8%	103.2%	91.7%
140/155Mbit/s	n/a	58.9%	31.9%	55.0%	46.1%
All Trunk	138.3%	152.0%	96.3%	149.3%	130.0%
Total PPC	54.5%	62.0%	57.9%	58.9%	58.2%

Source: Ofcom

5.5 We note that the ratios reported in **Tables 5.1 and 5.2** demonstrate some volatility year-on-year. This volatility is driven primarily by variations in the DSAC data rather than revenues (in nominal terms prices have stayed largely constant). In its submission to the 2008 LLCC Consultation (submitted on 6 March 2009), BT argued that the principal causes of DSAC volatility are:

- the level of asset inflation for the year (i.e. holding gains/losses);
- changes in the methodology for valuing assets;
- volume variations (particularly for per unit DSAC estimates); and
- changes in the reporting system used by BT.

The relatively large holding losses incurred by BT in 2004/5, 2005/6 and 2006/7 will have therefore both significantly contributed to the volatility in the ratios in **Tables 5.1 and 5.2**, but also led to the lower ratios observed in these years compared to 2007/8.

5.6 The DSACs of an individual service can fluctuate from year to year, meaning that an unchanged charge that was below DSAC in one year might be above DSAC the year later. In considering the extent to which we can rely on individual years where charges are above DSAC, it is therefore important to bear in mind that BT sets its charges on the basis of the information that is available to it at the time. Given that the DSACs for the year are only known at the end of the year, BT does not know what the appropriate value will be when setting its charges. If charges do not change materially in a year but the DSAC unexpectedly declines, it could be argued that it is unreasonable to consider that this one charge in isolation represents an overcharge.

¹²¹ The 2004/05 regulatory financial statements did not contain sufficiently disaggregated volume and revenue data to enable all comparisons with DSACs to be made. The 'All Years' calculation for individual bandwidths within markets is therefore based on the data for the last three years. The 'All Years' market totals are based on the data for all four years.

- 5.7 There may also be accounting treatments of costs that affect the pattern of costs between years. For example, some costs might be expensed in the year in which they are incurred but also yield benefits in other years. In such circumstances revenues might look lower relative to cost in the year in which the costs are expensed and higher in the other years. Considering the comparison between revenues and costs over a period of years reduces the risk of drawing inappropriate conclusions.
- 5.8 For the purposes of resolving the Disputes, it therefore seems reasonable to conclude that overcharging has occurred where charges have been persistently above DSAC for the majority of the period (i.e. for at least three out of four years) or where the variation from the DSAC was caused by an increase in the charges for the service in question. Charges above DSAC for this length of time would indicate that BT has failed to take action to alter its charges in light of them being above DSAC.
- 5.9 Our analysis of the DSACs for BT's PPC services over the period (as set out in **Table 5.1**) indicates that BT has persistently set charges above DSAC for 2Mbit/s PPC trunk services. When averaged across the period 2004/05 to 2007/8, BT's charges for 2Mbit/s trunk services were above the average DSAC for that period. In three of the four years covered by the Disputes (i.e. 2005/06 to 2007/08) BT's charges for 2Mbit/s trunk services were significantly above the DSAC, with the charges more than double the DSAC in 2007/08. **Table 5.1** suggests that BT's 2Mbit/s trunk charges were also above DSAC for 2004/05, albeit only marginally (i.e. by a total of £130,000). Given that the adjustments we have proposed to BT's data are calculated to the nearest £million, we believe that the amount by which BT appears to have exceeded the DSAC in 2004/05 falls within the margin of error for our model. As such, we do not believe that it is appropriate to conclude that BT has overcharged the Disputing CPs in 2004/05 on the basis of this data.
- 5.10 Although there were several other PPC charges that were above DSAC for certain years during the period of the Disputes (e.g. 34/45Mbit/s PPC trunk services), these charges were only above DSAC for one or two years and never on average across the period of the Disputes. We therefore do not believe that it is appropriate to conclude that BT has overcharged the Disputing CPs for these PPC services.
- 5.11 The analysis above covers the period up to the end of March 2008. However, the scope of the Disputes means that we need to assess whether overcharging has taken place in the period from 1 April 2008 to 30 September 2008 as well. This is complicated by the fact that the financial year 2008/09 has only just ended, meaning that we do not yet have regulatory accounting data for this year. In particular, we do not have DSAC data.
- 5.12 Ofcom has identified three options for resolving the question of whether BT has overcharged the Disputing CPs during the last six months of the Disputes:
- (i) **Assume that BT's actual charges in the period are reasonable** – this would imply that BT is pricing within the DSAC ceiling for the 2008/09 financial year. Given that the pricing of 2Mbit/s trunk services has not changed materially over the period, and that prices have significantly exceeded the DSAC in the previous three years, we do not believe that it is probable that BT's charges in 2008/09 are below DSAC. As a consequence, this approach would appear to unduly favour BT and therefore would not balance the interests of the Parties;
 - (ii) **Estimate the unit DSAC for the period on the basis of the 2007/08 value (adjusted for inflation)** – as identified above, BT's charges for 2Mbit/s trunk

were above the DSAC during 2007/08. However, basing the estimate of the DSAC for the period April 2008 to September 2008 on a single year's data is unappealing because there is significant volatility in the unit DSACs over the period. The DSAC value for 2007/08 is relatively low (and hence would result in it being concluded that BT had significantly overcharged the Disputing CPs). As a consequence, it seems to be unfair to BT to adopt this approach; or

- (iii) **Estimate the unit DSAC on the basis of the average DSAC for the last three years** – to avoid DSAC variability problems that arise from using one year's DSAC as the basis for estimating a DSAC for 2008/09, we could calculate the unit DSAC for this period by using the average DSAC for the last three years for which we do have financial data (i.e. 2005/06 to 2007/08).¹²² This would appear to be the fairest approach to assessing overcharging between 1 April 2008 and 30 September 2008, as it strikes a fair balance between the interests of the Parties. It is therefore the approach we propose to adopt.

- 5.13 On the basis of the estimated DSAC for April to September 2008 and the revenue that BT has generated from sales to the Disputing CPs over that period, we have identified that BT has also set charges for 2Mbit/s trunk services that were above DSAC during this period.

Proposed conclusion on cost ceilings

- 5.14 On the basis of the information set out in **Table 5.1** above, we believe that there is clear evidence that BT has set charges for certain of its PPC trunk services that are above the DSAC for those services. Specifically, the charges are above their DSACs for 2Mbit/s trunk charges for the period between 1 April 2005 and 30 September 2008. We do not believe that there is sufficient evidence to conclude that BT set charges above DSAC in the period June 2004 to March 2005.
- 5.15 In order to balance the interests of the Parties involved in the Disputes, Ofcom provided BT with an opportunity to demonstrate that its charges were cost oriented. In the covering letter that accompanied the section 191 notice that we sent to BT on 1 October 2008, we asked BT to:

“In line with the obligations in SMP Conditions G3, GG3 and H3 (Basis of Charges), please demonstrate that each and every of the charges for the services listed below that were in place during the bracketed years were 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:

- (i) 2Mbit/s main link charges for external customers (2007/08)*
- (ii) 140/155Mbit/s connection charges (2007/08)*
- (iii) 140/155Mbit/s distribution (terminating segment) charges (2007/08)*
- (iv) 2Mbit/s trunk charges (2007/08)*

¹²² Data for 2004/05 is not comparable to the later years due to the use of route to radial factors when calculating the distance of trunk and terminating segments.

- (v) 34/45Mbit/s trunk charges (2007/08)
- (vi) 2Mbit/s connection charges for external customers (2006/07)
- (vii) 2Mbit/s main link charges (2006/07)
- (viii) 2Mbit/s local end charges (2006/07)
- (ix) 34/45Mbit/s main link charges (2006/07)
- (x) 140/155Mbit/s main link charges (2006/07)
- (xi) 140/155Mbit/s distribution (terminating segment) charges (2006/07)
- (xii) 2Mbit/s trunk charges (2006/07)
- (xiii) 2Mbit/s connection charges (2005/06)
- (xiv) 140/155Mbit/s main link charges (2005/06)
- (xv) 2Mbit/s trunk charges (2005/06)
- (xvi) 34/45Mbit/s trunk charges (2005/06)
- (xvii) 2Mbit/s trunk charges (2004/05)

In each case, please explain why you believe that the mark up for recovery of common costs and the return on capital employed are appropriate.”¹²³

- 5.16 BT provided no information in its responses of 7 and 13 October 2008 to demonstrate why it believes that the charges listed in **paragraph 5.15** are consistent with its cost orientation obligations. Similarly, the BT Submission provided no demonstration that the specific charges identified were set below DSAC. BT instead rejected the claims that it had overcharged and argued that on an aggregated basis there was no evidence of overcharging.

Rate of return assessment

- 5.17 Having identified from the cost orientation assessment that it appears that BT has overcharged for 2Mbit/s PPC trunk services since April 2005, we now consider whether the assessment of the rates of return earned by BT on PPC services supports this preliminary conclusion.
- 5.18 **Table 5.3** sets out the rates of return¹²⁴ that BT earned each year on its regulated PPC services, in terms of each of the respective product markets and on PPCs

¹²³ The services listed in **paragraph 5.15** are those that initially appeared to Ofcom to warrant further investigation in light of the cost information available to it at the time that the information request was sent to BT.

¹²⁴

$$\text{ROCE} = \frac{\text{Revenue} - \text{Adjusted cost (excluding the cost of capital)}}{\text{Adjusted mean capital employed}}$$

overall. As discussed in **Section 4**, we have used BT's restated and revised financial data, adjusted to take account of the factors described in **Figure 4.6** above.¹²⁵

Table 5.3: Rates of return earned by BT on PPC services in wholesale leased line markets

PPC service	2004/05	2005/06	2006/07	2007/08	All Years
TISBO					
64kbit/s	-15.0%	-0.3%	-23.0%	-27.3%	-15.2%
2Mbit/s	-2.9%	-2.6%	-1.9%	19.4%	1.2%
Low Bandwidth TISBO	-7.4%	-1.7%	-10.2%	0.4%	-5.1%
TISBO					
34/45Mbit/s	-9.3%	-11.2%	6.3%	8.6%	-3.0%
140/155Mbit/s	1.1%	24.2%	49.0%	31.6%	22.2%
High Bandwidth TISBO	-3.9%	7.7%	26.4%	20.8%	10.0%
Total TISBO ROCE	-6.6%	0.5%	-2.2%	5.7%	-1.5%
Trunk					
2Mbit/s	81.3%	104.9%	134.0%	136.7%	107.7%
34/45Mbit/s	-5.4%	10.4%	39.0%	52.0%	20.3%
140/155Mbit/s	16.5%	2.0%	-9.8%	16.3%	7.6%
All Trunk ROCE	49.5%	58.1%	78.1%	87.1%	64.7%
Aggregated TISBO+Trunk					
64kbit/s	-15.0%	-0.3%	-23.0%	-27.3%	-15.2%
2Mbit/s	13.7%	19.5%	20.1%	44.4%	22.0%
34/45Mbit/s	-8.3%	-4.0%	15.5%	22.2%	3.9%
140/155Mbit/s	5.2%	17.4%	33.1%	27.2%	18.1%
Total PPC ROCE	2.9%	11.4%	9.7%	20.8%	10.0%
BT WACC	13.3%	12.0%	11.4%	11.4%	11.8%

Source: Ofcom

- 5.19 The estimates presented in **Table 5.3** show that BT has earned an average rate of return on capital across all PPC products of 10.0%. This compares with BT's average WACC across the period of around 11.8%.¹²⁶ This level of rate of return would suggest that BT has not overcharged overall for PPCs. However, as discussed in **Section 3**, we do not believe that aggregated PPCs are the appropriate level at which to carry out our assessment. It is therefore necessary for us to consider the rates of return earned in the separate PPC markets and by the individual services within those markets.
- 5.20 Looking at the individual markets, it can be seen that BT has earned rates of return on TISBO services that are at or below its WACC, with very high rates of return being earned on trunk services.
- 5.21 The rates of return earned on low bandwidth TISBO services are generally very low. Whilst we acknowledge BT's view that it appears not to have earned a reasonable rate of return on these services, we would note the following:

¹²⁵ The ROCEs quoted in this document may differ from those quoted in the 2008 BCMR Statement and the 2008 LLCC Consultation because the adjustments we have made to BT's data differ slightly from those used in the forward looking charge control. These differences are justified by the historical nature of the Disputes.

¹²⁶ This is a time-weighted WACC that allows for the variations in BT's WACC over the period of the dispute. The WACC is adjusted to reflect that only the latter half of the financial year 2004/05 is in the dispute period.

- These services are the subject of an RPI-x charge control;
 - The risk of underperforming the price cap is a central component of the incentive properties of RPI-x charge controls. By explicitly linking the regulated firm's profitability with its performance, the regulatory regime incentivises the firm to improve efficiency and grow the market. The symmetric nature of these incentives (i.e. that the firm can under-recover as well as over-recover) is important in reinforcing the strength of the incentives on the firm (indeed, BT has in the past earned returns in excess of its estimated WACC for some other services which are subject to charge controls as a result achieving greater efficiency improvements or volume growth than anticipated in the related charge controls);
 - Ofcom set the starting charges for TISBO services in 2004. The decision to set the TISBO charges at those levels was based on a methodology agreed with BT in the PPC Phase 1 and 2 Directions in 2001/02. BT proposed an alternative methodology towards the end of our consideration of the PPC charge control in 2004 which would have involved rebalancing trunk and terminating segment prices. The effect of this rebalancing, however, would have been to significantly increase some terminating segment charges (which were the subject of the charge control), whilst reducing trunk charges (which were not part of the charge control). Ofcom carried out detailed analysis of BT's proposals but BT was unable to satisfy Ofcom that there was justification for the price increases and that its calculation of costs and charges for PPC services was more appropriate than that proposed by Ofcom.¹²⁷ BT was unable to provide analysis showing that its rates of return on TISBO services were too low, though its overall rates of return on PPC services indicated that it was recovering its costs. A number of the respondents to the 2004 LLCC Consultation also objected to BT's proposals on the grounds that as trunk charges were outside the scope of the charge control, any reductions in these charges should not be taken into consideration when assessing BT's proposals in relation to increased TISBO charges. Ofcom therefore concluded that it was appropriate to use the PPC starting charges that it had proposed. BT chose not to appeal this decision; and
 - If during the course of the charge control period BT felt that the price caps imposed on TISBO were such that it was unable to recover its costs, the appropriate course of action for it would have been to ask Ofcom to consider whether the charge control remained appropriate. Although BT did suggest in the course of the 2005 trunk investigation that if trunk prices were to be reduced then the price cap may need to be revisited, it did not make any formal approach to Ofcom to request that we revisit the charge control. Low returns on TISBO services do not justify setting trunk charges which are not fair and reasonable.
- 5.22 The consistently high rates of return identified in relation to 2Mbit/s trunk services are indicative that overcharging may have taken place and support the conclusions of our cost orientation assessment. Similarly, the low rates of return on most TISBO services, and in particular the fact that they are the subject of a charge control that limits BT's ability to set high prices, suggests that there has been no overcharging for TISBO services.

¹²⁷ See Annex C of the 2004 LLCC Statement:
http://www.ofcom.org.uk/consult/condocs/ppc_charge_control/statement/.

International benchmarking data

- 5.23 In addition to the cost orientation and rate of return assessments carried out above, Ofcom has also considered international benchmarking data to help it assess whether BT has been overcharging the Disputing CPs for PPC services.
- 5.24 As part of its submission of 14 October 2008, BT argued that its PPC charges were not high compared to those of other EU incumbents and included the Deloitte Report to support its arguments. Deloitte had collected data on the published prices of PPC offerings in other European countries and compared these with BT's PPC charges.
- 5.25 Deloitte used data from nine incumbent operators in Western Europe that are subject to the same EU regulatory framework as BT is in the UK. Market assessments have been carried out by regulators in all these countries and regulation (often including cost orientation obligations) has been imposed where SMP was identified in PPC markets. Where no regulation was imposed, Deloitte assumed that this was because the regulator considered that it was not appropriate to do so given the level of competition and that this would constrain prices towards cost.
- 5.26 Deloitte argued that if BT's PPC charges were excessive then it would be expected that PPC charges in at least one EU country would be markedly lower than BT's charges. If this was not the case then overcharging by BT would only be possible if its cost base was much lower than the incumbents in the other countries or if PPC prices in other countries were also not cost oriented.
- 5.27 On the basis of its analysis, Deloitte identified that BT's charges did not appear to be consistently higher or lower than comparative PPC charges in other EU countries and concluded that this indicated that BT's charges were not excessive. Deloitte further noted that there seemed to be no intuitive reason as to why BT should have lower network costs than other incumbent operators and considered it unlikely that charges in all the other countries would not be cost oriented.

The Altnets' position

- 5.28 Several months prior to BT submitting the benchmarking data described above, the Altnets commented in the letter that accompanied their dispute submission that they did not believe that international comparisons would be relevant when assessing BT's PPC charges.¹²⁸ They argued that "*the differences in market conditions, geography, network topology and population density in other countries are too fundamental to make a valid comparison*". COLT has not commented on the use of international comparisons.

Ofcom's assessment

- 5.29 Taken at face value, the benchmarking data compiled by Deloitte suggests that BT's PPC charges are lower than the EU averages for both PPC terminating segments and trunk/terminating segments combined, at each of the bandwidths considered (64kbit/s, 2Mbit/s and 34Mbit/s).
- 5.30 A more detailed examination of the report, however, has led us to identify a number of issues that cause us to question the extent to which the comparisons can be relied

¹²⁸ Letter from Olswang to Ofcom, dated 25 June 2008.

upon, particularly in relation to trunk charges, and consequently the weight we should give to this evidence.¹²⁹

- 5.31 Our analysis of accounting rates of return and the cost ceiling benchmarks above suggests that trunk charges, most notably for 2Mbit/s, are of key importance to the Disputes. International benchmarking that specifically considers these charges is therefore the most relevant to our analysis.
- 5.32 Given the concerns that we have identified in **Section 3** regarding the lack of availability of comparable pricing information for trunk services and the differences in the competitiveness and level of regulation in the trunk markets, we do not believe that it is possible to draw any reliable inferences from Deloitte's benchmarking work with respect to BT's trunk charges. Moreover, we do not believe that any other international benchmarking data exists that does not suffer from the concerns that we have highlighted above in relation to the Deloitte Report.

Proposed conclusions on overcharging

- 5.33 For the reasons set out above, although the benchmarking information is interesting, we do not feel that we can draw any reliable conclusions on overcharging from the data.
- 5.34 On this basis, our assessment relies primarily on the cost orientation assessment, as supported by the rate of return analysis, that we have carried out in relation to 2Mbit/s trunk services
- 5.35 We therefore propose to conclude that BT has overcharged the Disputing CPs for 2Mbit/s PPC trunk services in the period April 2005 to September 2008.

Setting appropriate charges

- 5.36 As part of their dispute submission, the Altnets requested that Ofcom "*determine the proper charges for PPCs provided by BT to THUS, C&W, Virgin Media, Global Crossing and Verizon from 24 June 2004 to the date of the determination of the dispute*". COLT included a similar request in the COLT Dispute Submission.
- 5.37 Having identified that, as a result of 2Mbit/s PPC trunk charges, BT has overcharged the Disputing CPs since April 2005, it is necessary for Ofcom to identify what trunk charges it would have been appropriate for BT to have levied for the PPC services.
- 5.38 There are various methodologies that could be used to calculate an appropriate trunk charge.
- 5.39 The Altnets suggested in their dispute submission that Ofcom should adopt a "neutral" value when setting charges, adding: "*If this results in a worse outcome for BT than could have been achieved had BT complied with its obligations from the outset, it creates a positive incentive for BT to comply voluntarily with its obligations*".¹³⁰ In the context of the approach adopted in their submission, it appears that the Altnets believe that this neutral value is FAC. Therefore the Altnets seem to consider that we should revert any charges we deem to be inappropriate to FAC. We do not believe that this would strike a fair balance between the interests of the

¹²⁹ These concerns are discussed in **paragraphs 3.30 to 3.43** above.

¹³⁰ Paragraph 2.53.3 of the Altnets' Dispute Submission.

Parties. COLT did not comment on the methodology for setting a trunk charge in its submissions.

- 5.40 The level of regulation imposed on BT in relation to PPC trunk services during the period of the Disputes was less than that imposed in relation to terminating segments. It would therefore seem perverse for us to impose charges as a result of a dispute that would amount to a tougher control (i.e. a rate of return control rather than a RPI-x glidepath) than that imposed through the *ex ante* regulation imposed in the 2004 LLCC Statement. This could effectively undermine incentives for new entry and investment in their own networks.
- 5.41 Imposing something akin to rate of return regulation would damage BT's incentives to reduce costs, since cost reductions would simply be passed on in lower charges. Moreover, imposing such a control could undermine any entry incentive arising from temporarily high returns in other markets in the future, thereby harming competition. As the promotion of competition and efficiency are part of Ofcom's objectives, reliance on FAC rates of return as a benchmark might, on these grounds, be regarded as inconsistent with Ofcom's duties and Community obligations.
- 5.42 In light of this, we believe that it is appropriate to view BT's overcharging in terms of the maximum amount that BT could have charged for 2Mbit/s PPC trunk services without being found to have overcharged the Disputing CPs. In the absence of any specific justification to the contrary, this maximum amount is the DSAC for 2Mbit/s trunk services.
- 5.43 Our assessment of overcharging is primarily based on whether BT's charges are above the DSACs that we have calculated (using DSAC figures originally provided by BT and adjusted in the manner discussed in **Section 4**) for PPC services, and not whether its rate of return on a fully allocated cost basis is too high. This assessment would also seem to provide the appropriate basis for identifying appropriate PPC charges.
- 5.44 As part of our consideration of whether it is reasonable to reduce the charges for 2Mbit/s PPC trunk services to DSAC, we have considered what the impact of this would be on BT. We have assessed what the impact of repaying the overcharged revenue to the Altnets would have on BT's rate of return for PPCs over the period of overcharging (i.e. April 2005 to September 2008) and identified that it would fall from 13.7% to 12.7%. This level of rate of return is still higher than BT's average WACC in that period (i.e. around 12%), indicating that BT would still have recovered its costs of providing PPCs over the period in which we might require that repayments be made.
- 5.45 The Altnets claimed in their dispute submission that BT had disproportionately loaded common costs on to services consumed by external customers (i.e. low bandwidth services) as compared with the services that BT purchased more of (i.e. high bandwidth services).¹³¹ The Altnets suggested that Ofcom should avoid replicating this situation when setting charges.

¹³¹ The Altnets also suggested in their dispute submission that discrimination had potentially occurred as a result of information in BT's internal reference offer and regulatory financial statements being wrong, leading BT's downstream divisions to potentially margin squeeze when competing for contracts. The Altnets provided no evidence to show that this had actually happened and the issues fall outside the scope of the dispute that Ofcom is resolving. COLT also alleged that BT has discriminated in favour of its internal customers through its PPC charges, but did not expand further on this claim. As such, Ofcom has not investigated these issues further and would not propose to do so unless presented with evidence to support the allegations.

- 5.46 There is little evidence to suggest that BT is in fact loading common costs on to low bandwidth services as opposed to high bandwidth services. The analysis carried out by Ofcom suggests that BT has been earning lower rates of return on low bandwidth services as compared to high bandwidth services, with some low bandwidth services being priced significantly below the DSAC ceiling.
- 5.47 In any event, by requiring BT to reduce certain of its 2Mbit/s trunk services to DSAC, we are reducing the over-recovery on these services and are therefore not replicating the situation described by the Altnets.

Section 6

Addressing BT's overcharging

- 6.1 Having determined that BT appears to have overcharged the Disputing CPs for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008 and identified what the appropriate charges should have been, we now turn to consider whether it is appropriate and proportionate for us to exercise our powers under section 190 of the Act to make any directions to give effect to our determinations.
- 6.2 One of Ofcom's main powers under section 190 of the Act is the power to give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums by way of an adjustment of an overpayment (or underpayment).¹³²

Repayment of overcharges

The Disputing CPs' position

- 6.3 As part of their dispute submissions, the Disputing CPs argued that BT should be required to reimburse them for any overpayments that they had made to BT as a result of it overcharging for PPCs.
- 6.4 The Altnets in particular claimed that requiring BT to reimburse them would help to promote competition, ensure that BT does not retain unfairly any overcharge and provide an incentive for BT to comply with its obligations in the future.
- 6.5 The level of reimbursement should be calculated on a service by service basis with reference to FAC, the Altnets suggested. They noted that such a retrospective application of FAC would not equate to rate of return regulation through the backdoor as they were not suggesting that FAC should be used to assess compliance.

BT's position

- 6.6 The BT Submission (supported by the Keyworth Paper) argued strongly that it was not reasonable or proportionate for Ofcom to apply £200 million of price changes historically, as was being suggested by the Disputing CPs, without evidence of economic harm having occurred.
- 6.7 BT noted the points made by the Disputing CPs about repayment of charges in their dispute submissions and suggested that even if economic harm had occurred, it was unlikely that any price changes would be passed on to the customers of the Disputing CPs that had suffered that harm.
- 6.8 BT's view appears to be based on three key assertions:
- it is the level of total PPC charges, and not the mix of individual service charges, that determines whether consumers experience any economic harm;
 - overall, PPC charges have not been excessive and therefore the level of charges has been appropriate; and

¹³² See section 190(2)(d) of the Act.

- even if there had been economic harm, intervention by Ofcom through repayments to the Disputing CPs would not address the harm as the CPs would not pass on the refunds to those end-customers that would have been affected.

6.9 The Keyworth Paper suggests that it is not obvious that high trunk charges would give rise to any material economic harm. It identifies that high trunk charges would make market entry more attractive to BT's competitors.

Ofcom's position on repayment of overcharges

6.10 We do not agree with BT's overall assessment. We would note firstly that it is not necessary for Ofcom to show that economic harm has occurred in order for it to determine that BT has overcharged the Disputing CPs or that BT should repay these overcharges.

6.11 Regardless of whether or not it is necessary to show economic harm, we believe that if BT has overcharged the Disputing CPs for trunk circuits, then there is a significant risk that economic harm has arisen. Furthermore, we believe that there is good justification in this case for intervention regardless of who directly benefits from that intervention.

6.12 This assessment is based on three separate considerations:

- We believe that BT has overcharged for some wholesale PPCs overall during the period of the Disputes;
- An imbalance between the recovery of costs for trunk and terminating circuits could give rise to a number of inefficient distortions in the market; and
- Given the above, failure by Ofcom to intervene in this case would provide BT with a perverse set of incentives, which would be inconsistent with our statutory duties and Community obligations.

We consider each of these issues in the following paragraphs.

Impact of overcharging on consumers

6.13 As we have explained in **paragraph 5.19** and **Table 5.3**, although BT may have failed to achieve a rate of return that covers its cost of capital over the period of the Dispute as a whole, it has earned an average rate of return on PPCs in excess of its cost of capital over the years that we are proposing to require BT to make a repayment. We do not, however, consider this to be an appropriate test for assessing economic harm.

6.14 Rather, we believe that it is necessary to consider the impact of overcharging on consumers. We believe that overcharging may have given rise to economic harm to retail leased lines end consumers through higher prices than they would have paid if BT had not been overcharging for 2Mbit/s trunk services.

6.15 The relationship between overcharging and economic harm to retail customers is acknowledged in paragraph 28 of the Keyworth Paper:

"Absent discrimination, "excessive" PPC charges would still, of course, unduly raise the PPC input costs faced by CPs, and could give rise to material detrimental effects. Most obviously, "excessive"

PPC charges would be expected to have resulted in unduly high downstream prices for retail leased lines. That is, one would expect some direct consumer harm through high retail prices."

- 6.16 It is difficult to assess the exact extent to which the Disputing CPs will pass on higher input prices from BT to their retail customers, as this depends upon a number of factors. However, we believe overcharging for 2Mbit/s trunk services could lead to higher retail prices for two principal reasons:
- **Impact on the marginal cost of service provision for the Disputing CPs** – the cost of acquiring 2Mbit/s trunk services is likely to be considered by the Disputing CPs as a marginal cost in providing retail leased lines. This is both in terms of the initial one-off costs (e.g. connection), but also for the on-going rental costs. Assuming that the Disputing CPs are profit maximising firms, higher prices of 2Mbit/s trunk services (through overcharging) would therefore lead to the firms setting higher prices for retail circuits that include such trunk services.
 - **Reduction in the competitive threat to BT** – by setting high prices for 2Mbit/s trunk services to the Disputing CPs, BT is able to reduce the ability of those CPs to undercut its prices for retail circuits. The reduction in this competitive constraint means that BT can maintain higher prices for its own retail circuits than would be the case in the absence of wholesale overcharging.

- 6.17 As the Keyworth Paper acknowledges, these higher retail prices would be expected to result in direct consumer harm. BT and the Keyworth Paper seek to avoid this conclusion by offsetting the overcharging on 2Mbit/s trunk services by the much lower returns earned by BT on terminating segments, which were regulated under charge caps during the period covered by the Disputes. For the reasons set out above (e.g. see **paragraph 5.21**), we regard the level of the charge caps for terminating segments as a distinct matter. We also address the mix of PPC charges in greater detail in the next sub-section.

Introduction of inefficient market distortions

- 6.18 BT and the Keyworth Paper argue that the mix of PPC service charges is not important in determining whether there is economic harm, but rather that it is the overall level of charges that is important:

*"...the impact of BT's PPC charges on the PPC input costs of CPs will depend on the combined impact of trunk and terminating segment charges. In particular, if the total level of PPC charges (i.e. total trunk and terminating segment charges) in relation to a given retail service can reasonably be said to be cost-orientated, then a CP's costs of retail leased line provision will not have been unduly raised as a result of BT's PPC charging, irrespective of the precise structure of PPC charges that the CP faced (or the extent to which BT recovers a given level of PPC costs from trunk and terminating segment charges)."*¹³³

- 6.19 In considering the validity of BT's assertions it is important to note that even if BT's overall rate of return on PPCs was around or, as it argues, below its cost of capital, this does not imply that the combined rate of return for circuits (i.e. combinations of TISBO and trunk) of individual bandwidths is necessarily also around (or below) its

¹³³ See paragraph 24 of the Keyworth Paper.

cost of capital. Our analysis of BT's accounting information suggests that the rates of return BT achieves on end-to-end wholesale leased lines vary significantly across the bandwidths (see **Table 5.3**).

- 6.20 Although, as we have explained above, we agree with BT that the overall level of charges is important in generating economic harm, Ofcom believes that the mix of services purchased by individual CPs is also important. For the assertion to hold that the mix between trunk and TISBO does not matter, all consumers of wholesale and retail leased lines would need to consume the services in fixed and identical proportions. This is not the case. Information provided by both BT and the Disputing CPs regarding expenditure on individual PPC services shows that there is variation in relative consumption patterns (see **Figure 3.1** above). In particular, TISBO is often purchased on its own and combined with self-supplied trunk circuits.
- 6.21 Given the variation in consumption patterns, by distorting relative prices of different wholesale PPC services, BT's pricing behaviour could have given rise to distortions in economic decision-making within the market. This distorted behaviour is likely to lead to inefficient outcomes and a reduction in economic welfare.
- 6.22 We believe that three key distortions could be introduced:
- **Distorted retail competition between CPs** - the relative requirements for TISBO and trunk services between the Disputing CPs are not homogeneous. Those CPs with large existing networks are likely to be in a relatively better position to self-supply trunk circuits than those with more limited networks. As a consequence, the split between trunk and TISBO spend for the Disputing CPs will be different, with some of the CPs purchasing proportionately more trunk than terminating segments. Overcharging by BT for trunk circuits will therefore lead to relatively higher costs for those CPs with smaller networks of their own and, as a consequence, could lead to a potential distortion in retail competition;
 - **Distorted prices to end users** – like the Disputing CPs themselves, end users of retail leased lines are not homogeneous in terms of the proportion of trunk and TISBO that they consume. A retail customer who wants to link offices in Glasgow and London requires a very different mix of TISBO and trunk circuits than a customer who wants to link offices in Glasgow and Edinburgh. In this example, the former consumer would face a disproportionately higher retail cost than the latter for their leased line due to the relatively higher consumption of trunk services (for which we believe BT has overcharged). These pricing distortions may not only harm those consumers that have to purchase above average proportions of trunk circuits, but could more generally distort consumers' purchasing decisions, resulting in reduced economic welfare;
 - **Distorted investment decisions** - high BT trunk prices may also have the effect of encouraging inefficient entry into the market, which can also distort competition. High charges for wholesale services could give rise to circumstances whereby it is profitable for the Disputing CPs to invest in self-supply of the services despite their costs of provision being higher than for BT. This is inefficient for society as a whole. Although entry may lead to increased infrastructure competition over time and, therefore, some mitigating dynamic efficiency benefits, these are less likely to offset static inefficiency where, as a result of overcharging, the margins available to entrants are very high. This is especially the case where prices are above relevant measures of standalone cost, as we believe is the case for trunk services in particular. Although widespread inefficient market entry does not appear to have happened during the

period of the Disputes, anecdotal evidence suggests that this was because the Disputing CPs believed that BT's trunk charges were too high and expected that Ofcom would ultimately take action to reduce them.

Implication for BT's incentives

- 6.23 The BT Submission makes it very clear that BT believes that there will be no "beneficial consequence" of any repayment for end consumers:

"...customers will not receive any refund for BT's alleged overcharging..."

*"Plainly there is no guarantee, or even likelihood, at all that the consumers would benefit from any repayment."*¹³⁴

- 6.24 We infer from these statements that BT considers there would be little or no consumer gain from Ofcom intervening should we find that BT has overcharged. We disagree.
- 6.25 We agree with BT that it is not certain that the Disputing CPs will pass through any repayments to those end customers that have been affected by BT's overcharging (i.e. provide them with a refund). For those end users that have remained as customers of the Disputing CPs, and continue to do so, they may benefit from any additional investment or lower prices that the Disputing CPs may be able to deliver as a consequence of any repayment. However, we accept that this may well not provide complete compensation for all those affected.
- 6.26 However, we do not believe that this argument is sufficient to justify us not acting in this case. We believe that among the greatest benefits of a determination in disputes of this nature are the incentives and regulatory signals that they send to BT (and other CPs) as to how we will interpret regulatory obligations and assess future conduct.
- 6.27 As identified earlier, we believe that BT's actions may have caused economic harm to consumers and competition. In line with our statutory duties and Community obligations under sections 3 and 4 of the Act, we believe that BT should therefore be strongly incentivised not to pursue such behaviour in the future (both in the PPC market and in other markets).
- 6.28 We cannot fail to act in this case, given the apparent evidence of overcharging that we have identified. Any failure to act would risk sending BT a signal that Ofcom might not act to remedy overcharging in the future. This could give rise to considerable future consumer detriment. Introducing such incentives and regulatory signals is therefore clearly at odds with Ofcom's principal duties in section 3(1) of the Act to further the interests of citizens and consumers in relation to communications matters. Specifically, it would fail to address the economic harm concerns discussed in **paragraphs 3.105 - 3.110**, which would be contrary to supporting competition in the provision of retail leased lines by providers other than BT.

Ofcom's approach to overpayment in other disputes

- 6.29 In considering whether or not it is appropriate to require BT to reimburse the Disputing CPs for the overcharged trunk services, we have had regard to our

¹³⁴ See paragraphs 109 and 110 of BT's submission of 14 October 2008.

previous decisions in other disputes to see whether they offer us any guidance as to how we should resolve these Disputes.

The Opal dispute

- 6.30 The Opal dispute related to BT's recovery of the costs of carrier pre-selection ("CPS") Facilities ("the Opal Dispute").¹³⁵ Ofcom found that BT had been under-recovering its 'per-provider' costs and over-recovering its 'per-customer' costs and, on that basis, was able to calculate the point at which BT broke even. Ofcom concluded that BT had recovered its costs of providing CPS Facilities at the end of November 2003, and that an offer by BT to backdate its charges to 28 November 2003 was therefore reasonable. Ofcom required BT to make repayments by way of adjustment to the other charges in dispute to the same date.
- 6.31 In resolving the Disputes we are effectively requiring BT to reduce the prices it charged historically for 2Mbit/s trunk services. There is therefore no "break even" point (and no agreed charge that can be backdated to a break even point). We cannot therefore adopt the methodology that we used in resolving the Opal Dispute in deciding whether BT should be required to make payments to the Disputing CPs in this case.

WLR ISDN2 charges dispute

- 6.32 In its determination of a dispute relating to BT's charges for WLR ISDN2 ("the WLR ISDN2 Charges Dispute") Ofcom concluded that BT had over-recovered from its wholesale customers the costs it incurred in providing WLR ISDN2 between 28 November 2003 and 30 September 2004.¹³⁶ Ofcom's determination of 9 March 2005 required BT to make repayments by way of adjustment to the charges that applied over that period.
- 6.33 In the WLR ISDN2 Charges Dispute, Ofcom concluded that for a period of time BT's charges for WLR ISDN2 services were not based on the forward-looking LRIC of providing those services and that BT was therefore over-recovering its costs. Ofcom therefore required BT to make repayments in respect of the period for which it was over-recovering its costs, 28 November 2003 to 30 September 2004.
- 6.34 In the WLR ISDN2 Charges Dispute, Ofcom had never set BT's charges. BT was therefore responsible for ensuring that it was complying with its cost orientation obligations and set fair and reasonable charges without a signal from Ofcom as to what level of charge would be appropriate.
- 6.35 This set of facts is broadly similar to that in the Disputes. Ofcom has never set BT's trunk charges but had rather required BT to comply with its cost orientation obligation. Unlike in the WLR ISDN2 Charges Dispute, Ofcom has previously given BT indications that it identified BT's high PPC trunk charges as a concern. For example, in paragraph 3.88 of the 2004 LLMR Statement, Ofcom noted that "*despite it appearing that there is a prospect of competition on major trunk routes, BT has*

¹³⁵ *Determination to resolve a dispute regarding the retrospective application of CPS charges*, published at: http://www.ofcom.org.uk/consult/condocs/cps_charges/determination.pdf

¹³⁶ *Resolution of a dispute between Energis and BT relating to BT's charges for WLR ISDN2 from 28 November 2003 until 1 October 2004*, <http://www.ofcom.org.uk/consult/condocs/energis-bt/resolution/resolution.pdf>

nevertheless been able to maintain its prices significantly above the competitive level'.¹³⁷

Conclusions on Ofcom's approach to overpayments from other disputes

- 6.36 Having reviewed the Opal Dispute and the WLR ISDN2 Charges Dispute, we have concluded that the facts in the latter case are similar to those of the Disputes. In line with our duties in section 3(3) of the Act to act in a consistent manner, we propose to require BT to make payments to the Disputing CPs.

Calculating the level of individual repayment

- 6.37 Having identified that BT has overcharged the Disputing CPs for 2Mbit/s PPC trunk services in the period since April 2005 and that it is appropriate to require BT to refund these overpayments, it is necessary for us to identify the amount that BT should repay each Disputing CP.
- 6.38 In order to make this assessment we needed to obtain data from the Parties as to the amount of 2Mbit/s trunk that each company had purchased from BT over the period of the Disputes. We requested that the Disputing CPs and BT provide this data in terms of both volume of 2Mbit/s trunk purchased and the amount of money spent in doing so.
- 6.39 We anticipated that the information provided by the Disputing CPs and BT would be broadly consistent and would enable us to calculate easily how much each company had overpaid BT. Unfortunately there was considerable discrepancy between the data provided by the Disputing CPs, the data provided by BT and the data for the markets in total contained within the regulatory accounting information supplied to us by BT.
- 6.40 In particular, there were substantial differences between the volumes of 2Mbit/s trunk circuits that the Disputing CPs believe they had purchased from BT, the number of circuits that appeared in BT's regulatory accounting information and the number of circuits that BT's billing data suggested that it had sold to the Disputing CPs. These differences appear to have been caused by the lack of clarity on BT's invoices (particularly in the earlier years) as to the types of circuits purchased, which necessitated assumptions to be made by the Disputing CPs about the number of each type of circuit that they had purchased. In addition, some of the Altnets did not have complete invoice sets for all of their related companies that had purchased PPCs over the period of the Disputes.
- 6.41 We do not, therefore, feel that we can have sufficient confidence in the volume data provided by either BT or the Disputing CPs in order to identify the precise amount that each Disputing CP should be reimbursed.
- 6.42 The data provided by BT and the Disputing CPs as to the amount of money spent on each PPC service was far more in alignment, particularly when considered in terms of the total amount spent by each company on PPC services. Across the period of the Disputes, there was a difference of just 1% in terms of total spend on PPCs. The difference in terms of 2Mbit/s PPC trunk services was 4%, with BT's estimate of the amount spent being higher than that claimed by the Disputing CPs.

¹³⁷ See http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

- 6.43 On this basis, we propose to use the 2Mbit/s spend data provided by BT (rather than volumes data) as the basis of our refund calculations as it appears likely to be the most accurate.
- 6.44 On the basis of the data on internal and external revenue per unit and the adjusted unit DSACs from the regulatory accounts, we were able to identify the percentage refund required for each affected service in each year (i.e. for 2004/05 to 2007/08) for the Disputing CPs and BT's own downstream businesses.¹³⁸ The DSAC averaged over the last three years of the Disputes (as discussed in **paragraphs 5.11 to 5.13**) has been used to calculate the refund required for the period 1 April 2008 to 30 September 2008.
- 6.45 To calculate refunds for each Disputing CP in each year we then applied the calculated percentage refund rate for each service to the operator-specific expenditure data provided by BT. Ideally we would have used operator-level data from the regulatory accounts to ensure consistency. Unfortunately such data does not exist. However, comparison of the aggregated operator-level data from BT and the regulatory accounts total external revenues suggested that it was sufficiently consistent for the purposes of resolving this dispute.¹³⁹ Furthermore, the CP expenditure data from BT is also broadly consistent with the data from the Disputing CPs for 2Mbit/s trunk services.
- 6.46 On the basis of this proposed methodology, we set out in **Table 6.1** below the total amounts that the Disputing CPs have overpaid BT for the provision of 2Mbit/s PPC trunk services.

Table 6.1: Repayments due to the Disputing CPs in £m

Refund (£m)	THUS	C&W	Global	Virgin	Verizon	COLT	Total
2004/05	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2005/06	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2006/07	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2007/08	[X]	[X]	[X]	[X]	[X]	[X]	[X]
2008/09	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]	[X]	[X]	42.75

Source: Ofcom – based on data supplied by BT

Interest on repayments

- 6.47 In addition to requesting that we require BT to repay any identified overpayments, the Disputing CPs additionally requested that we require BT to pay interest on any overpayments.
- 6.48 In considering whether to require BT to pay interest on the overpayments, we have had regard to the terms and conditions on which the Disputing CPs purchase PPCs

¹³⁸ The unit DSAC is assumed to be the corrected price and the refund is calculated as the percentage difference between this corrected price and the original price.

¹³⁹ Over the period 2004/05 to 2007/08 the difference between the two data sets is around 5%. Given that the operators in dispute do not represent the entirety of the market (as reflected by the regulatory accounts), this difference appears to be reasonable.

from BT – the BT Standard PPC Handover Agreement (“the Agreement”).¹⁴⁰ Paragraph 9.7 of the Agreement states that:

“9.7 If any charge (or the means of calculating that charge) for a BT service or facility has retrospective effect (for whatever reason) then BT shall, as soon as reasonably practicable following publication in the Carrier Price List, adjust and recalculate the charges in respect of such service or facility using the new charge and calculate the interest for any sum overpaid or underpaid at the Oftel Interest Rate.”

6.49 The “Oftel Interest Rate” is defined in Annex D to the Agreement as:

“three eighths of one per cent (3/8%) above the London Inter Bank Offered Rate being the rate per annum of the offered quotation for sterling deposits for delivery on the due date for payment for a period of three months as displayed on page 3750 on the Telerate Service (or any other page that may replace page 3750 on that service) at or about 11 am London time on the due date of payment provided that if such a rate is not so displayed London Inter Bank Offered Rate shall mean the rate quoted by National Westminster Bank PLC to leading banks in the London interbank market at or about 11 am London time on the due date of payment for the offering of sterling deposits of a comparable amount for a period of three months. Such interest shall be calculated on a daily basis.”

6.50 The Agreement clearly envisages a situation such as that arising in the Disputes occurring (i.e. charges for PPC services having a retrospective effect) and sets out that where this occurs, BT should recalculate the charges using the new charges and calculate interest using the Oftel Interest Rate.

6.51 We therefore consider on the facts of these disputes that it is appropriate and proportionate for Ofcom to exercise its powers under section 190(2)(d) of the Act to require BT to repay the amounts identified in **Table 6.1** and accordingly propose to require BT to repay these overpayments with interest at the Oftel Interest Rate.

Ofcom’s statutory obligations and regulatory principles

6.52 Ofcom’s statutory obligations and regulatory principles are set out in **Annex 11** below. Ofcom considers that the following obligations and principles are relevant to its proposed decision to require BT to make repayments by way of adjustment to the 2Mbit/s PPC trunk charges.

6.53 Accepting the Disputes for resolution fits with Ofcom’s regulatory principle to intervene where there is a specific regulatory duty to do so.

6.54 Ofcom considers that to require BT to make payments to the Disputing CPs by way of adjustment for overpayments supports its obligation to further the interests of consumers, where appropriate by promoting competition, as it encourages BT to comply with its SMP obligations (the purpose of which is to promote competition). It promotes competition more generally by enabling other providers to compete with BT

¹⁴⁰

http://www.btwholesale.com/pages/static/Pricing_and_Contracts/Reference_Offers/Partial_Private_Circuits_PPC_Reference_Offer/PPC_Contracts.html

in the provision of retail leased lines to businesses. Promoting competition in this case leads to benefits for businesses in the form of increased choice, downward pressure on retail prices and improved quality of service.

- 6.55 Requiring BT to make repayments for the period between 1 April 2005 and 30 September 2008 therefore supports Ofcom's principal duty at section 3(1)(b) of the Act, as well as its duty under section 4 of the Act to promote competition in communications markets in accordance with the Framework Directive.
- 6.56 In addition, Ofcom considers that requiring BT to make payments to the Disputing CPs by way of adjustment for overpayments, by encouraging BT to comply with its SMP Conditions and thereby helping to level the playing field for BT's competitors, supports its obligation at section 3(2)(b) of the Act to secure the availability of a wide range of communications services, as well as its duty under section 4 of the Act to encourage the provision of network access (here, PPC trunk services) for the purposes of securing efficiency and sustainable competition, for the benefits of consumers.
- 6.57 Requiring BT to make repayments for the period between 1 April 2005 and 30 September 2008, by supporting the duties set out above, also supports Ofcom's principal duty to further the interests of consumers. While Ofcom does not consider, in this case, that retail consumers will necessarily benefit directly as a result of the Disputing CPs passing on the reduced trunk charges in retail prices, the effect on competition of this transfer of funds between CPs will benefit consumers in the form of greater competition, leading to downward pressure on prices, availability of a wider range of services, and improved quality of service.
- 6.58 Finally, Ofcom considers that its proposal to require BT to make payments to the Disputing CPs by way of adjustment for overpayments from 1 April 2005 is fair and reasonable as between the Parties to the Disputes, and that this is in line with Ofcom's duty and regulatory principle to ensure that its regulatory activities are transparent, accountable, evidence-based, proportionate, consistent and targeted.
- 6.59 Ofcom considers that this document clearly sets out the Parties' arguments and Ofcom's reasoning that leads to this proposed conclusion, thereby supporting Ofcom's duty and regulatory principle to ensure that its decision making process is evidence-based, proportionate and consistent. The Parties will have an opportunity to comment on Ofcom's proposals, supporting Ofcom's duty to ensure that its regulatory activities are transparent, accountable, evidence-based and consistent. Ofcom considers that its determinations are proportionate, in that they strike a fair balance between the Parties to the Disputes, and targeted in that they are binding on the parties to the Disputes.

Proposed resolution

- 6.60 Based on the analysis set out in **Sections 5 and 6**, Ofcom proposes to determine:
- (i) That BT has overcharged the Disputing CPs for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008;
 - (ii) That the amounts that BT has overcharged the Disputing CPs for 2Mbit/s trunk services in each of the years of the Disputes is as set out in **Table 6.1** above; and

- (iii) That BT should refund the Disputing CPs, with interest at standard contract rates (i.e. the Oftel Interest Rate), the amount that it has overcharged them during the period of the Disputes.

6.61 Ofcom proposes to adopt the draft Determinations set out in **Annexes 4-9** of this explanatory statement by the end of June 2009.

Next steps

6.62 Stakeholders are invited to comment on Ofcom's proposed resolution of these disputes by **noon on 29 May 2009**.

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 29 May 2009**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <http://www.ofcom.org.uk/consult/condocs/XXXX>, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email martin.hill@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Martin Hill
4th Floor
Competition Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7783 4103
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Martin Hill on 020 7783 4334.

Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/accoun/disclaimer/>

Next steps

- A1.11 Following the end of the consultation period, Ofcom intends to publish final Determinations by the end of July 2009.
- A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

- A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing

☐

Name/contact details/job title

☐

Whole response

☐

Organisation

☐

Part of the response

☐

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

☐

Name

Signed (if hard copy)

Annex 4

Draft Determination to resolve the dispute between BT and Cable & Wireless

Determination under Sections 188 and 190 of the Communications Act 2003 (“2003 Act”) for resolving a dispute between Cable & Wireless UK (“C&W”) and British Telecommunications Plc (“BT”) concerning BT’s charges for partial private circuits.

WHEREAS—

(A) Section 188(2) of the 2003 Act provides that, where Ofcom has decided pursuant to Section 186(2) of the 2003 Act that it is appropriate for it to handle a dispute, Ofcom must consider the dispute and make a determination for resolving it. The determination that Ofcom makes for resolving the dispute must be notified to the parties in accordance with Section 188(7) of the 2003 Act, together with a full statement of the reasons on which the determination is based. Ofcom must publish so much of its determination as (having regard, in particular, to the need to preserve commercial confidentiality) it considers appropriate to publish for bringing it to the attention of the members of the public, including to the extent that Ofcom considers pursuant to Section 393(2)(a) of the 2003 Act that any such disclosure is made for the purpose of facilitating the carrying out by Ofcom of any of its functions;

(B) Section 190 of the 2003 Act sets out the scope of Ofcom’s powers on resolving a dispute which may include, in accordance with Section 190(2) of the 2003 Act;

- a) making a declaration setting out the rights and obligations of the parties to the dispute;
- b) giving a direction fixing the terms or conditions of transactions between the parties to the dispute;
- c) giving a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
- d) for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties to the dispute to the other, giving a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment;

(C) On 24 June 2004, Ofcom published a statement called “*Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*”¹⁴¹ (the “2004 LLMR Statement”) which found that BT held significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;

¹⁴¹ See: http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area; and
- c) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(D) In the 2004 LLMR Statement, Ofcom imposed a series of SMP conditions on BT in these markets under section 45 of the Act, including a basis of charges obligation which requires:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

(E) On 25 June 2008, Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media jointly referred a dispute with BT to Ofcom for dispute resolution requesting a determination that BT has overcharged them for partial private circuits provided to them from 24 June 2004 to date (which depends on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost oriented during that time) and, if so, by how much they have been overcharged and should therefore be reimbursed;

(F) Having considered the submissions of all the parties to the disputes referred by Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media, Ofcom set the scope of the issues in dispute to be resolved as follows-

“The finalised scope is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:

i. BT has or will have overcharged the Parties for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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) and, if so;

ii. by how much the Parties will have been overcharged; and

iii. whether and by how much BT should reimburse the Parties.

As Ofcom progresses the resolution of these disputes, we will consider whether any of the matters arising in the disputes raise industry wide issues that it would be appropriate for us to deal with on our own-initiative.”;

(G) On 8 December 2008, Ofcom published a statement concluding a market review into the markets for retail leased lines, symmetric broadband origination and wholesale trunk segments¹⁴² (the “2008 BCMR Statement”) which found that BT had significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including forty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area;
- c) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above forty five megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area; and
- d) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(H) The 2008 BCMR Statement imposed SMP conditions on BT in these markets, including a basis of charges condition, which imposes a cost orientation obligation on BT:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

¹⁴² The Business Connectivity Market Review - www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf

(I) In order to resolve this dispute, Ofcom has considered (among other things) the information provided by the parties and Ofcom has further acted in accordance with its general duties set out in section 3 of and the Community requirements set out in section 4 of the 2003 Act;

(J) A fuller explanation of the background to the dispute and Ofcom's reasons for making this Determination is set out in the explanatory statement accompanying this Determination; and

(K) This draft determination is issued on 27 April 2009, for which responses are invited by 29 May 2009.

NOW, THEREFORE, OFCOM MAKES, FOR THE REASONS SET OUT IN THE ACCOMPANYING EXPLANATORY STATEMENT, THE FOLLOWING [DRAFT] DETERMINATION FOR RESOLVING THE DISPUTE:

I Declaration of rights and obligations, etc.

1. BT has overcharged C&W for the provision of 2Mbit/s PPC trunk services for the period between 1 April 2005 and 30 September 2008.

2. BT must pay to C&W, by way of adjustment of an overpayment for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008, the sum of £[>] plus interest calculated at the rate specified in paragraph 9.7 of the Agreement.

II Binding nature and effective date

3. This Determination is binding on BT in accordance with Section 190(8) of the 2003 Act.

4. This Determination shall take effect on the day it is published.

III Interpretation

5. For the purpose of interpreting this Determination—

a) except as otherwise defined in paragraph 9 below of this Determination, words or expressions used in this Determination (and in the recitals hereto) shall have the same meaning as they have been ascribed in, under or for the purposes of the 2004 LLMR Statement;

b) headings and titles shall be disregarded; and

c) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.

6. In this Determination—

a) "2003 Act" means the Communications Act 2003 (c.21);

b) "Agreement" means the BT Standard PPC Handover Agreement that C&W has entered into with BT;

c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by Section 736 of the Companies Act 1985, as amended by the Companies Act 1989;

d) "Ofcom" means the Office of Communications;

- e) "Relevant Period" means the period beginning on 24 June 2004 and ending on 30 September 2008;

Neil Buckley
Director of Investigations

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

27 April 2009

Annex 5

Draft Determination to resolve the dispute between BT and THUS

Determination under Sections 188 and 190 of the Communications Act 2003 (“2003 Act”) for resolving a dispute between THUS plc (“THUS”) and British Telecommunications Plc (“BT”) concerning BT’s charges for partial private circuits.

WHEREAS—

(A) Section 188(2) of the 2003 Act provides that, where Ofcom has decided pursuant to Section 186(2) of the 2003 Act that it is appropriate for it to handle a dispute, Ofcom must consider the dispute and make a determination for resolving it. The determination that Ofcom makes for resolving the dispute must be notified to the parties in accordance with Section 188(7) of the 2003 Act, together with a full statement of the reasons on which the determination is based. Ofcom must publish so much of its determination as (having regard, in particular, to the need to preserve commercial confidentiality) it considers appropriate to publish for bringing it to the attention of the members of the public, including to the extent that Ofcom considers pursuant to Section 393(2)(a) of the 2003 Act that any such disclosure is made for the purpose of facilitating the carrying out by Ofcom of any of its functions;

(B) Section 190 of the 2003 Act sets out the scope of Ofcom’s powers on resolving a dispute which may include, in accordance with Section 190(2) of the 2003 Act;

- a) making a declaration setting out the rights and obligations of the parties to the dispute;
- b) giving a direction fixing the terms or conditions of transactions between the parties to the dispute;
- c) giving a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
- d) for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties to the dispute to the other, giving a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment;

(C) On 24 June 2004, Ofcom published a statement called “*Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*”¹⁴³ (the “2004 LLMR Statement”) which found that BT held significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;

¹⁴³ See: http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area; and
- c) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(D) In the 2004 LLMR Statement, Ofcom imposed a series of SMP conditions on BT in these markets under section 45 of the Act, including a basis of charges obligation which requires:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

(E) On 25 June 2008, Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media jointly referred a dispute with BT to Ofcom for dispute resolution requesting a determination that BT has overcharged them for partial private circuits provided to them from 24 June 2004 to date (which depends on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost oriented during that time) and, if so, by how much they have been overcharged and should therefore be reimbursed;

(F) Having considered the submissions of all the parties to the disputes referred by Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media, Ofcom set the scope of the issues in dispute to be resolved as follows-

“The finalised scope is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:

i. BT has or will have overcharged the Parties for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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) and, if so;

ii. by how much the Parties will have been overcharged; and

iii. whether and by how much BT should reimburse the Parties.

As Ofcom progresses the resolution of these disputes, we will consider whether any of the matters arising in the disputes raise industry wide issues that it would be appropriate for us to deal with on our own-initiative.”;

(G) On 8 December 2008, Ofcom published a statement concluding a market review into the markets for retail leased lines, symmetric broadband origination and wholesale trunk segments¹⁴⁴ (the “2008 BCMR Statement”) which found that BT had significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including forty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area;
- c) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above forty five megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area; and
- d) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(H) The 2008 BCMR Statement imposed SMP conditions on BT in these markets, including a basis of charges condition, which imposes a cost orientation obligation on BT:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

¹⁴⁴ The Business Connectivity Market Review - www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf

(I) In order to resolve this dispute, Ofcom has considered (among other things) the information provided by the parties and Ofcom has further acted in accordance with its general duties set out in section 3 of and the Community requirements set out in section 4 of the 2003 Act;

(J) A fuller explanation of the background to the dispute and Ofcom's reasons for making this Determination is set out in the explanatory statement accompanying this Determination; and

(K) This draft determination is issued on 27 April 2009, for which responses are invited by 29 May 2009.

NOW, THEREFORE, OFCOM MAKES, FOR THE REASONS SET OUT IN THE ACCOMPANYING EXPLANATORY STATEMENT, THE FOLLOWING [DRAFT] DETERMINATION FOR RESOLVING THE DISPUTE:

I Declaration of rights and obligations, etc.

1. BT has overcharged THUS for the provision of 2Mbit/s PPC trunk services for the period between 1 April 2005 and 30 September 2008.

2. BT must pay to THUS, by way of adjustment of an overpayment for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008, the sum of £[<] plus interest calculated at the rate specified in paragraph 9.7 of the Agreement.

II Binding nature and effective date

3. This Determination is binding on BT in accordance with Section 190(8) of the 2003 Act.

4. This Determination shall take effect on the day it is published.

III Interpretation

5. For the purpose of interpreting this Determination—

- a) except as otherwise defined in paragraph 9 below of this Determination, words or expressions used in this Determination (and in the recitals hereto) shall have the same meaning as they have been ascribed in, under or for the purposes of the 2004 LLMR Statement;
- b) headings and titles shall be disregarded; and
- c) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.

6. In this Determination—

- a) "2003 Act" means the Communications Act 2003 (c.21);
- b) "Agreement" means the BT Standard PPC Handover Agreement that THUS has entered into with BT;
- c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by Section 736 of the Companies Act 1985, as amended by the Companies Act 1989;
- d) "Ofcom" means the Office of Communications;

- e) "Relevant Period" means the period beginning on 24 June 2004 and ending on 30 September 2008;

Neil Buckley
Director of Investigations

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

27 April 2009

Annex 6

Draft Determination to resolve the dispute between BT and Global Crossing

Determination under Sections 188 and 190 of the Communications Act 2003 (“2003 Act”) for resolving a dispute between Global Crossing (UK) Telecommunications Limited (“Global Crossing”) and British Telecommunications Plc (“BT”) concerning BT’s charges for partial private circuits.

WHEREAS—

(A) Section 188(2) of the 2003 Act provides that, where Ofcom has decided pursuant to Section 186(2) of the 2003 Act that it is appropriate for it to handle a dispute, Ofcom must consider the dispute and make a determination for resolving it. The determination that Ofcom makes for resolving the dispute must be notified to the parties in accordance with Section 188(7) of the 2003 Act, together with a full statement of the reasons on which the determination is based. Ofcom must publish so much of its determination as (having regard, in particular, to the need to preserve commercial confidentiality) it considers appropriate to publish for bringing it to the attention of the members of the public, including to the extent that Ofcom considers pursuant to Section 393(2)(a) of the 2003 Act that any such disclosure is made for the purpose of facilitating the carrying out by Ofcom of any of its functions;

(B) Section 190 of the 2003 Act sets out the scope of Ofcom’s powers on resolving a dispute which may include, in accordance with Section 190(2) of the 2003 Act;

- a) making a declaration setting out the rights and obligations of the parties to the dispute;
- b) giving a direction fixing the terms or conditions of transactions between the parties to the dispute;
- c) giving a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
- d) for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties to the dispute to the other, giving a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment;

(C) On 24 June 2004, Ofcom published a statement called “*Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*”¹⁴⁵ (the “2004 LLMR Statement”) which found that BT held significant market power in a number of markets, including those for:

¹⁴⁵ See: http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area; and
- c) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(D) In the 2004 LLMR Statement, Ofcom imposed a series of SMP conditions on BT in these markets under section 45 of the Act, including a basis of charges obligation which requires:

"[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition."

(E) On 25 June 2008, Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media jointly referred a dispute with BT to Ofcom for dispute resolution requesting a determination that BT has overcharged them for partial private circuits provided to them from 24 June 2004 to date (which depends on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost oriented during that time) and, if so, by how much they have been overcharged and should therefore be reimbursed;

(F) Having considered the submissions of all the parties to the disputes referred by Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media, Ofcom set the scope of the issues in dispute to be resolved as follows-

"The finalised scope is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:

- i. BT has or will have overcharged the Parties for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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) and, if so;

ii. by how much the Parties will have been overcharged; and

iii. whether and by how much BT should reimburse the Parties.

As Ofcom progresses the resolution of these disputes, we will consider whether any of the matters arising in the disputes raise industry wide issues that it would be appropriate for us to deal with on our own-initiative.”;

(G) On 8 December 2008, Ofcom published a statement concluding a market review into the markets for retail leased lines, symmetric broadband origination and wholesale trunk segments¹⁴⁶ (the “2008 BCMR Statement”) which found that BT had significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including forty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area;
- c) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above forty five megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area; and
- d) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(H) The 2008 BCMR Statement imposed SMP conditions on BT in these markets, including a basis of charges condition, which imposes a cost orientation obligation on BT:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be

¹⁴⁶ The Business Connectivity Market Review - www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf

able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

(I) In order to resolve this dispute, Ofcom has considered (among other things) the information provided by the parties and Ofcom has further acted in accordance with its general duties set out in section 3 of and the Community requirements set out in section 4 of the 2003 Act;

(J) A fuller explanation of the background to the dispute and Ofcom's reasons for making this Determination is set out in the explanatory statement accompanying this Determination; and

(K) This draft determination is issued on 27 April 2009, for which responses are invited by 29 May 2009.

NOW, THEREFORE, OFCOM MAKES, FOR THE REASONS SET OUT IN THE ACCOMPANYING EXPLANATORY STATEMENT, THE FOLLOWING [DRAFT] DETERMINATION FOR RESOLVING THE DISPUTE:

I Declaration of rights and obligations, etc.

1. BT has overcharged Global Crossing for the provision of 2Mbit/s PPC trunk services for the period between 1 April 2005 and 30 September 2008.
2. BT must pay to Global Crossing, by way of adjustment of an overpayment for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008, the sum of £[x] plus interest calculated at the rate specified in paragraph 9.7 of the Agreement.

II Binding nature and effective date

3. This Determination is binding on BT in accordance with Section 190(8) of the 2003 Act.
4. This Determination shall take effect on the day it is published.

III Interpretation

5. For the purpose of interpreting this Determination—
 - a) except as otherwise defined in paragraph 9 below of this Determination, words or expressions used in this Determination (and in the recitals hereto) shall have the same meaning as they have been ascribed in, under or for the purposes of the 2004 LLMR Statement;
 - b) headings and titles shall be disregarded; and
 - c) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.
6. In this Determination—
 - a) “2003 Act” means the Communications Act 2003 (c.21);
 - b) “Agreement” means the BT Standard PPC Handover Agreement that Global Crossing has entered into with BT;

- c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by Section 736 of the Companies Act 1985, as amended by the Companies Act 1989;
- d) "Ofcom" means the Office of Communications;
- e) "Relevant Period" means the period beginning on 24 June 2004 and ending on 30 September 2008;

Neil Buckley
Director of Investigations

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

27 April 2009

Annex 7

Draft Determination to resolve the dispute between BT and Verizon

Determination under Sections 188 and 190 of the Communications Act 2003 (“2003 Act”) for resolving a dispute between Verizon UK Limited (“Verizon”) and British Telecommunications Plc (“BT”) concerning BT’s charges for partial private circuits.

WHEREAS—

(A) Section 188(2) of the 2003 Act provides that, where Ofcom has decided pursuant to Section 186(2) of the 2003 Act that it is appropriate for it to handle a dispute, Ofcom must consider the dispute and make a determination for resolving it. The determination that Ofcom makes for resolving the dispute must be notified to the parties in accordance with Section 188(7) of the 2003 Act, together with a full statement of the reasons on which the determination is based. Ofcom must publish so much of its determination as (having regard, in particular, to the need to preserve commercial confidentiality) it considers appropriate to publish for bringing it to the attention of the members of the public, including to the extent that Ofcom considers pursuant to Section 393(2)(a) of the 2003 Act that any such disclosure is made for the purpose of facilitating the carrying out by Ofcom of any of its functions;

(B) Section 190 of the 2003 Act sets out the scope of Ofcom’s powers on resolving a dispute which may include, in accordance with Section 190(2) of the 2003 Act;

- a) making a declaration setting out the rights and obligations of the parties to the dispute;
- b) giving a direction fixing the terms or conditions of transactions between the parties to the dispute;
- c) giving a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
- d) for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties to the dispute to the other, giving a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment;

(C) On 24 June 2004, Ofcom published a statement called “*Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*”¹⁴⁷ (the “2004 LLMR Statement”) which found that BT held significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;

¹⁴⁷ See: http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area; and
- c) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(D) In the 2004 LLMR Statement, Ofcom imposed a series of SMP conditions on BT in these markets under section 45 of the Act, including a basis of charges obligation which requires:

"[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition."

(E) On 25 June 2008, Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media jointly referred a dispute with BT to Ofcom for dispute resolution requesting a determination that BT has overcharged them for partial private circuits provided to them from 24 June 2004 to date (which depends on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost oriented during that time) and, if so, by how much they have been overcharged and should therefore be reimbursed;

(F) Having considered the submissions of all the parties to the disputes referred by Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media, Ofcom set the scope of the issues in dispute to be resolved as follows-

"The finalised scope is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:

i. BT has or will have overcharged the Parties for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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) and, if so;

ii. by how much the Parties will have been overcharged; and

iii. whether and by how much BT should reimburse the Parties.

As Ofcom progresses the resolution of these disputes, we will consider whether any of the matters arising in the disputes raise industry wide issues that it would be appropriate for us to deal with on our own-initiative.”;

(G) On 8 December 2008, Ofcom published a statement concluding a market review into the markets for retail leased lines, symmetric broadband origination and wholesale trunk segments¹⁴⁸ (the “2008 BCMR Statement”) which found that BT had significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including forty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area;
- c) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above forty five megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area; and
- d) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(H) The 2008 BCMR Statement imposed SMP conditions on BT in these markets, including a basis of charges condition, which imposes a cost orientation obligation on BT:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

¹⁴⁸ The Business Connectivity Market Review - www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf

(I) In order to resolve this dispute, Ofcom has considered (among other things) the information provided by the parties and Ofcom has further acted in accordance with its general duties set out in section 3 of and the Community requirements set out in section 4 of the 2003 Act;

(J) A fuller explanation of the background to the dispute and Ofcom's reasons for making this Determination is set out in the explanatory statement accompanying this Determination; and

(K) This draft determination is issued on 27 April 2009, for which responses are invited by 29 May 2009.

NOW, THEREFORE, OFCOM MAKES, FOR THE REASONS SET OUT IN THE ACCOMPANYING EXPLANATORY STATEMENT, THE FOLLOWING [DRAFT] DETERMINATION FOR RESOLVING THE DISPUTE:

I Declaration of rights and obligations, etc.

1. BT has overcharged Verizon for the provision of 2Mbit/s PPC trunk services for the period between 1 April 2005 and 30 September 2008.

2. BT must pay to Verizon, by way of adjustment of an overpayment for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008, the sum of £[<] plus interest calculated at the rate specified in paragraph 9.7 of the Agreement.

II Binding nature and effective date

3. This Determination is binding on BT in accordance with Section 190(8) of the 2003 Act.

4. This Determination shall take effect on the day it is published.

III Interpretation

5. For the purpose of interpreting this Determination—

a) except as otherwise defined in paragraph 9 below of this Determination, words or expressions used in this Determination (and in the recitals hereto) shall have the same meaning as they have been ascribed in, under or for the purposes of the 2004 LLMR Statement;

b) headings and titles shall be disregarded; and

c) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.

6. In this Determination—

a) "2003 Act" means the Communications Act 2003 (c.21);

b) "Agreement" means the BT Standard PPC Handover Agreement that Verizon has entered into with BT;

c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by Section 736 of the Companies Act 1985, as amended by the Companies Act 1989;

d) "Ofcom" means the Office of Communications;

- e) "Relevant Period" means the period beginning on 24 June 2004 and ending on 30 September 2008;

Neil Buckley
Director of Investigations

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

27 April 2009

Annex 8

Draft Determination to resolve the dispute between BT and Virgin Media

Determination under Sections 188 and 190 of the Communications Act 2003 (“2003 Act”) for resolving a dispute between Virgin Media Limited (“Virgin”) and British Telecommunications Plc (“BT”) concerning BT’s charges for partial private circuits.

WHEREAS—

(A) Section 188(2) of the 2003 Act provides that, where Ofcom has decided pursuant to Section 186(2) of the 2003 Act that it is appropriate for it to handle a dispute, Ofcom must consider the dispute and make a determination for resolving it. The determination that Ofcom makes for resolving the dispute must be notified to the parties in accordance with Section 188(7) of the 2003 Act, together with a full statement of the reasons on which the determination is based. Ofcom must publish so much of its determination as (having regard, in particular, to the need to preserve commercial confidentiality) it considers appropriate to publish for bringing it to the attention of the members of the public, including to the extent that Ofcom considers pursuant to Section 393(2)(a) of the 2003 Act that any such disclosure is made for the purpose of facilitating the carrying out by Ofcom of any of its functions;

(B) Section 190 of the 2003 Act sets out the scope of Ofcom’s powers on resolving a dispute which may include, in accordance with Section 190(2) of the 2003 Act;

- a) making a declaration setting out the rights and obligations of the parties to the dispute;
- b) giving a direction fixing the terms or conditions of transactions between the parties to the dispute;
- c) giving a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
- d) for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties to the dispute to the other, giving a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment;

(C) On 24 June 2004, Ofcom published a statement called “*Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*”¹⁴⁹ (the “2004 LLMR Statement”) which found that BT held significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;

¹⁴⁹ See: http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area; and
- c) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(D) In the 2004 LLMR Statement, Ofcom imposed a series of SMP conditions on BT in these markets under section 45 of the Act, including a basis of charges obligation which requires:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

(E) On 25 June 2008, Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media jointly referred a dispute with BT to Ofcom for dispute resolution requesting a determination that BT has overcharged them for partial private circuits provided to them from 24 June 2004 to date (which depends on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost oriented during that time) and, if so, by how much they have been overcharged and should therefore be reimbursed;

(F) Having considered the submissions of all the parties to the disputes referred by Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media, Ofcom set the scope of the issues in dispute to be resolved as follows-

“The finalised scope is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:

i. BT has or will have overcharged the Parties for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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) and, if so;

ii. by how much the Parties will have been overcharged; and

iii. whether and by how much BT should reimburse the Parties.

As Ofcom progresses the resolution of these disputes, we will consider whether any of the matters arising in the disputes raise industry wide issues that it would be appropriate for us to deal with on our own-initiative.”;

(G) On 8 December 2008, Ofcom published a statement concluding a market review into the markets for retail leased lines, symmetric broadband origination and wholesale trunk segments¹⁵⁰ (the “2008 BCMR Statement”) which found that BT had significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including forty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area;
- c) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above forty five megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area; and
- d) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(H) The 2008 BCMR Statement imposed SMP conditions on BT in these markets, including a basis of charges condition, which imposes a cost orientation obligation on BT:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

¹⁵⁰ The Business Connectivity Market Review - www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf

(I) In order to resolve this dispute, Ofcom has considered (among other things) the information provided by the parties and Ofcom has further acted in accordance with its general duties set out in section 3 of and the Community requirements set out in section 4 of the 2003 Act;

(J) A fuller explanation of the background to the dispute and Ofcom's reasons for making this Determination is set out in the explanatory statement accompanying this Determination; and

(K) This draft determination is issued on 27 April 2009, for which responses are invited by 29 May 2009.

NOW, THEREFORE, OFCOM MAKES, FOR THE REASONS SET OUT IN THE ACCOMPANYING EXPLANATORY STATEMENT, THE FOLLOWING [DRAFT] DETERMINATION FOR RESOLVING THE DISPUTE:

I Declaration of rights and obligations, etc.

1. BT has overcharged Virgin for the provision of 2Mbit/s PPC trunk services for the period between 1 April 2005 and 30 September 2008.

2. BT must pay to Virgin, by way of adjustment of an overpayment for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008, the sum of £[3<] plus interest calculated at the rate specified in paragraph 9.7 of the Agreement.

II Binding nature and effective date

3. This Determination is binding on BT in accordance with Section 190(8) of the 2003 Act.

4. This Determination shall take effect on the day it is published.

III Interpretation

5. For the purpose of interpreting this Determination—

a) except as otherwise defined in paragraph 9 below of this Determination, words or expressions used in this Determination (and in the recitals hereto) shall have the same meaning as they have been ascribed in, under or for the purposes of the 2004 LLMR Statement;

b) headings and titles shall be disregarded; and

c) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.

6. In this Determination—

a) "2003 Act" means the Communications Act 2003 (c.21);

b) "Agreement" means the BT Standard PPC Handover Agreement that Virgin has entered into with BT;

c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by Section 736 of the Companies Act 1985, as amended by the Companies Act 1989;

d) "Ofcom" means the Office of Communications;

- e) "Relevant Period" means the period beginning on 24 June 2004 and ending on 30 September 2008;

Neil Buckley
Director of Investigations

A person duly authorised in accordance with paragraph 18 of the Schedule to the
Office of Communications Act 2002

27 April 2009

Annex 9

Draft Determination to resolve the dispute between BT and COLT Telecommunications

Determination under Sections 188 and 190 of the Communications Act 2003 ("2003 Act") for resolving a dispute between COLT Telecommunications ("COLT") and British Telecommunications Plc ("BT") concerning BT's charges for partial private circuits.

WHEREAS—

(A) Section 188(2) of the 2003 Act provides that, where Ofcom has decided pursuant to Section 186(2) of the 2003 Act that it is appropriate for it to handle a dispute, Ofcom must consider the dispute and make a determination for resolving it. The determination that Ofcom makes for resolving the dispute must be notified to the parties in accordance with Section 188(7) of the 2003 Act, together with a full statement of the reasons on which the determination is based. Ofcom must publish so much of its determination as (having regard, in particular, to the need to preserve commercial confidentiality) it considers appropriate to publish for bringing it to the attention of the members of the public, including to the extent that Ofcom considers pursuant to Section 393(2)(a) of the 2003 Act that any such disclosure is made for the purpose of facilitating the carrying out by Ofcom of any of its functions;

(B) Section 190 of the 2003 Act sets out the scope of Ofcom's powers on resolving a dispute which may include, in accordance with Section 190(2) of the 2003 Act;

- a) making a declaration setting out the rights and obligations of the parties to the dispute;
- b) giving a direction fixing the terms or conditions of transactions between the parties to the dispute;
- c) giving a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
- d) for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties to the dispute to the other, giving a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment;

(C) On 24 June 2004, Ofcom published a statement called "*Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets*"¹⁵¹ (the "2004 LLMR Statement") which found that BT held significant market power in a number of markets, including those for:

¹⁵¹ See: http://www.ofcom.org.uk/consult/condocs/llmr/statement/state_note.pdf.

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area; and
- c) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(D) In the 2004 LLMR Statement, Ofcom imposed a series of SMP conditions on BT in these markets under section 45 of the Act, including a basis of charges obligation which requires:

"[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition."

(E) On 25 June 2008, Cable & Wireless, Thus, Global Crossing, Verizon and Virgin Media jointly referred disputes with BT to Ofcom for dispute resolution requesting determinations that BT has overcharged them for partial private circuits provided to them from 24 June 2004 to date (which depends on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost oriented during that time) and, if so, by how much they have been overcharged and should therefore be reimbursed;

(F) Separately, on 20 October 2008, COLT also referred a dispute with BT to Ofcom for dispute resolution requesting a determination that BT has overcharged them for partial private circuits provided to them from 24 June 2004 to date (which depends on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were cost oriented during that time) and, if so, by how much they have been overcharged and should therefore be reimbursed. In its submission, COLT stated that it had no specific evidence or unique issues in its dispute with BT that would warrant any different treatment of its case to that of the other operators that had submitted similar disputes on 25 June 2008.

(G) Having considered the submissions of COLT, Ofcom set the scope of the issues in dispute to be resolved as follows-

“The scope of the dispute is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:

i. BT has overcharged COLT for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, 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) and, if so;

ii. by how much COLT has been overcharged; and

iii. whether and by how much BT should reimburse COLT..“;

(H) On 8 December 2008, Ofcom published a statement concluding a market review into the markets for retail leased lines, symmetric broadband origination and wholesale trunk segments¹⁵² (the “2008 BCMR Statement”) which found that BT had significant market power in a number of markets, including those for:

- a) the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom but not including the Hull Area;
- b) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above eight megabits per second and up to and including forty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area;
- c) the provision of traditional interface symmetric broadband origination with a bandwidth capacity above forty five megabits per second and up to and including one hundred and fifty five megabits per second within the United Kingdom but not including the Hull Area and the Central and East London Area; and
- d) the provision of wholesale trunk segments at all bandwidths within the United Kingdom.

(I) The 2008 BCMR Statement imposed SMP conditions on BT in these markets, including a basis of charges condition, which imposes a cost orientation obligation on BT:

“[x]3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by [the requirement to provide network access on reasonable request] 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.

[x]3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by [the

¹⁵² The Business Connectivity Market Review - www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf

requirement to provide network access on reasonable request] is for a service which is subject to a charge control under [the charge control condition], the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition [x]3.1.

[x]3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”;

(J) In order to resolve this dispute, Ofcom has considered (among other things) the information provided by the parties and Ofcom has further acted in accordance with its general duties set out in section 3 of and the Community requirements set out in section 4 of the 2003 Act;

(K) A fuller explanation of the background to the dispute and Ofcom's reasons for making this Determination is set out in the explanatory statement accompanying this Determination; and

(L) This draft determination is issued on 27 April 2009, for which responses are invited by 29 May 2009.

NOW, THEREFORE, OFCOM MAKES, FOR THE REASONS SET OUT IN THE ACCOMPANYING EXPLANATORY STATEMENT, THE FOLLOWING [DRAFT] DETERMINATION FOR RESOLVING THE DISPUTE:

I Declaration of rights and obligations, etc.

1. BT has overcharged COLT for the provision of 2Mbit/s PPC trunk services for the period between 1 April 2005 and 30 September 2008.

2. BT must pay to COLT, by way of adjustment of an overpayment for 2Mbit/s PPC trunk services in the period 1 April 2005 to 30 September 2008, the sum of £[x] plus interest calculated at the rate specified in paragraph 9.7 of the Agreement.

II Binding nature and effective date

3. This Determination is binding on BT in accordance with Section 190(8) of the 2003 Act.

4. This Determination shall take effect on the day it is published.

III Interpretation

5. For the purpose of interpreting this Determination—

- a) except as otherwise defined in paragraph 9 below of this Determination, words or expressions used in this Determination (and in the recitals hereto) shall have the same meaning as they have been ascribed in, under or for the purposes of the 2004 LLMR Statement;
- b) headings and titles shall be disregarded; and
- c) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.

6. In this Determination—

- a) “2003 Act” means the Communications Act 2003 (c.21);

- b) "Agreement" means the BT Standard PPC Handover Agreement that COLT has entered into with BT;
- c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by Section 736 of the Companies Act 1985, as amended by the Companies Act 1989;
- d) "Ofcom" means the Office of Communications;
- e) "Relevant Period" means the period beginning on 24 June 2004 and ending on 30 September 2008;

Neil Buckley
Director of Investigations

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

27 April 2009

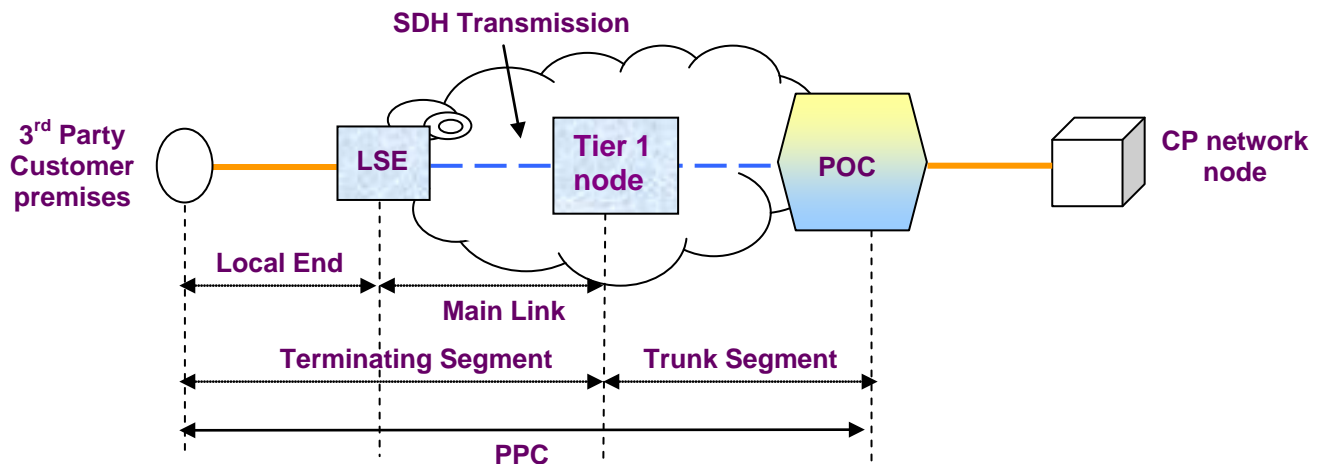
Annex 10

Constituent parts of a PPC

A10.1 PPCs provide dedicated symmetric transmission at a range of bandwidths between a 3rd party customer premise and a communications provider's network via a Point of Connection ("POC").¹⁵³ The 3rd party customer premises are linked to the Local Serving Exchanges ("LSE") via copper or fibre-optic pair local ends with SDH or PDH transmission¹⁵⁴ being used to provide the link between the customer premises and the POC.

A10.2 PPCs can in turn be made up of 'terminating segments', which for the period of the dispute were defined as running from a customer site to a Tier 1 node in BT's network, and 'trunk segments', which typically run over longer distances between Tier 1 nodes.¹⁵⁵ Not all PPCs will be sold with a trunk segment – this will generally depend on the proximity of the Altnet's POC to the LSE. All PPCs will have at least one terminating segment.

Figure A10.1: Constituent parts of a PPC



¹⁵³ The meaning of the terms 'symmetric transmission' and 'Point of Connection', along with the meanings of the other technical terms used in this section, are set out in the Glossary in **Annex 16** below.

¹⁵⁴ SDH and PDH (Plesiochronous and Synchronous Digital Hierarchy) are transmission technologies that support the transmission of various bandwidths of data over fibre optic networks and are used extensively in the provision of Leased Lines services. They are explained in more detail in the Glossary in **Annex 10**.

¹⁵⁵ As set out in **Figure A10.1**, terminating segments can, in turn, be made up of local ends and main links.

Annex 11

Key provisions of the legal and regulatory framework

The legal framework

- A11.1 Regulation of electronic communications (including leased lines) across Europe is based on the CRF which was published in April 2002 and had to be implemented by the Member States by July 2003. This superseded earlier EU regulatory instruments. The CRF comprises five EU Communications Directives (together “the Directives”):
- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (Framework Directive);
 - Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive);
 - Directive 2002/20/EC on the authorisation of electronic communications networks and services (Authorisation Directive);
 - Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services , (Universal Service Directive); and
 - Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (Privacy Directive).
- A11.2 The Framework Directive, the Access Directive, the Authorisation Directive and the Universal Service Directive were implemented in the United Kingdom on 25 July 2003 via the Act. The Privacy Directive was implemented by Regulation which came into force on 11 December 2003.
- A11.3 Article 16 of the Framework Directive requires each NRA to carry out an analysis of the relevant markets as soon as possible after the adoption of the Commission's recommendation on relevant product and service markets or any updating thereof (“the Recommendation”). The Commission adopted the first edition of the Recommendation on 11 February 2003.¹⁵⁶ The Commission issued a revised Recommendation on 17 December 2007.¹⁵⁷

¹⁵⁶ Commission Recommendation 2003/311/EC of 11 February 2003 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communication networks and services.
http://ec.europa.eu/information_society/policy/ecomm/doc/library/recomm_guidelines/relevant_market_s/i_11420030508en00450049.pdf

¹⁵⁷ Commission Recommendation 2007/879/EC of 17 December 2007 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services.
http://ec.europa.eu/information_society/policy/ecomm/doc/library/proposals/rec_markets_en.pdf

- A11.4 Where an NRA determines that a relevant market is not effectively competitive it must identify undertakings with SMP on that market and must then impose on these undertakings appropriate specific regulatory obligations, or maintain or amend these obligations where they already exist. These obligations, commonly referred to as “the SMP conditions”, include the setting of price controls and basis of charges (cost orientation) obligation.
- A11.5 The CRF was implemented in the UK by provisions in the Act. Section 45 of the Act empowers Ofcom to set conditions of various kinds, including SMP conditions.

The regulatory framework

The cost orientation obligations

- A11.6 SMP Condition G3 states as follows:

“Condition G3 – Basis of charges

G3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition G1 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.

G3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by Condition G1 is for a service which is subject to a charge control under Condition G4, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition G3.1.

G3.3 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”

The charge control obligations

- A11.7 The revised SMP Condition G4 states as follows:

“Condition G4 – Charge control

G4.1 Without prejudice to the generality of Condition G3, and subject to paragraph G4.2, the Dominant Provider shall take all reasonable steps to secure that, at the end of each Relevant Year, the Percentage Change (determined in accordance with paragraphs G4.3, G4.4 or G4.5 as appropriate) in:

(a) the aggregate of charges for all of the products and services listed in Annex A to this Condition;

(b) the aggregate of charges for all of the products and services listed in Annex B to this Condition,

(c) the aggregate of charges for the connection services listed in Part 1 of Annex A to this Condition;

(d) the aggregate of charges for the rental and maintenance services listed in Part 2 of Annex A to this Condition; and

(e) each of the charges for the products and services listed in Annex B to this Condition;

is not more than the Controlling Percentage (determined in accordance with paragraph G4.6).

...

G4.6 Subject to paragraphs G4.7 and G4.8, the Controlling Percentage in relation to any Relevant Year means RPI reduced:

(a) for the category of products and services specified in paragraph G4.1(a), by 4 percentage points;

(b) for the category of products and services specified in paragraph G4.1(b), by 8.9 percentage points;

(c) for the category of products and services specified in paragraph G4.1(c), by 0 percentage points;

(d) for the category of products and services specified in paragraph G4.1(d), by 0 percentage points; and

(e) for the category of products and services specified in paragraph G4.1(e), by 3 percentage points.

G4.7 Where the Percentage Change in any Relevant Year is less than the Controlling Percentage, then for the purposes of the categories of products and services identified in paragraphs G4.1(a) and G4.1(b) the Controlling Percentage for the following Relevant Year shall be determined in accordance with paragraph G4.6, but increased by the amount of such deficiency.

G4.8 Where the Percentage Change in any Relevant Year is more than the Controlling Percentage, then for the purposes of the categories of products and services identified in paragraphs G4.1(a) and G4.1(b) the Controlling Percentage for the following Relevant Year shall be determined in accordance with paragraph G4.6, but decreased by the amount of such excess.

...

G4.13 In this Condition:

(a) "Relevant Financial Year" means the period of 12 months ending on 31 March immediately preceding the Relevant Year;

(b) "Controlling Percentage" is to be determined in accordance with Condition G4.6;

(c) *"Relevant Year" means any of the four periods of 12 months beginning on 1st October starting with 1st October 2004 and ending on 30 September 2008;*

(d) *"Retail Prices Index" means the index of retail prices compiled by an agency or a public body on behalf of Her Majesty's Government or a governmental department (which is the Office of National Statistics at the time of publication of this Notification) from time to time in respect of all items; and*

(e) *"RPI" means the amount of the change in the Retail Prices Index in the period of twelve months ending on 30th June immediately before the beginning of a Relevant Year, expressed as a percentage (rounded to two decimal places) of that Retail Prices Index as at the beginning of that first mentioned period.*

G4.14 In the Annexes to this Condition:

(a) *"Partial Private Circuit" or "PPC" means a circuit provided pursuant to the PPC Contract and in accordance with any directions made by Ofcom pursuant to SMP services conditions G1, G3 or G7 under section 49 of the Act; and*

(b) *"PPC Contract" means the Dominant Provider's Standard PPC Handover Agreement as at 24 June 2004."*

A11.8 Again, the wording of SMP Condition GG4 is broadly similar to that of SMP Condition G4 (with references to 'G' being replaced with those for 'GG'). The main exceptions being the services that are included in the Annexes to each SMP Condition and the Controlling Percentages set out in sub-paragraph 6. SMP Condition GG4.6 states:

"GG4.6 Subject to paragraphs GG4.7 and GG4.8, the Controlling Percentage in relation to any Relevant Year means RPI reduced:

(a) for the category of products and services specified in paragraph GG4.1(a), by 6.5 percentage points;

(b) for the category of products and services specified in paragraph GG4.1(b), by 8.9 percentage points;

(c) for the category of products and services specified in paragraph GG4.1(c), by 0 percentage points;

(d) for the category of products and services specified in paragraph GG4.1(d), by 0 percentage points; and

(e) for the category of products and services specified in paragraph GG4.1(e), by 3 percentage points."

The non-discrimination obligations

A11.9 SMP Condition G2 states:

"Condition G2 – requirement not to unduly discriminate

G2.1 The Dominant Provider shall not unduly discriminate against particular persons or against a particular description of persons, in relation to matters connected with Network Access.

G2.2 In this Condition, the Dominant Provider may be deemed to have shown undue discrimination if it unfairly favours to a material extent an activity carried on by it so as to place at a competitive disadvantage persons competing with the Dominant Provider."

A11.10 The wording of SMP Condition GG2 and H2 is identical to that of SMP Condition G2 (with references to 'G' being replaced with those for 'GG' and 'H').

Network Access

A11.11 The term "Network Access" is not specifically defined in the SMP Conditions set out in the 2004 LLMR Statement. The SMP Conditions, however, make clear that *"except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them and otherwise any word or expression shall have the same meaning as it has in the Act".*¹⁵⁸

A11.12 Section 197 of the Act makes clear that for the purposes of Ofcom's dispute resolution powers in sections 185 to 191 of the Act, the term "Network Access" has the same meaning as in Chapter 1 of Part 2 of the Act.

A11.13 Section 151(1) of the Act states that, for the purposes of Chapter 1 of Part 2 of the Act (which includes sections 32 to 151 of the Act):

"...

"network access" is to be construed in accordance with subsection (3);

..."

A11.14 Section 151(3) of the Act states:

"In this Chapter references to network access are references to—

(a) interconnection of public electronic communications networks; or

(b) any services, facilities or arrangements which—

(i) are not comprised in interconnection; but

(ii) are services, facilities or arrangements by means of which a communications provider or person making available associated facilities is able, for the purposes of the provision of an electronic communications service (whether by him or by another), to make use of anything mentioned in subsection (4);

¹⁵⁸ See paragraph 3 of Schedule 1 to the Notification under sections 48(1) and 79(4) of the Act that identify the PPC markets in which SMP exists, determine the communications providers that have SMP in those markets and set out the SMP Conditions that should apply to those communications providers. The Notification is set out in Annex D of the 2004 LLMR Statement.

and references to providing network access include references to providing any such services, making available any such facilities or entering into any such arrangements.”

A11.15 Section 151(4) states:

“The things referred to in subsection (3)(b) are—

(a) any electronic communications network or electronic communications service provided by another communications provider;

(b) any apparatus comprised in such a network or used for the purposes of such a network or service;

(c) any facilities made available by another that are associated facilities by reference to any network or service (whether one provided by that provider or by another);

(d) any other services or facilities which are provided or made available by another person and are capable of being used for the provision of an electronic communications service.”

Ofcom's dispute resolution powers

EU Legislation

A11.16 These proposed Determinations relate to the exercise by Ofcom of its dispute resolution powers. These powers derive from two provisions in the CRF, Article 20 of the Framework Directive and Article 5 of the Access Directive. Article 20 of the Framework Directive provides as follows:

“1. In the event of a dispute arising in connection with obligations arising under this Directive or the Specific Directives between undertakings providing electronic communications networks or services in a Member State, the national regulatory authority concerned shall, at the request of either party, and without prejudice to the provisions of paragraph 2, issue a binding decision to resolve the dispute in the shortest possible time frame, and in any case within four months except in exceptional circumstances. The Member State concerned shall require that all parties cooperate fully with the national regulatory authority.

2. Member states may make provision for national regulatory authorities to decline to resolve a dispute through a binding decision where other mechanisms, including mediation, exist and would better contribute to resolution of the dispute in a timely manner in accordance with the provisions of Article 9.

3. In resolving a dispute, the national regulatory authority shall take decisions aimed at achieving the objectives set out in Article 8. Any obligations imposed on an undertaking by the national regulatory authority in resolving a dispute shall respect the provisions of this Directive or the Specific Directives.”

A11.17 Article 20 thus covers all disputes arising in connection with obligations under the Framework Directive and the Specific Directives.¹⁵⁹

A11.18 The 32nd Recital to the Framework Directive describes what Article 20 is meant to achieve. It states:

“32. In the event of a dispute between undertakings in the same Member State in an area covered by this Directive or the Specific Directives, for example relating to obligations of access and interconnection or to the means of transferring subscriber lists, an aggrieved party that has negotiated in good faith but failed to reach agreement should be able to call on the national regulatory authority to resolve the dispute. National regulatory authorities should be able to impose a solution on the parties. The intervention of a national regulatory authority in the resolution of a dispute between undertakings providing electronic communications networks or services in a Member State should seek to ensure compliance with the obligations arising under this Directive or the Specific Directives.”

A11.19 Article 5 of the Access Directive deals with the NRA's functions in respect to interconnection. The CRF recognises that the ability of competitors and potential competitors in the telecoms sector is entirely dependent on their ability to interconnect with the networks of the other market participants. Article 5 therefore requires Member States to confer on the NRA the power to require networks to enter into interconnection agreements with each other. Article 5(1) provides:

“National Regulatory Authorities shall, acting in pursuit of the objectives set out in Article 8 of the Framework Directive encourage and, where appropriate ensure, in accordance with the provisions of this Directive, adequate access and interconnection, and interoperability of services, exercising their responsibility in a way that promotes efficiency, and sustainable competition and gives the maximum benefit to end-users.

In particular, without prejudice to measures that may be taken regarding undertakings with significant market power in accordance with Article 8, national regulatory authorities shall be able to impose:

(a) to the extent that it is necessary to ensure end-to-end connectivity, obligations on undertakings that control access to end-users including in justified cases the obligation to interconnect their networks where this is not already the case;”

A11.20 Article 5(4) deals with the power of the NRA to resolve disputes which arise with regard to access and interconnection:

“With regard to access and interconnection, Member States shall ensure that the national regulatory authority is empowered to intervene at its own initiative where justified or, in the absence of agreement between undertakings, at the request of either of the parties involved, in order to secure the policy objectives of Article 8

¹⁵⁹ ‘Specific Directives’ is defined as meaning Directive 2002/20/EC (Authorisation Directive), Directive 2002/19/EC (Access Directive), Directive 2002/22/EC (Universal Service Directive) and Directive 97/66/EC (EU Data Protection Directive).

[of the Framework Directive], in accordance with the provisions of this Directive and the procedures referred to in Articles 6 and 7, 20 and 21 of [the Framework Directive]."

A11.21 Article 5(4) thus requires Member States to confer two powers on the NRA: the power to intervene either on its own initiative or at the request of the parties to a dispute in order to secure the policy objectives referred to. Both Articles 20 and 5(4) refer to the policy objectives set out in Article 8 of the Framework Directive. Article 8 of the Framework Directive sets out the policy objectives and regulatory principles of which the NRAs are required to take the utmost account in carrying out their tasks under the Framework Directive and the Specific Directives.

A11.22 These objectives can be summarised as including promoting competition in the provision of electronic communications networks and services¹⁶⁰ by *inter alia* –

- a) ensuring that users, including disabled users, derive maximum benefit in terms of choice, price and quality;
- b) ensuring that there is no distortion or restriction of competition;
- c) encouraging efficient investment in infrastructure and promoting innovation; and
- d) encouraging efficient use and ensuring the effective management of radio frequencies and numbering resources.

A11.23 In addition, the NRAs are required to contribute to the development of the internal market¹⁶¹ by *inter alia* –

- a) removing remaining obstacles to the provision of electronic communications networks, associated facilities and services and electronic communications services at European level;
- b) encouraging the establishment and development of trans-European networks and the interoperability of pan-European services, and end-to-end connectivity;
- c) ensuring that, in similar circumstances, there is no discrimination in the treatment of undertakings providing electronic communications networks and services; and
- d) co-operating with each other and the Commission in a transparent manner to ensure the development of consistent regulatory practice and the consistent application of the Framework Directive and the Specific Directives.

A11.24 Finally, the NRAs are required to promote the interests of the citizens of the European Union¹⁶² by *inter alia* –

- a) ensuring that all citizens have access to a universal service specified in Directive 2002/22/EC (Universal Service Directive);
- b) ensuring a high level of protection for consumers in their dealings with suppliers, in particular by ensuring the availability of simple and inexpensive dispute resolution procedures carried out by a body that is independent of the parties involved;

¹⁶⁰ See Article 8(2) of the Framework Directive.

¹⁶¹ See Article 8(3) of the Framework Directive.

¹⁶² See Article 8(4) of the Framework Directive.

- c) contributing to ensuring a high level of protection of personal data and privacy;
- d) promoting the provision of clear information, in particular requiring transparency of tariffs and conditions for using publicly available electronic communications services;
- e) addressing the needs of specific social groups, in particular disabled users; and
- f) ensuring that the integrity and security of public communications networks are maintained.

National legislation

A11.25 The relevant provisions of the Framework Directive and the Access Directive were implemented in the UK by the Act. Ofcom's dispute resolution powers and obligations are set out in sections 185 to 191 of the Act. These sections apply to disputes relating to the provision of network access and to other disputes relating to rights and obligations conferred or imposed by or under Part 2 of the Act.

A11.26 In summary, where Ofcom is referred a dispute between different CPs which relates to the provision of network access, Ofcom must accept and resolve the dispute unless there are alternative means of resolving it. Once Ofcom has accepted a dispute, it must resolve it by issuing a determination within four months, unless exceptional circumstances exist.

A11.27 Section 185 of the Act describes the types of disputes to which Ofcom's powers apply and sets out the manner in which disputes can be referred to Ofcom:

"185 Reference of disputes to OFCOM

(1) This section applies in the case of a dispute relating to the provision of network access if it is –

(a) a dispute between different communications providers;

...

(3) Any one or more of the parties to the dispute may refer it to OFCOM.

(4) A reference made under this section is to be made in such manner as OFCOM may require.

...

(8) For the purposes of this section –

(a) the disputes that relate to the provision of network access include disputes as to the terms or conditions on which it is or may be provided in a particular case;

..."

A11.28 Section 186 of the Act sets out the action that Ofcom must take having received a dispute referred under and in accordance with section 185 of the Act:

“186 Action by OFCOM on dispute reference

...

(2) OFCOM must decide whether or not it is appropriate for them to handle the dispute.

(3) Unless they consider –

(a) that there are alternative means available for resolving the dispute,

(b) that a resolution of the dispute by those means would be consistent with the Community requirements set out in section 4; and

(c) that a prompt and satisfactory resolution of the dispute is likely if those alternative means are used for resolving it,

their decision must be a decision that it is appropriate for them to handle the dispute.

(4) As soon as reasonably practicable after OFCOM have decided –

(a) that it is appropriate for them to handle the dispute, or

(b) that it is not,

they must inform each of the parties to the dispute of their decision and of their reasons for it.

...”

A11.29 Section 187 of the Act relates to legal proceedings about referred disputes. It states:

“187 Legal proceedings about referred disputes

(1) Where a dispute is referred or referred back to OFCOM under this Chapter, the reference is not to prevent—

(a) the person making it,

(b) another party to the dispute,

(c) OFCOM, or

(d) any other person,

from bringing, or continuing, any legal proceedings with respect to any of the matters under dispute.

(2) Nor is the reference or reference back to OFCOM under this Chapter of a dispute to prevent OFCOM from—

(a) giving a notification in respect of something that they have reasonable grounds for believing to be a contravention of any obligation imposed by or under any an enactment;

(b) exercising any of their other powers under any enactment in relation to a contravention of such an obligation; or

(c) taking any other step in preparation for or with a view to doing anything mentioned in the preceding paragraphs.

(3) If, in any legal proceedings with respect to a matter to which a dispute relates, the court orders the handling of the dispute by OFCOM to be stayed or sisted—

(a) OFCOM are required to make a determination for resolving the dispute only if the stay or sist is lifted or expires; and

(b) the period during which the stay or sist is in force must be disregarded in determining the period within which OFCOM are required to make such a determination.

(4) Subsection (1) is subject to section 190(8) and to any agreement to the contrary binding the parties to the dispute.

(5) In this section “legal proceedings” means civil or criminal proceedings in or before a court.”

A11.30 Section 188 of the Act sets out the procedures that Ofcom must follow where it has decided, under section 186(2) of the Act, to accept a dispute for resolution:

“188 Procedure for resolving disputes

(1) This section applies where –

(a) OFCOM have decided under section 186(2) that it is appropriate for them to handle a dispute; or

...

(2) OFCOM must –

(a) consider the dispute; and

(b) make a determination for resolving it.

(3) The procedure for consideration and determination of the dispute is to be the procedure that OFCOM consider appropriate.

...

(5) Except in exceptional circumstances and subject to section 187(3), OFCOM must make their determination no more than four months after the following day –

(a) in a case falling within subsection (1)(a), the day of the decision by OFCOM that it is appropriate for them to handle the dispute; and

...

A11.31 Section 190 of the Act sets out the only powers that Ofcom has to resolve disputes:

“190 Resolution of referred disputes

(1) Where OFCOM make a determination for resolving a dispute referred to them under this Chapter, their only powers are those conferred by this section.

(2) Their main power (except in the case of a dispute relating to rights and obligations conferred or imposed by or under the enactments relating to the management of the radio spectrum) is to do one or more of the following—

(a) to make a declaration setting out the rights and obligations of the parties to the dispute;

(b) to give a direction fixing the terms or conditions of transactions between the parties to the dispute;

(c) to give a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by OFCOM; and

(d) for the purpose of giving effect to a determination by OFCOM of the proper amount of a charge in respect of which amounts have been paid by one of the parties of the dispute to the other, to give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment.

(3) Their main power in the excepted case is just to make a declaration setting out the rights and obligations of the parties to the dispute.

(4) Nothing in this section prevents OFCOM from exercising the following powers in consequence of their consideration under this Chapter of any dispute—

(a) their powers under Chapter 1 of this Part to set, modify or revoke general conditions, universal service conditions, access related conditions, privileged supplier conditions or SMP conditions;

(b) their powers to vary, modify or revoke wireless telegraphy licences or grants of recognised spectrum access;

(c) their power to make, amend or revoke regulations under section 1 or 3 of the Wireless Telegraphy Act 1949 (c. 54).

...

(6) Where OFCOM make a determination for resolving a dispute, they may require a party to the dispute—

(a) to make payments to another party to the dispute in respect of costs and expenses incurred by that other party in consequence of the reference of the dispute to OFCOM, or in connection with it; and

(b) to make payments to OFCOM in respect of costs and expenses incurred by them in dealing with the dispute.

...

(8) A determination made by OFCOM for resolving a dispute referred or referred back to them under this Chapter binds all the parties to the dispute.

..."

A11.32 Section 190(2)(d) of the Act, therefore, includes the power in considering a dispute to determine the proper level of a charge that has been paid and to order repayment of sums that are found to have been overpaid.

A11.33 Ofcom has published guidelines on its processes and submission requirements for the handling of complaints and disputes.¹⁶³ The guidelines make clear that before accepting a dispute, Ofcom will require the submitting party to provide:

- a) a clear scope of the dispute that they wish to have resolved;
- b) evidence of failed commercial negotiations between the parties; and
- c) a statement by an officer of the company, preferably the CEO, that best endeavours have been used to resolve the dispute through commercial negotiation.

Ofcom's duties in carrying out its functions

A11.34 Sections 3 and 4 of the Act set out the main duties that Ofcom must have regard to when carrying out its functions, including its dispute resolution functions.

A11.35 Section 3 of the Act deals with Ofcom's general duties. To the extent that they are relevant to the Disputes, the provisions of section 3 of the Act are set out below.

"3 General duties of OFCOM

(1) It shall be the principal duty of OFCOM, in carrying out their functions –

(a) to further the interests of citizens in relation to communications matters; and

(b) to further the interests of consumers in relevant markets, where appropriate by promoting competition.

¹⁶³ *Guidelines for the handling of competition complaints, and complaints and disputes about breaches of conditions imposed under the EU Directive*, July 2004. A copy of the guidelines are available on Ofcom's website at: http://www.ofcom.org.uk/bulletins/eu_directives/guidelines.pdf

(2) The things which, by virtue of subsection (1), OFCOM are required to secure in the carrying out of their functions include, in particular, each of the following –

...

(b) the availability throughout the United Kingdom of a wide range of electronic communications services;

...

(3) In performing their duties under subsection (1), OFCOM must have regard, in all cases, to –

(a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and

(b) any other regulatory principles appearing to OFCOM to represent the best regulatory practice.

(4) OFCOM must also have regard, in performing those duties, to such of the following as appear to them to be relevant in the circumstances –

...

(b) the desirability of promoting competition in relevant markets;

...

(d) the desirability of encouraging investment and innovation in relevant markets;

(e) the desirability of encouraging the availability and use of high speed data transfer services throughout the United Kingdom;

...

(5) In performing their duty under this section of furthering the interests of consumers, OFCOM must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.

(6) Where it appears to OFCOM, in relation to the carrying out of any of the functions mentioned in section 4(1), that any of their general duties conflict with one or more of their duties under sections 4, 24 and 25, priority must be given to their duties under those sections.

(7) Where it appears to OFCOM that any of their general duties conflict with each other in a particular case, they must secure that the conflict is resolved in the manner they think best in the circumstances.

..."

A11.36 Section 4 of the Act sets out Ofcom's duties for the purpose of fulfilling its Community obligations. To the extent that they are relevant to the Disputes, the provisions of section 4 of the Act are set out below.

"4 Duties for purpose of fulfilling Community obligations

(1) This section applies to the following functions of OFCOM –

(a) their functions under Chapter 1 of Part 2;

...

(c) their functions under Chapter 3 of Part 2 in relation to disputes referred to them under section 185;

...

(2) It shall be the duty of OFCOM, in carrying out any of those functions, to act in accordance with the six Community requirements (which give effect, amongst other things, to the requirements of Article 8 of the Framework Directive and to be read accordingly).

(3) The first Community requirement is a requirement to promote competition –

(a) in relation to the provision of electronic communications networks and electronic communications services;

(b) in relation to the provision and making available of services and facilities that are provided or made available in association with the provision of electronic communications networks and electronic communications services; and

(c) ...

(4) The second Community requirement is a requirement to secure that OFCOM's activities contribute to the development of the European internal market.

(5) The third Community requirement is a requirement to promote the interests of all persons who are citizens of the European Union (within the meaning of Article 17 of the Treaty establishing the European Community).

(6) The fourth Community requirement is a requirement to take account of the desirability of OFCOM's carrying out their functions in a manner which, so far as practicable, does not favour –

(a) one form of electronic communications network, electronic communications service or associated facility; or

(b) one means of providing or making available such a network, service or facility,

over another.

(7) The fifth Community requirement is a requirement to encourage, to such extent as OFCOM consider appropriate for the purpose mentioned in subsection (8), the provision of network access and service interoperability.

(8) That purpose is the purpose of securing –

(a) efficiency and sustainable competition in the markets for electronic communications networks, electronic communications services and associated facilities; and

(b) the maximum benefit for the persons who are customers of communications providers and of persons who make such facilities available.

...

(11) Where it appears to OFCOM that any of the Community requirements conflict with each other, they must secure that the conflict is resolved in the manner they think best in the circumstances."

A11.37 We also exercise our regulatory functions according to the following regulatory principles:¹⁶⁴

- We will regulate with a clearly articulated and publicly reviewed annual plan, with stated policy objectives;
- We will intervene where there is a specific statutory duty to work towards a public policy goal which markets alone cannot achieve;
- We will operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required;
- We will strive to ensure our interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;
- We will always seek the least intrusive regulatory mechanisms to achieve our policy objectives;
- We will research markets constantly and will aim to remain at the forefront of technological understanding; and
- We will consult widely with all relevant stakeholders and assess the impact of regulatory action before imposing regulation upon a market.

¹⁶⁴ http://www.ofcom.org.uk/consult/condocs/plan/annual_plan/regulatory_principles.pdf

Annex 12

History of negotiation between the Parties

THUS

A12.1 THUS first wrote to BT alleging a breach of BT's PPC cost orientation obligations in July 2007.¹⁶⁵ Since then, THUS and BT have discussed their respective interpretations of the cost orientation obligations, with BT maintaining throughout that it was fully compliant with the SMP obligations imposed in relation to PPCs.¹⁶⁶

A12.2 Having provided BT with a copy of the RGL Report on 21 December 2007, THUS sought to discuss the contents and conclusions of the report with BT.¹⁶⁷ BT responded on 18 January 2008, advising that *"our position in this matter remains unchanged"*. BT added that they *"continue to work with Ofcom to resolve outstanding issues and we do not think it appropriate to discuss further while this is underway"*.¹⁶⁸

A12.3 Further discussions followed without the issues raised in the RGL Report being addressed. BT concluded discussions on the matter with its letter to THUS of 22 April 2008, confirming its position that:

"... we believe we have complied with the cost orientation obligations on PPCs and that until Ofcom have completed their consideration of the replicability matters that form the basis for much of the RGL work we do not consider any meaningful discussions can take place.

...

*However, we contend that in considering the appropriate way to resolve some of the issues you have raised in relation to how conditions should have been applied in the past, the findings of Ofcom in their forthcoming statement on the way in which such obligations should be applied – and their views on the intent of particular regulatory obligations – will be pertinent. It is for that reason that we believe that it would be inappropriate to pre-judge Ofcom's findings and hence that we should leave this matter in abeyance for just a little longer and return to discuss it after Ofcom has issued its final statement."*¹⁶⁹

A12.4 On the basis of this correspondence, Ofcom concluded that BT had effectively suspended commercial discussions with THUS on the question of any overcharging for PPCs until such point as Ofcom completed its consideration of replicability matters and published its conclusions in the 2008 BCMR Statement and 2008 LLCC Statement.

¹⁶⁵ Letter from Richard Sweet (Director of Government Affairs, THUS) to Angus Flett (Director of Product Management, BT Wholesale), dated 10 July 2007.

¹⁶⁶ Including, for example, in letters from Angus Flett to Richard Sweet, dated 20 September 2007 and 23 November 2007.

¹⁶⁷ Letter from Richard Sweet to Angus Flett, dated 21 December 2007.

¹⁶⁸ Letter from Angus Flett to Richard Sweet, dated 18 January 2008.

¹⁶⁹ Letter from Steve Best (Director of Product Management, BT Wholesale) to Richard Sweet, dated 22 April 2008. The statement referred to in the final sentence of the quote from BT's letter is the statement that Ofcom intended to issue to conclude the 2008 BCMR.

C&W

- A12.5 Energis Communications Ltd (“Energis”) (which is now part of C&W) began discussions with BT in August 2004 in relation to when and how BT would be implementing the cost orientation requirements applicable to PPC trunk segments that had been imposed in the 2004 LLMR Statement.¹⁷⁰ C&W has been seeking information from BT about how PPC charges are calculated since October 2005.¹⁷¹
- A12.6 On 21 January 2008, C&W wrote to BT to raise concerns about PPC charges, alleging that they were out of line with BT's costs. C&W made reference to the RGL Report to support its claims.¹⁷²
- A12.7 On 5 February 2008, BT responded to C&W with a similarly worded letter to that discussed in **paragraph A12.2** above.¹⁷³ Following several meetings between BT and C&W, during which BT reaffirmed its position¹⁷⁴, C&W wrote to BT on 16 April 2008 setting out details of the amount that they believed BT had overcharged them for PPC services and warning that unless BT agreed to repay this sum they would submit a dispute to Ofcom.¹⁷⁵
- A12.8 BT responded to C&W on 22 April 2008, along the same lines set out in **paragraph A12.3** above.¹⁷⁶
- A12.9 On the basis of this correspondence, Ofcom concluded that BT had effectively suspended commercial discussions with C&W on the question of any overcharging for PPCs until such point as Ofcom completed its consideration of replicability matters and published its conclusions in the 2008 BCMR Statement and 2008 LLCC Statement.

Global Crossing

- A12.10 Global Crossing first wrote to BT in relation to its concerns about PPC charges on 23 January 2008. Global Crossing made reference to the RGL Report and requested that BT refund any overpayments made for PPC services.¹⁷⁷
- A12.11 BT responded to Global Crossing on 24 January 2008, using similar wording to that set out in **paragraph A12.2** above.¹⁷⁸ BT reaffirmed this position in an email to Global Crossing of 15 April 2008, in which BT stated:

“Our Regulatory Accounts and the information contained within them are currently being looked at by Ofcom as part of the ongoing

¹⁷⁰ Email from Andrea Sheridan (Regulatory Manager, Energis) to Richard Gill (Data Connectivity Product Manager, Partial Private Circuits, BT Wholesale), dated 31 August 2004.

¹⁷¹ Email from Nick Harding (Manager, Regulatory Strategy, C&W) to Mike Hoban (Senior Manager, Wholesale Regulation, BT Wholesale), dated 24 October 2005.

¹⁷² Letter from Andy May (Director of Regulatory Affairs, C&W) to Angus Flett (Director of Product Management, BT Wholesale), dated 21 January 2008.

¹⁷³ Letter from Angus Flett to Andy May, dated 5 February 2008.

¹⁷⁴ Email from Angus Flett to Nick Harding, dated 18 February 2008, which summarised the discussions.

¹⁷⁵ Letter from Nick Harding to Angus Flett, dated 16 April 2008.

¹⁷⁶ Letter from Steve Best (Director of Product Management, BT Wholesale) to Nick Harding, dated 22 April 2008.

¹⁷⁷ Email from Robert Turnbull (VP Access Management, Global Crossing) to Martin Kemp (Sales Business Manager, BT Wholesale), dated 23 January 2008.

¹⁷⁸ Email from Martin Kemp to Robert Turnbull, dated 24 January 2008.

Replicability review. BT are working closely with Ofcom to provide all the necessary information which Ofcom need to make a decision on the accuracy of our reporting. As mentioned in our earlier letter to Global Crossing we have noted their concerns but consider it inappropriate to enter into discussions with our customers until Ofcom have completed their review and have made their recommendations. At this point we will be happy to discuss with our customers any issues they may have with our Regulatory Reports. Ofcom's investigations have not yet reached a conclusion but I will let you know as soon as they have and will be happy to meet with Global Crossing at this time."¹⁷⁹

- A12.12 On 9 May 2008, Global Crossing provided BT with details of the amount that they believe they had been overcharged for PPC services.¹⁸⁰ Global Crossing followed this up with a further email to BT on 22 May 2008, stating:

*"In relation to the PPC Overcharging Dispute, Global Crossing has been seeking a commercial settlement with BT in order to avoid reference to Ofcom. Am I correct to interpret from what you have said that BT no longer intends to pursue a commercial settlement with GC on this matter, pending action before Ofcom?"*¹⁸¹

BT's response was to refer Global Crossing to its previously communicated position.¹⁸²

- A12.13 On the basis of this correspondence, Ofcom concluded that BT had effectively suspended commercial discussions with Global Crossing on the question of any overcharging for PPCs until such point as Ofcom completed its consideration of replicability matters and published its conclusions in the 2008 BCMR Statement and 2008 LLCC Statement.

Virgin

- A12.14 Virgin first raised its concerns about PPC charging at a meeting with BT on 20 December 2007.

- A12.15 BT responded to the issues raised at the meeting in an email to Virgin of 16 January 2008, stating:

"In conclusion BT believes that it has met all of its regulatory obligations with regard to PPC trunk pricing. The LLMR and PPC Price Control review are currently underway and BT would expect any re-alignment deemed necessary by Ofcom to be presented in the findings of those reviews.

I trust the above will address your issues but, should you have any further concerns, we believe that your best course of action would be

¹⁷⁹ Email from Sean McMahon (Client Manager, BT Wholesale) to Robert Turnbull, dated 15 April 2008.

¹⁸⁰ Email from Robert Turnbull to Martin Kemp, dated 9 May 2008.

¹⁸¹ Email from Robert Turnbull to Martin Kemp, dated 22 May 2008.

¹⁸² Email from Martin Kemp to Robert Turnbull, dated 26 May 2008.

*to refer these to Ofcom to be addressed as part of the current Leased Line Market Review.”*¹⁸³

- A12.16 Virgin responded on 21 January 2008, explaining that the market review work being carried out by Ofcom was unlikely to address the concerns that Virgin had raised as the market review was forward looking while Virgin's concerns related to the historical overcharging of PPC trunk services. Virgin made reference to the RGL Report to support their arguments.¹⁸⁴
- A12.17 BT replied to Virgin by email on 22 January 2008, along the lines set out in **paragraph A12.2**, and additionally stating that “we see no reason to revise our opinion on this long standing issue”.¹⁸⁵
- A12.18 Virgin wrote to BT again on 21 April 2008, reiterating their claims and quantifying the amount that they believed they had been overcharged by BT for PPC services. Virgin requested that BT confirm whether it was prepared to refund Virgin the amount claimed as they planned to refer a dispute to Ofcom if BT failed to do so.¹⁸⁶
- A12.19 On 28 April 2008, BT responded to Virgin using near identical language to that set out in **paragraph A12.3** above.¹⁸⁷
- A12.20 On the basis of this correspondence, Ofcom concluded that BT had effectively suspended commercial discussions with Virgin on the question of any overcharging for PPCs until such point as Ofcom completed its consideration of replicability matters and published its conclusions in the 2008 BCMR Statement and 2008 LLCC Statement.

Verizon

- A12.21 Verizon first raised its concerns about PPC charges with BT in February 2008, making reference to the findings of the RGL Report.¹⁸⁸
- A12.22 BT responded to Verizon on 3 March 2008.¹⁸⁹ In common with its responses to the other Altnets, BT informed Verizon:

“On your substantive point, we continue to believe that our pricing is in line with our cost orientation obligations.

Happy to meet, but we see no reason to revise our opinion prior to the conclusion of the work with Ofcom.”

- A12.23 Verizon wrote again to BT on 4 June 2008, reiterating their concerns about PPC charges and seeking assurances that BT was prepared to negotiate over the overpayments otherwise Verizon would refer the matter to Ofcom for resolution.¹⁹⁰

¹⁸³ Email from Richard Jones (Senior Commercial Manager, BT Wholesale) to Mark Holland (Senior Interconnect Economist, Virgin) and Vito Morawetz (Director of Interconnection, Virgin), dated 16 January 2008.

¹⁸⁴ Email from Mark Holland to Richard Jones, dated 21 January 2008.

¹⁸⁵ Email from Richard Jones to Mark Holland, dated 22 January 2008.

¹⁸⁶ Letter from Vito Morawetz to Richard Jones, dated 21 April 2008.

¹⁸⁷ Letter from Steve Best (Director of Product Management, BT Wholesale) to Vito Morawetz, dated 28 April 2008.

¹⁸⁸ Email from Jean-Stephane Gourevitch (Director, Regulatory & Government Affairs – UK & Ireland, Verizon) to Kishor Tanna (Senior Commercial Manager, BT Wholesale), dated 26 February 2008.

¹⁸⁹ Email from Kishor Tanna to Jean-Stephane Gourevitch, dated 3 March 2008.

A12.24 On 10 June 2008, BT responded to Verizon using near identical language to that set out in **paragraph A12.3** above.¹⁹¹

A12.25 On the basis of this correspondence, Ofcom concluded that BT had effectively suspended commercial discussions with Verizon on the question of any overcharging for PPCs until such point as Ofcom completed its consideration of replicability matters and published its conclusions in the 2008 BCMR Statement and 2008 LLCC Statement.

¹⁹⁰ Letter from Vikram Raval (Senior Manager, Regulatory and Government Affairs, Verizon) to Kishor Tanna, dated 4 June 2008.

¹⁹¹ Letter from Steve Best (Director of Product Management, BT Wholesale) to Vikram Raval, dated 10 June 2008.

Annex 13

Economic theory of cost orientation

A13.1 As set out at **paragraph 2.9**, the cost orientation obligations imposed on BT in the PPC markets require BT to secure that “*each and every charge offered, payable or proposed for Network Access covered by Condition G1 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*” (emphasis added). In summary, this obligation requires PPC charges to be LRIC-based and to provide for the recovery of an appropriate share of common costs.

Some relevant cost concepts

A13.2 Incremental cost is the cost of producing a specified additional product, service or increment of output over a specified time period. In many cases, the relevant increment may be the entire output of a particular service or group of services. The incremental costs of a service are then those costs which are directly caused by the provision of that service in addition to the other services which the firm also produces. Another way of expressing this is that the incremental costs of a service are the difference between the total costs in a situation where the service is provided and the costs in another situation where the service is not provided. When considering which costs are fixed and which are variable the time period is key. In the short-run some costs (particularly capital costs) are fixed. The shorter the time period considered, the more costs are likely to be fixed. In the long-run, all costs are (by definition) considered variable.

A13.3 LRIC is a forward-looking approach to costing that values assets on the basis of the cost of replacing them today. Ofcom has long considered that LRIC is the appropriate basis for considering interconnection charges.

“Forward looking costs constitute the appropriate cost base for interconnection charges because they reflect resource costs and are consistent with the workings of a contestable market. Ideally for economic efficiency, the prices of retail services should be set in a way which encourages consumers to take account of the resource costs of their purchasing decisions. Operators would be encouraged to set efficient retail prices if they could purchase a major input (interconnection) at a charge that was set by reference to the cost of the resources consumed by its provision. Since replacement costs would be the costs faced by a new entrant, signals would be given to encourage efficient entry into and exit from interconnection services, if the incumbent's interconnection charges were set on the basis of forward looking costs. An entrant into provision of interconnection services that was more efficient than the incumbent could make a profit by setting a charge below the incumbent's charge, whereas an inefficient firm would be unprofitable if it were to match the incumbent's charge.”¹⁹²

¹⁹² See paragraph 3.3 of Oftel's consultation: *Network Charges from 1997 – Consultative Document* http://www.ofcom.org.uk/static/archive/oftel/publications/1995_98/pricing/netcha97/contents.htm

- A13.4 Incremental cost can be contrasted with the SAC of a service, which is the cost of providing that particular service on its own, and with **common costs**. Common costs are those which arise from the provision of a group of services but which are not incremental to the provision of any individual service. If the incremental costs of each service are removed from the total cost of providing all services, what are left are the common costs. The stand alone cost of a service is the sum of the incremental cost of the service plus all of the costs which are common between that service and other services. As with many other network industries, the telecommunications industry is characterised by very significant common costs.
- A13.5 If a firm is not recovering any of its common costs from a product, it will be pricing in such a way as to cover only the incremental costs of the product (i.e. the product LRIC). If the firm was to price below this level it would incur incremental losses on the product, effectively resulting in a negative contribution to common costs.
- A13.6 Because of the existence of significant common costs between BT's activities, BT will only recover costs overall if at least some of its charges are above LRIC. However, there may be many different ways of attributing these common costs to different services, none of which may be uniquely correct or reasonable. The maximum proportion of these common costs which it is reasonable for BT to recover from any given service is generally given by SAC, which includes all (relevant) common costs.
- A13.7 This is consistent with guidelines issued by the OFT which state:
- “To assess the profitability of a line of business it may be necessary to allocate common costs to the particular activities identified...In some circumstances the standalone cost of the line of business may be relevant...Where an activity generates revenues that persistently and significantly exceed its standalone costs...this would be good evidence of excessive profits being earned on that activity.”¹⁹³*
- A13.8 The concept of SAC has its origins in the theory of contestable markets.¹⁹⁴ A contestable market is one in which the complete absence of barriers to entry means that incumbent firms, even monopolists, are constrained to price no higher than average costs by the threat of entry. The highest price that a multi-product firm could charge for any individual good or service in a contestable market is given by the efficient SAC of that good or service. This is because a price above this level would attract entry by a single product firm which would compete the price down to this level. In the multi-product context, a price (significantly and persistently) above SAC might therefore be regarded as excessive.
- A13.9 The implication of charging for one service at SAC is that, if the firm was to charge more than LRIC for any of the remaining services, it would over recover its common costs and therefore earn profits in excess of its cost of capital.

¹⁹³ OFT 414a: *Assessment of conduct: Draft competition law guideline for consultation*, April 2004 (http://www.ofg.gov.uk/shared_ofg/business_leaflets/competition_law/ofg414a.pdf) – see paragraphs 2.12-2.13.

¹⁹⁴ See Baumol, W., Panzar, J. and Willig, R. *Contestable Markets and the Theory of Industry Structure*, (1982), New York, Harcourt Brace Jovanovich).

Cost recovery

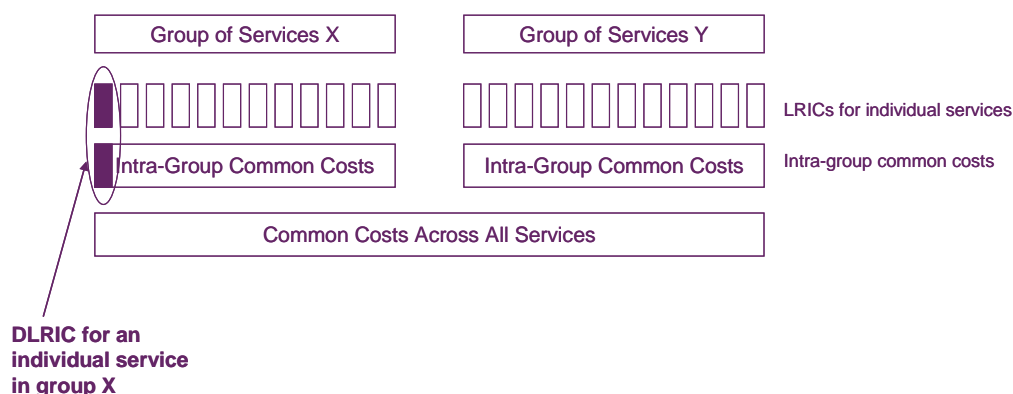
- A13.10 The substantial divergence between the SAC and LRIC at the individual product level provides a high degree of flexibility in how common costs can be allocated and recovered. This is particularly the case for a multi-product firm, such as BT, in an industry where there are substantial common costs which are incurred to provide a range of different products.¹⁹⁵
- A13.11 While this pricing flexibility can enable a firm to recover common costs efficiently and earn a reasonable rate of return on capital, it could also provide scope for a firm to act in an anti-competitive or exploitative manner. Such behaviour might include a firm recovering a high proportion of common costs from uncontestable or uncompetitive products in order for it to price contestable services at, or around, LRIC. It is therefore unlikely to be sufficient to consider whether an individual charge in isolation is between LRIC and SAC. It is also likely to be necessary to consider how charges across a range of services relate to costs. It is for this reason that there is a requirement in the cost orientation obligation that only an “appropriate” mark-up for the recovery of common costs be allowed.
- A13.12 Therefore, in deciding the reasonableness of a particular charge, it is likely to be necessary also to consider whether the prices for different combinations of services are between the incremental and stand-alone costs of those combinations of services (the so-called “combinatorial tests”). Where all the different combinations satisfy the test then there is no over-recovery of common costs. Depending upon the size of the product portfolio and the types of common costs, the number of combinatorial tests could be very significant. This would be the case for PPC common costs as many of these costs relate to network infrastructure that is used for the provision of numerous different services by BT, including most of BT's voice telephony and broadband services.
- A13.13 Carrying out a significant number of combinatorial tests is clearly not possible in the timescales available to Ofcom for resolving the Dispute. Therefore, an alternative methodology that proxies this is necessary. One approach that has been adopted by Ofcom (and Oftel previously) in the context of the network charge control is the use of the DSAC and DLRIC.¹⁹⁶ This is also the approach that BT has advocated that we adopt in its submission of 14 October 2008.
- A13.14 In essence, a DLRIC is estimated by including a share of the common costs for a group of products in the incremental cost of an individual product within the product group. As a consequence, the DLRIC is normally above the ‘pure’ LRIC for an individual product. The share of common costs is allocated to the individual products in proportion to their respective LRICs (i.e. by using equi-proportional mark-ups).¹⁹⁷ So, for example, if a service shares common costs with other services in a group, then the DLRIC will be the service LRIC plus a share of the common costs allocated in proportion to the service LRIC compared to the other services’ LRICs. The concept is demonstrated in **Figure A13.1**.

¹⁹⁵ We note however that fixed costs are not always common costs – often they can be attributed to an individual service or product.

¹⁹⁶ See *Guidelines on the Operation of the Network Charge Controls* from October 2001, for example, http://www.ofcom.org.uk/static/archive/oftel/publications/ind_guidelines/pcr1201.htm#b

¹⁹⁷ Further details of DSACs and DLRICs, and how BT calculates them, can be found in BT's *Primary Accounting Documents* which are available on its website at: <http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2008/PrimaryAccountingDocuments2008.pdf>

Figure A13.1: Calculation of DLRIC



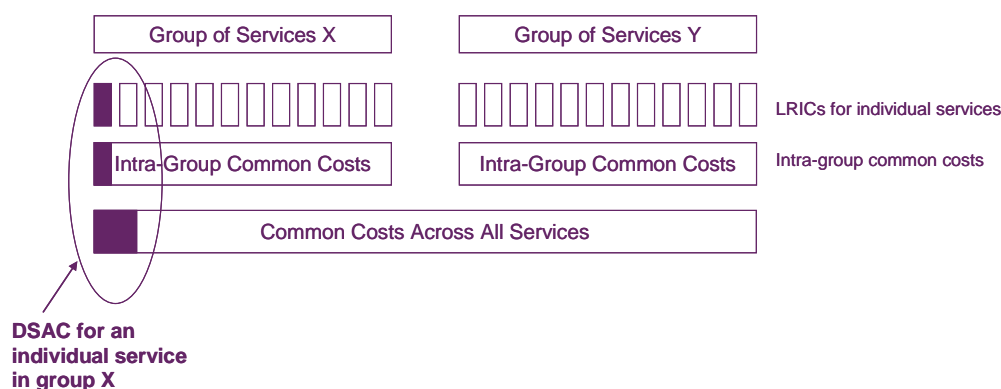
A13.15 In the example demonstrated in **Figure A13.1**, the DLRIC for the first service in group X is equal to the two purple blocks. The top block represents the LRIC for the service and the lower block represents the share of the intra-group common costs allocated to the service.

A13.16 As a consequence of the way in which the common costs are allocated across the services, the sum of the individual service DLRICs within the group is equal to the LRIC of the group of services taken as a single increment.

A13.17 A similar approach is adopted with the SAC to generate the DSAC. However, rather than only including a proportion of the intra-group common costs (as is the case with the DLRIC), the DSAC for any individual service also includes a proportion of costs that are common across all groups of services. In the example, all the common costs across all services would be allocated to group X, and this total would then be shared out among the services in group X.

A13.18 The concept is demonstrated in **Figure A13.2**. The three purple blocks represent the DSAC. As in **Figure A13.1**, the top two blocks represent the DLRIC. The lower block represents the share of costs which are common to group of services X and all other services that is allocated to this service.

Figure A13.2: Calculation of DSAC



A13.19 As for DLRICs, the common costs included in the DSACs are in effect allocated among the 'Group of Services X'. Reflecting the allocation of only a proportion of the full common costs of the service, the DSAC is normally below the 'pure' SAC.

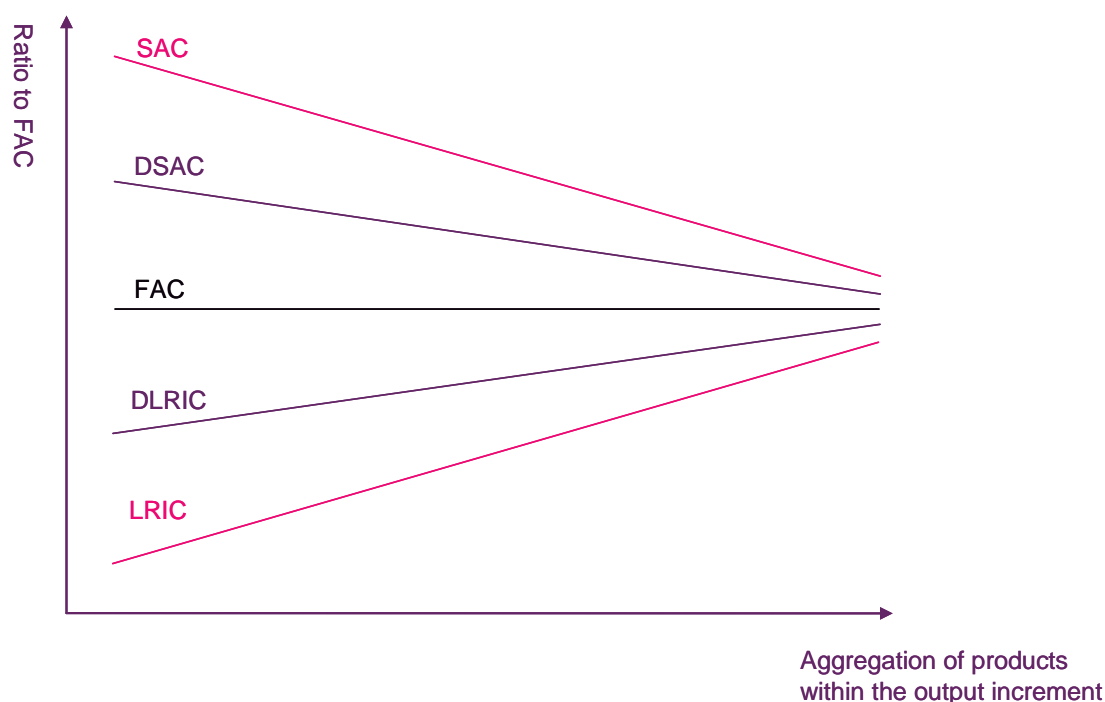
- A13.20 As with DLRICs, the sum of individual service DSACs within a service group is equal to the SAC for the service group taken as a single increment.
- A13.21 BT's regulatory financial statements contain details of the DSAC and DLRIC of each individual service (albeit referring to them as the "LRIC floor" and "LRIC ceiling" respectively).

Relationship between DLRIC, DSAC and FAC

- A13.22 FAC is an accounting concept designed to ensure that all of a firm's costs (both incremental and common) are attributed to its activities. As such, if a firm sets its charges equal to unit FAC, all things being equal, it would be expected to recover (but not over recover) all its costs, including all of its common costs. These costs typically also include an allowance for a return on capital which is measured at the firm's cost of capital (i.e. its WACC).
- A13.23 There are numerous methodologies for generating FAC estimates, although typically firms use some form of activity-based costing modelling. This form of modelling involves allocating all costs (both incremental and common) to individual activities and services. Other approaches can involve simply allocating common costs to services in line with the incremental or variable costs incurred (e.g. LRIC+EPMU), BT's approach to calculating FAC is therefore only one approach, but it is not unique. Other methodologies may also be reasonable and could produce quite different views of BT's rate of return on individual services.
- A13.24 As FAC involves allocating all the firm's common costs across all products, the costs for individual products would normally be above the LRIC and below SAC for the product.¹⁹⁸ Furthermore, we would normally expect FAC to also lie in-between the DLRIC and DSAC. However, the extent to which the measures diverge depends upon the size of the output increment being considered.
- A13.25 Where the relevant increment of output is the entire output of the firm, then the entire firm's costs are incremental, including costs that may be common to groups of individual services. As such, the LRIC/DLRIC/FAC/DSAC/SAC measures all converge.
- A13.26 Conversely, where the output increment is much smaller than the entire output of the firm, a single product for a multi-product firm for example, and there are likely to significant common costs, which will result in a divergence between the cost measures.
- A13.27 These relationships with FAC are demonstrated in **Figure A13.3**.

¹⁹⁸ SAC ceilings are intended to be used to indicate where a firm may have entered into excessively high or exploitative pricing. As a consequence, the ceilings should be based on the costs of an efficient operator (and therefore not necessarily on the costs of the firm itself). It is therefore technically possible that the actual FAC incurred by the firm could be above the efficient SAC. How likely such a relationship is in practice depends on the services concerned.

Figure A13.3: Convergence of DSAC and DLRIC with FAC



A13.28 PPCs form only one set of products within BT's product portfolio. As a result, there are considerable common costs that are shared with other sets of products. Therefore, we would expect the DSAC and DLRIC values for individual services to diverge from the FACs for those products. Therefore, on the basis of the first-order test (i.e. pricing between DLRIC and DSAC), it is entirely conceivable that BT could be pricing in a manner that is considered to be cost-orientated, but that results in a rate of return on capital in excess of its WACC.

The interaction between cost orientation and a charge control

A13.29 Charge controls are typically imposed on the prices for a basket of goods and services rather than on individual charges.¹⁹⁹ It is the weighted average of prices for all the services across the basket that is regulated by the price cap.

A13.30 By imposing price regulation at the basket level, the regulated firm is given flexibility in pricing individual services, as long as the prices across the basket are compliant with the control.

A13.31 As discussed in **Section 2**, Ofcom imposed RPI-X price controls on three PPC service baskets in the 2004 LLCC Statement – low bandwidth connection and rental and maintenance charges (i.e. sub 8Mbit/s); high bandwidth connection and rental and maintenance charges (i.e. above 8Mbit/s); and POC end and third party end equipment charges. In addition, following consultation, sub-baskets were also introduced within all three main baskets.

A13.32 Within both of the main low and high bandwidth baskets two additional sub-baskets were defined:

¹⁹⁹ Although we note that in some cases sub-caps may also be imposed on groups of services within the basket.

- connection charges; and
- rental and maintenance charges.

Within the POC end and third party equipment charge basket, all charges were subject to separate sub-caps.

- A13.33 Therefore, although BT was obliged to price the services within the low and high bandwidth baskets in such a way that the weighted average price²⁰⁰ complied with the control, it had flexibility over the charges for the individual services within the basket and sub-baskets.
- A13.34 For services within charge control baskets, however, BT's ability to set charges close to the ceiling will be constrained by the requirement for it to comply with the charge control. This is because the charge control is designed to regulate charges relative to the incremental costs of providing the services plus a proportion (but not all) of the common costs shared by the services. Therefore, setting one charge within a basket near the ceiling will mean that other charges in the basket will need to be set nearer the floor to meet the requirements of the control.
- A13.35 Cost orientation obligations were therefore imposed in conjunction with basket-level charge controls to provide a complementary (but independent) constraint on BT's ability to flex individual prices in order to recover common costs in a way that could be considered inappropriate or, indeed, anti-competitive.
- A13.36 It is important to note that adherence to the charge control does not necessarily mean that each and every of the regulated firm's charges are cost orientated. Equally, adherence to cost orientation does not necessarily imply that the firm's charges are consistent with the charge control. For example, if a firm prices all services at a level that is marginally below the individual DSAC for each of the services, on the basis of the first order test, each charge may be considered cost orientated, but it is highly unlikely that the overall set of charges would be compliant with a charge control.
- A13.37 In considering the extent to which BT's charges deviate from the FAC associated with the particular service it is important to also consider the implications of the incentive properties of a charge control. By capping the maximum prices BT can charge for TISBO circuits within a charge control (i.e. disconnecting its service revenues from its incurred costs), the charge control by design creates incentives for BT to actively seek to minimise costs and maximise volumes in order to profit maximise.
- A13.38 By virtue of this central feature of the charge control regime, we would expect BT to seek to increase the profitability for services over the charge control. Therefore, if BT outperforms the price cap we would anticipate outturn ROCE values to trend above the WACC assumed within the charge control over the control period. This will result in revenues moving away from the FAC towards the DSAC. The gap between BT's revenues and FAC that emerges as a result of this (efficient) behaviour will then be closed (on a forward-looking basis) in the next charge control so that the benefits are shared between BT (through the within charge control excess profits) and consumers (lower prices in the long term).

²⁰⁰ The average price calculation uses the previous year's revenue share to create the weights.

- A13.39 So, if for example BT is able to deliver PPCs in a more cost efficient manner than Ofcom had anticipated in the 2004 LLCC Statement, subject to the cost orientation obligations, it would not be obliged to pass these cost savings on to customers within the charge control period. This would contribute to higher than expected profitability. However, in setting the next charge control, Ofcom will take the lower cost base into account in setting the next set of price caps.
- A13.40 The existence of returns in excess of the cost of capital in markets where a charge control is in operation therefore is consistent with the charge control operating correctly, rather than necessarily being symptomatic of a problem. Clawing back these excess profits on a backwards-looking basis, through the effective imposition of rate of return regulation, could act to significantly reduce the regulated firm's incentives to improve efficiency in the future, thereby undermining the entire charge control regime.
- A13.41 The role of cost orientation in such circumstances is therefore not to deny the incumbent firm any opportunity to earn returns in excess of its cost of capital, but rather to restrict its ability to attempt to stifle competition or otherwise act to the detriment of consumers by setting charges on the basis of an anti-competitive allocation of common costs between services (most notably between its charge controlled and non-charge controlled services, but also between different services in the baskets).

Annex 14

PPC financial data

- A14.1 The three Tables below set out the three sets of PPC data available to Ofcom;
- A14.2 **Table A14.1** sets out the total revenue, FAC and DSAC cost ceiling for each PPC market. These have been calculated by combining various pieces of data from the regulatory financial statements originally published by BT for 2004/05, 2005/06, 2006/07 and 2007/08. The data has not been restated and has had no cost or revenue adjustments made to it. Additionally, it includes some services (e.g. Siteconnect) that are out of scope of the Disputes. The data for 2007/08 has been prepared on a different basis to that for the three previous years for the reasons discussed in **Section 4** above.
- A14.3 **Table A14.2** sets out the total revenue, FAC and DSAC cost ceiling for each PPC market as provided to us by BT in response to our section 191 information request. The data for all years has been adjusted to remove out of scope services such as Siteconnect and has been prepared on a consistent basis with that set out in the 2007/08 regulatory financial statements. The data for 2004/05 and 2005/06 has therefore been revised from that published and the data for 2006/07 is the restated data contained in the 2007/08 financial statements. The data also takes account of changes to total cost data that arose when BT represented its unit costs for 2006/7. It eliminates a presentational assumption that was present in the unit cost data (but not in the market total costs) for 2Mbit/s TISBO local ends only, when originally published.
- A14.4 **Table A14.3** sets out the total revenue and DSAC cost ceiling for external customers in each PPC market and is based on the data provided by BT in response to the information request but which has been subject to the adjustments described by Ofcom in **Section 4**. This is the data set that Ofcom has used to assess whether BT has overcharged for PPC services.

Table A14.1: PPC financial data originally published by BT in its regulatory financial statements²⁰¹

	2004/05			2005/06		
Service	Total revenue (£)²⁰²	FAC (£)	DSAC ceiling (£)	Total revenue (£)	FAC (£)	DSAC ceiling (£)
64kbit/s	n/a	296,973,231	564,322,725	186,907,632	259,957,159	458,075,241
2Mbit/s	n/a	575,269,501	898,919,307	443,957,613	547,434,798	820,252,157
LB TISBO	659,000,000	872,242,732	1,463,242,032	630,865,245	807,391,957	1,278,327,399
45Mbit/s	n/a	117,303,052	181,284,990	60,599,640	125,124,032	186,133,355
155Mbit/s	n/a	111,600,589	176,774,375	135,241,426	125,979,132	189,197,852
HB TISBO	138,000,000	228,903,640	358,059,365	195,841,066	251,103,164	375,331,207
2Mbit/s trunk	n/a	n/a	n/a	260,616,508	76,777,868	136,680,919
45Mbit/s trunk	n/a	n/a	n/a	44,723,304	18,079,340	33,861,606
155Mbit/s trunk	n/a	n/a	n/a	29,162,640	23,859,526	49,519,284
TOTAL TRUNK	322,000,000	110,463,378	232,864,824	334,502,451	118,716,734	220,061,809

²⁰¹ Market totals include only those services in the scope of the Disputes (except where noted) and therefore are not the same as the market totals in the regulatory financial statements.

²⁰² Total revenue as presented here is from the regulatory financial statements and includes out of scope services which are not separately disclosed for 2004/05.

	2006/07			2007/08		
Service	Total revenue (£)	FAC (£)	DSAC ceiling (£)	Total revenue (£)	FAC (£)	DSAC ceiling (£)
64kbit/s	142,860,652	241,144,921	474,951,341	72,089,435	192,561,562	319,901,567
2Mbit/s	429,872,707	508,573,542	793,479,304	336,646,704	391,756,633	589,587,159
LB TISBO	572,733,358	749,718,463	1,268,430,645	408,736,139	584,318,195	909,488,726
45Mbit/s	66,769,258	77,379,017	126,122,246	56,008,463	77,458,967	120,941,656
155Mbit/s	131,810,457	76,089,241	133,435,907	93,828,518	95,516,631	165,183,296
HB TISBO	198,579,715	153,468,258	259,558,153	149,836,981	172,975,598	286,124,951
2Mbit/s trunk	214,652,062	74,196,047	154,627,586	179,265,673	48,743,992	83,952,403
45Mbit/s trunk	46,320,702	33,795,925	70,435,722	41,074,078	22,827,446	39,802,790
155Mbit/s trunk	21,965,060	28,012,210	68,773,448	20,690,540	18,962,880	37,651,979
TOTAL TRUNK	282,937,824	136,004,183	293,836,755	241,030,292	90,534,317	161,407,172

Table A14.2: Restated and/or revised PPC financial data provided by BT in response to Ofcom's section 191 notice

	2004/05			2005/06		
Service	Total revenue (£)	FAC (£)	DSAC ceiling (£)	Total revenue (£)	FAC (£)	DSAC ceiling (£)
64kbit/s	142,703,718	299,797,740	567,459,745	183,399,597	259,275,278	456,741,572
2Mbit/s	323,214,893	547,499,763	865,430,889	325,277,297	509,213,470	769,196,802
LB TISBO	465,918,611	847,297,503	1,432,890,635	508,676,894	768,488,748	1,225,938,374
45Mbit/s	41,804,488	117,309,803	181,284,156	50,710,055	125,124,005	186,133,223
155Mbit/s	59,472,577	111,592,999	176,774,174	109,540,462	125,978,919	189,198,074
HB TISBO	101,277,066	228,902,803	358,058,330	160,250,518	251,102,924	375,331,296
2Mbit/s trunk	198,634,935	73,277,626	147,308,750	224,818,371	76,772,129	136,688,012
45Mbit/s trunk	14,201,629	13,124,715	29,642,488	37,802,585	18,079,339	33,861,758
155Mbit/s trunk	29,249,677	23,937,248	55,554,372	24,412,419	23,859,807	49,518,715
TOTAL TRUNK	242,086,241	110,339,590	232,505,609	287,033,375	118,711,274	220,068,485

	2006/07			2007/08		
Service	Total revenue (£)	FAC (£)	DSAC ceiling (£)	Total revenue (£)	FAC (£)	DSAC ceiling (£)
64kbit/s	115,690,518	251,723,736	485,730,951	72,088,290	191,722,246	318,504,956
2Mbit/s	292,252,154	440,569,950	702,408,342	301,617,080	337,224,351	515,159,549
LB TISBO	407,942,672	692,293,685	1,188,139,292	373,705,370	528,946,598	833,664,505
45Mbit/s	53,940,087	77,378,892	126,122,399	56,008,544	77,458,967	120,941,907
155Mbit/s	90,921,148	73,826,199	129,884,744	91,669,235	93,613,667	161,630,793
HB TISBO	144,861,235	151,205,091	256,007,143	147,677,780	171,072,634	282,572,700
2Mbit/s trunk	175,555,077	71,002,652	146,777,746	172,640,624	49,239,051	84,800,588
45Mbit/s trunk	43,091,671	33,796,088	70,436,027	41,074,078	22,827,446	39,802,787
155Mbit/s trunk	15,986,360	27,491,620	67,495,642	20,241,000	18,588,245	36,907,907
TOTAL TRUNK	234,633,108	132,290,361	284,709,414	233,955,702	90,654,741	161,511,282

Table A14.3: Restated and/or revised PPC financial data provided by BT and adjusted by Ofcom in line with the proposals in Section 5

	2004/05		2005/06	
Service	External revenue (£)	External DSAC (£)	External Revenue (£)	External DSAC (£)
64kbit/s	28,966,561	113,252,451	35,285,464	78,588,840
2Mbit/s	70,841,164	164,897,060	77,308,667	136,528,702
LB TISBO	99,807,725	278,149,511	112,594,131	215,117,542
45Mbit/s	6,490,264	22,940,965	9,676,331	25,406,242
155Mbit/s	621,237	1,672,174	1,257,183	1,622,731
HB TISBO	7,111,501	24,613,139	10,933,514	27,028,972
2Mbit/s trunk	23,609,455	23,479,899	31,010,346	18,310,075
45Mbit/s trunk	1,457,879	6,231,682	5,617,879	8,693,447
155Mbit/s trunk	127,252	276,886	131,338	346,175
TOTAL TRUNK	25,194,585	29,988,467	36,759,562	27,349,697

Note: Separate DSACs for internal and external circuits have been estimated to take into account the difference in SGA costs between internal and external circuits in 2004/05. This is discussed at paragraph 5.88 above.

	2006/07		2007/08	
Service	External revenue (£)	External DSAC (£)	External Revenue (£)	External DSAC (£)
64kbit/s	29,429,233	110,368,602	17,895,846	74,533,068
2Mbit/s	89,888,849	176,127,023	109,086,360	152,749,604
LB TISBO	119,318,082	286,495,624	126,982,206	227,282,672
45Mbit/s	12,201,082	22,188,594	14,673,112	25,507,013
155Mbit/s	1,908,304	2,054,052	3,391,239	4,247,012
HB TISBO	14,109,386	24,242,646	18,064,350	29,754,025
2Mbit/s trunk	29,269,778	22,426,530	33,886,630	14,884,273
45Mbit/s trunk	6,484,567	10,051,468	8,995,239	8,333,803
155Mbit/s trunk	237,380	955,911	504,660	900,899
TOTAL TRUNK	35,991,725	33,433,908	43,386,529	24,118,975

Annex 15

The Deloitte Report

A copy of the Deloitte Report supplied by BT as part of its submission on 14 October 2008 has been published as a separate Annex to this document.

Annex 16

Glossary

Term	Description
Communications Provider (CP)	A person who provides an Electronic Communications Network or provides and Electronic Communications Service (as defined by section 32 of the Communications Act 2003).
Current Cost Accounting (CCA)	An accounting convention, where assets are valued and depreciated according to their current replacement cost whilst maintaining the operating or financial capital of the business entity.
Customer Sited Handover (CSH)	Interconnection occurs at a communications provider's premises.
Fully allocated cost (FAC)	An accounting approach under which all the costs of the company are distributed between its various products and services. The fully allocated cost of a product or service may therefore include some common costs that are not directly attributable to the service.
In Span Handover (ISH)	Interconnection occurring at a point between BT's premises and a communications provider's premises.
Leased line	A permanently connected communications link between two premises dedicated to the customers' exclusive use.
Long Run Incremental Cost (LRIC)	The cost caused by the provision of a defined increment of output given that costs can, if necessary, be varied and that some level of output is already produced.
Mbit/s	Megabits per second. A measure of speed of transfer of digital information.
Partial Private Circuit (PPC)	A generic term used to describe a category of private circuits that terminate at a point of connection between two communications providers' networks. It is therefore the provision of transparent transmission capacity between a customer's premises and a point of connection between the two communications providers' networks. It may also be termed a part leased line.
Plesiochronous Digital Hierarchy (PDH)	An older method of digital transmission used before SDH which requires each stream to be multiplexed or demultiplexed at each network layer and

	does not allow for the addition or removal of individual streams from larger assemblies.
Points of Connection (POC)	A point where one communications provider interconnects with another communications provider for the purposes of connecting their networks to 3 rd party customers in order to provide services to those end customers.
Public Switched Telephone Network (PSTN)	A telecommunications network providing voice telephony for the general public.
Radio Base Station (RBS) backhaul circuit	A circuit provided by BT that connects a mobile communications provider's base-station to the mobile communications provider's mobile switching centre.
Revenue System Size (RSS)	A term used by BT to describe the total number of circuits that generate revenue.
Stand Alone Cost (SAC)	An economic concept under which the total cost incurred in providing a product is allocated to that product.
Synchronous Digital Hierarchy (SDH)	A method of digital transmission where transmission streams are packed in such a way to allow simple multiplexing and demultiplexing and the addition or removal of individual streams from larger assemblies.
Symmetric broadband origination (SBO)	A symmetric broadband origination service provides symmetric capacity from a customer's premises to an appropriate point of aggregation, generally referred to as a node, in the network hierarchy. In this context, a "customer" refers to any public electronic communications network provider or end user.
Symmetric transmission	Symmetric transmission is where the upload and download transmission rates of a communications service are identical.
Tier 1	A tier in BT's SDH network that denotes a network of nodes covering areas of high population. These nodes are connected by very high capacity line systems and denote the BT trunk network.
Traditional interface symmetric broadband origination (TISBO)	A form of symmetric broadband origination service providing symmetric capacity from a customer's premises to an appropriate point of aggregation in the network hierarchy, using a CCITT G703 interface.
Working System Size (WSS)	A term used by BT to describe the total number of circuits in existence.