

# Ofcom's Consultation on proposed charge controls in Wholesale Narrowband Markets

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**BT Response** 

4 June 2009

## BT Response to Ofcom Consultation on proposed charge controls in Wholesale Narrowband Markets 4 June 2009

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## 1. Executive summary

1.1 BT agrees with Ofcom that the charge control must provide appropriate incentive for efficient investment in the long term interests of the consumer, and a further four year regime will present the industry with some much needed certainty. In light of the inexorable decline in fixed line call volumes over this period, increases in unit costs are unavoidable.

1.2 In this context, the proposed hypothetical technology neutral network model is the best way of modelling a sustainable network. A charge control based solely on the projected costs of an existing ailing legacy network will not provide appropriate incentives to maintain and improve efficiency. The model proposed by Ofcom is a pragmatic solution to the uncertainty arising from the migration to 21CN, but one that also recognizes expenditure on both existing and new technology will be required to uphold the voice service.

1.3 Overall the range of Xs are too low and our analysis of the parameters that drive the model suggest that charges should be set at the top end of the ranges. The latest actual volume figures suggest the Ofcom model is using volumes that are 5-10% too high at the start of the control and we recommend that Ofcom rerun their model with the lower starting volumes.

1.4 BT pension deficit top up contributions are now significant and can no longer be excluded from the cost model.

1.5 As a result of factors outside of our control, and which could not have been foreseen by Ofcom or BT, a one off price increase of 25% is required at the start of the control. Even after this price increase, BT's charges will still be amongst the lowest in Europe.

1.6 Provision needs to be made for negative inflation in the price control Condition by setting a RPI floor of zero, otherwise charges may decline without a corresponding reduction costs, thereby not enabling BT to recover its legitimate and efficiently incurred costs. Prices which are too low will not provide sufficient investment incentives either to BT or to the other players in the industry.

1.7 BT agrees that Ofcom is not in a position to set charges for 21CN voice services, BT will announce prices once launch dates have been established.

1.8 During migration to a new technology, efficiently incurred costs may rise, and this needs to be recognised in any subsequent regime should BT not fully recover its costs during the period of the proposed control.

# **2.** Introduction

2.1 This is BT's response to Ofcom's proposals and the associated range of Xs in the Review of BT network charge controls published in March 2009.

2.2 With the uncertainty in the world economy and the telecommunications industry at a time of consolidation and technical change, the NCC offers an opportunity to provide some stability, and BT supports Ofcom's proposal for a further 4 year regime. BT welcomes Ofcom's recognition that end of life assets do not offer a sustainable cost model for a network operator, and supports the proposed technology neutral hypothetical ongoing network model as a pragmatic approach to cost modelling in the current circumstances of transition to NGNs. BT welcomes the recognition that the inexorable fall in fixed volumes will inevitably result in higher unit costs. BT has concerns that the proposed glidepath means that BT's prices will be below its efficiently incurred costs, thereby preventing BT from fully recovering its efficiently incurred costs for most of the duration of the proposed control, which will in itself be market distorting.

2.3 Overall we are supportive of most of what Ofcom has proposed. In our response, we have sought to answer the specific questions and flesh out the more detailed issues that arise. We have proposed a number of improvements which will help provide the appropriate incentives for efficient investment in the interests of the consumer, BT and the industry.

## 3. Charge Control framework - NCC Duration

*Question 4.1*: Do you agree with Ofcom's proposal to set a four year NCC from 1 October 2009 – 30 September 2013?

3.1 BT supports Ofcom's proposal to set a 4 year NCC from October 1 2009 - 30 September 2013. These are uncertain times both within the telecommunications industry regarding the pace and timing of migration to Next Generation Networks, and in the broader economy. Ofcom's proposed use of a technology neutral model affords the opportunity to provide some certainty over the next four years, as well as providing appropriate incentives for innovation and dynamic efficiency, and allowing sufficient time for the incentives to become effective.

# 4. Charge Control Framework – approach to modelling

**Question 4.2:** Do you agree with Ofcom's proposal to use a hypothetical ongoing network model to establish the technology neutral cost base for the next NCCs?

**Question 4.3:** Do you agree with Ofcom's proposed methodology for the hypothetical ongoing model, including the use of adjusted base year costs from the previous NCC model to create a stable network from which to model cost?

4.1 As Ofcom sets out in the Consultation Document there will be a major change in the way BT provides PSTN services. This is due to the increasing use of BT's 21CN network for switched voice network services in place of current ('legacy') technology. This clearly creates severe challenges for the modelling of efficiently incurred unit costs. Were Ofcom not to use a technology neutral model, a model of 21CN unit costs and a view of the 'efficient' rate of migration of services between platforms would be required.

4.2 Such a modelling exercise is only feasible with the use of a huge range of assumptions which could not be evidenced in any way and might have no relation to the reality of service delivery. A much more straightforward and tractable approach to modelling is one built upon known data.

4.3 We therefore support, with some qualifications as discussed further below, the technology neutral approach described by Ofcom. This approach preserves incentives on BT to implement 21CN at the optimal rate as BT can only achieve 21CN based cost savings following actual implementation. This also leaves the risks of cost overruns of 21CN with BT and so ensures CPs and end-customers are not disadvantaged as a result of the change to new technology. In addition, the aggregation of volumes on both platforms for modelling purposes ensures that modelling work can be far more robust and reliable than separate models are likely to be at this early stage in the development of 21CN.

4.4 Clearly, the use of the technology neutral approach itself poses challenges as it must forecast the efficiently incurred costs that would have been incurred in delivering narrowband call services had the investment in 21CN not taken place. In particular, the costs reported in BT's financial statements do not reflect the ongoing costs of a sustainable network (i.e. true, long term efficiently incurred costs), nor do they reflect the investment required to sustain 20CN assets for a longer period.

4.5 Unless 21CN costs are to be forecast reliably and accurately (something we do not consider to be possible at this time), then it is inevitable that for regulatory pricing purposes there must be some departure from reported costs and the conceptual approach to identifying efficiently incurred costs. This is why, to minimise uncertainty, we agree that the use of known base year costs from the previous charge control provide the best basis for projecting technology neutral costs over the price period as they provide a clear and unambiguous foundation from which forecasts can be made.

4.6 BT agrees that this approach is preferable to that described at para 4.57 as it avoids the need to make subjective adjustments to BT's published data.

4.7 For these reasons, BT is supportive of Ofcom's proposals for constructing a hypothetical ongoing model using base year costs from the previous charge control.

**Question 4.4:** Do you agree with Ofcom's proposed approach to efficiency as regards BT's 21CN in proposing these charge controls?

4.8 BT has some concerns about Ofcom's approach to efficiency as regards BT's 21CN in proposing these charge controls, as these could result in an under-recovery of

efficiently incurred costs and provide a disincentive for investment, including for other infrastructure providers competing against BT.

4.9 Our expectation is that 21CN investments will only cost in over a significant number of years. This is for a number of reasons, not least of which is that, as the incumbent, BT has an obligation to maintain C7 interconnect for some time to allow other industry players time to make their own migration plans. In this respect, BT has worked long and hard with CPs to agree the migration of CP interconnect from those DLEs that are closing to Next Generation Switches. This has also entailed, where appropriate, system alteration costs of CPs to have been met by BT. It is clearly in the interests of the industry and the consumer that this migration is carefully planned and managed well, and this may well require at least several years of some parallel running.

4.10 BT notes the approach to cost recovery on new services previously proposed by Ofcom in the Leased Lines Charge Control Consultation of 8 December 2008, set out in the illustrative Figure below.



4.11 In this Consultation, Ofcom proposed that the extent of under-recovery represented by Area A could be compensated for by over-recovery represented by Area B within the period of the charge control, followed by further potential benefits to BT during a glidepath in a subsequent control.

4.12 Applied to voice network services, much, of course, depends on the speed and extent of BT's rollout plans, all of which are uncertain at this point in time. However, the cost of development and implementation, plus the requirement for a significant period of dual running during migration, strongly suggests that A would be larger than B *within* the period of the charge control. This means that there would still be some under-recovery to be compensated for in the subsequent charge control before BT starts to see any net benefits in terms of cost savings from migration to NGN call conveyance.

4.13 Whilst BT understands Ofcom's reluctance to 'fetter its discretion' on future possible regulation, it is unavoidable that if BT under-recovers costs during the next proposed regime, it would need recognition of this in the following charge control

period to adjust for the initial mandated under-recovery. This is entirely in line with normal commercial practice whereby a supplier expects to recover the cost of a product over its whole life.

4.14 The fact that the timings of the price controls bisect such a period (an expectation which is obscured by the way Figure 4.3 from the Consultation Document has been drawn) should not mean that different price controls deal with this cost issue – which is fundamentally about timing - in independent ways. BT therefore urges Ofcom to recognise this point and provide whatever certainty it can that any deficit of B *less* A will be recognised in setting future price controls. This would ensure inter-temporal consistency across subsequent price controls.

4.15 For example, in terms of Figure 4.3 from the Consultation Document, it is not consistent with Ofcom's duties to ignore any deficit when (in 2013 although the Figure is not drawn to show any deficit) this represents the costs of moving to what is a more efficient technology in the longer term. In other words, BT should not be left with the costs of migration and parallel running where these are, in the long term, clearly efficiently incurred costs and made for the long term benefit of consumers. This is clearly consistent with Ofcom's duties, so BT does not consider that it is asking Ofcom to 'fetter its discretion' in a way inconsistent with the Communications Act or in a way which is not justified by an objective examination of the facts of the matter.

## Modelling Parameters and the X Factors

4.16 BT is generally supportive of Ofcom's modelling approach. The structure of Ofcom's model and the logic it uses are the same as the last NCC control. This provides useful stability and predictability to the charge control when it is renewed. Using a version of the one component model used in the 2005-2009 NCC, as modified for the costs of continuing with today's technology, is consistent with the hypothetical ongoing network approach.

4.17 We do have the following comments on the parameters Ofcom is using to model the values of X.

#### Volumes

4.18 Fixed call volumes continue to fall. Examination of the available data for the year ending March 2009 shows that outturns volumes are lower than those provided to Ofcom. For example the call volumes provided in the KPI data with BT's quarterly results<sup>1</sup> show that BT originated calls fell by 18% in the year between March 08 and March 09. This drop is confirmed by the data published by Ofcom in its Quarterly Market Information study published in May 2009. In the year to December 2008 BT originated volumes also fall by 18%, and BT plus "other indirect access", a rough proxy for total network volumes, fall by 14%.

<sup>&</sup>lt;sup>1</sup> http://www.btplc.com/sharesandperformance/quarterlyresults/quarterlyresults.htm

4.19 The forecast provided to Ofcom showed BT originating calls falling by about 11%. Although the reduction of traffic on the fixed network will be partly offset by interconnect traffic (e.g. terminations originated on mobile and other fixed CPS) BT expects that the regulatory accounts when published will show significantly lower PSTN component volumes than forecast, by around 5-10%. BT has not completed a full reforecast of call volumes but it is inevitable that actual volumes in 08/9 will be lower than those used in both BT's and Ofcom's models.

4.20 BT therefore recommends and requests that Ofcom reruns its model using starting volumes that are 5-10% lower.

#### Efficiency

4.21 BT has provided its comments on efficiency in answer to question 4.9. The central case assumption should be 1%.

#### **Cost of Capital**

4.22 BT has provided its comments on the appropriate cost of capital for regulated services in its two responses to the Openreach Financial Framework Review, and incorporates them here by reference.<sup>2</sup>

4.23 Ofcom's proposals on the cost of capital do not adequately reflect the need to provide incentives for investment. BT's central estimate of the WACC for regulated services other than Openreach copper access (called "Rest of BT" in Ofcom's consultations) was 11.6%, rising to a high range of 13.3% following a statistical modelling method first described by the Competition Commission in the review by the CAA of airport landing charges. Moving above the centre of the range is a way of ensuring that under-investment does not occur. The risks to society may not be symmetric if the regulated WACC is set too low or too high relative to the true WACC, which can only be estimated rather than observed directly. BT's modelling uses a range of 11.6-13.3%.

#### Pension Deficit Contributions.

4.24 BT has consistently stated that pension deficit contributions, over and above the normal ones, should be included in the regulated product cost stacks - see the BT responses to the Leased Lines Charge Control and especially the Openreach Financial Framework Review consultations. No pension deficit contribution has been included in any regulated product costs to date.

4.25 In May 2009, BT announced that its deficit contributions would rise from £280m p.a. to £525m for 3 years. The triennial revaluation of the pension assets and liabilities is not yet completed, so in our modelling we assume that the deficit

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http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Consultativeresponses/Ofcom/2009/Open reach/index.htm and

http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Consultativeresponses/Ofcom/2008/Open reach/NewpricingframeworkforOpenreach.htm

contributions revert to £280m p.a. in the  $4^{th}$  year. The share attributed to regulated NCC services<sup>3</sup> is £13m p.a. falling to £7m p.a.

4.26 Ofcom is now proposing to consult on the issue of the treatment of pensions deficit contributions and who should bear the costs, but BT continues to maintain that pensions deficit payments should be included in the relevant cost stacks of regulated products as they are an ongoing charge that BT incurs. In the answer to question 4.6 we have suggested that pensions deficit contributions could conveniently be added to PPP. This is shown in the table below. While an X factor of c.15% may seem high at first sight, it should be noted that in 2007/8 PPP revenue was only £20m, or around 3% of the total for the services which are price controlled in this control.

### **Asset Price Changes**

4.27 The hypothetical ongoing network models the costs of continuing to sustain a network regardless of its actual replacement when the technology is finally replaced. Given the age of the PSTN, it is unlikely there is scope for significant real reductions in asset prices. Ofcom has used a form of forecasting CCA costs where holding gains and losses are "normalised". In essence this approach makes no direct attempt to forecast asset prices, but assumes they follow general inflation. This implies asset values fixed in real terms, and BT assumes no real asset price changes.

### **BT View on Range of Xs**

4.28 Our modelling gives the following range of Xs which we include as a basis for comparison with Ofcom's table 1.1. The low range of Ofcom's Xs is significantly too low. Xs should be set at or above the top end of the range quoted. However, it should be noted that we consider that one off price changes are a more appropriate approach - see section 11 of our response.

	Glide path			Ofcom Range			
X Factors	BT High	BT Low		High	Low		
Call Termination	10.75%	9.25%		10.50%	3.30%		
Call Origination	9.75%	8.25%		9.50%	2.50%		
Interconnect Services	7.00%	5.75%		6.50%	1.50%		
PPP	15.50%	14.25%		6.8%	0.0%		

# 5. CCA FAC

*Question 4.5*: Do you agree with Ofcom's proposal to use a FAC CCA methodology to establish the cost base for the next NCC?

<sup>&</sup>lt;sup>3</sup> Including local to tandem conveyance and single tandem transit but excluding inter-tandem services.

5.1 BT supports Ofcom's proposal to use a FAC CCA methodology to establish the cost base for the next NCC. FAC CCA is consistent with how price controls prices have been set over a number of periods including the last NCC. It is a well understood and simple proxy for LRIC + mark up.

5.2 Ofcom has stated in the past that LRIC plus mark up and CCA FAC have little difference in terms of practical outcome. Both are clearly significantly better than HCA as a costing approach as they represent the costs that a new market entrant would face. In terms of the choice between CCA FAC and LRIC +, Ofcom sets out the case for CCA FAC in the Openreach Financial Framework Review Second Consultation:

- CCA FAC is a widely understood concept and has been the anchor for many previous price controls;
- CCA FAC is based on public data and which has been reconciled to the audited regulatory financial statements
- in terms of 'static efficiency', charges set in line with CCA costs consistently across the portfolio will avoid creating competitive distortions; and
- a fully cost reflective charge ensures that competition is not founded on special protection for a particular type of entrant, or service user, and hence is likely to be good for 'dynamic efficiency'.

In such circumstances, it seems clear to us that CCA FAC provides an appropriate basis for evaluating starting charges for price controls.

5.3 This position is not altered by Ofcom's technology neutral approach, which involves ignoring any costs already incurred on the ultimate replacement technology for PSTN and modelling the costs of a sustainable PSTN network. The costs appropriate to this approach are still the CCA costs of providing PSTN services.

## 6. Charge Control Framework – basket design

**Question 4.6:** Do you agree that product management, policy and planning and interconnection circuits should be subject to separate controls?

6.1 BT agrees it is appropriate to have a separate charge control for interconnection circuits, and product management, policy and planning. Interconnection circuits are fixed links between a BT and CP exchange, and comprise line terminating equipment at each end of the circuit, and transmission equipment between the two. All the other NCC services except PPP are components of switched calls. All call minutes regardless of type, ownership or destination are included in deriving the unit costs of PSTN switches and transmission. It is longstanding practice that the costs and charges for NCC call services are measured in pence per minute, billed according to actual usage, while circuits are charged for via a fixed and distance related rental on an annual basis. The two types of service have significantly different cost drivers and costs characteristics and in general would be expected to have different future unit cost profiles. It is this cost profile that is the main determinant of the resulting X factor. RPI – X caps will better reflect costs and provide the efficiency incentives

described in question 4.5 if the services in a particular control have similar or the same cost drivers.

6.2 PPP is the name given to the non-network costs of providing call services. These costs are "sales, general and administration" costs in the normal financial language of the P &L and reflect activities such as account management, product pricing, billing etc. All services receive the relevant share of these costs and in the case of NCC services, where they are referred to as PPP, costs are recovered from all calls, whether BT or CP owned, on a once per call service basis. BT suggests that pension deficit costs be added to PPP. PPP is recovered across all calls, and this would be an equitable, appropriate and proportionate basis for recovery of additional pension costs.

# *Question 4.7:* Do you agree that there is no need to introduce sub-caps on rental charges in the ISB basket?

6.3 BT agrees there is no need to introduce sub-caps on rental charges in the ISB basket. Prices of the services within the ISB have been stable over the life of the current NCC with few relative price changes, especially in the last 3 years of the current 4 year control. This is without any sub caps applying.



The stated purpose of for a sub cap would be to prevent inappropriate strategic behaviour by BT such as cutting the price of connections while increasing the price of rentals. As PSTN volumes decline, it is natural to expect that there will be more cessations and fewer new connections.

6.4 The use of prior year revenue weights largely neutralises this apparent incentive to cut the price of connections while increasing the price of rentals. BT can only change prices subject to complying with the overall price control, and the RPI–X formula is revenue weighted, using prior year revenues. Connections have already reduced to 15% of reported revenues in the most recent published results, implying that rentals already dominate the weighting. Any attempt by BT to increase the price of rentals

relative to connections is therefore already seriously constrained. Prices for connections and rentals have been already been notified for the 18 months beyond the last published results, i.e. to the end of the current control. Ordinary commercial decisions by CPs in response to industry-wide reductions in fixed call volumes will have reduced the revenue weighting of connections still further.

6.5 BT experiences other incentives too. Direct interconnection between CP networks (especially between mobile operators) is increasing, and this competitive pressure also constrains BT's ability to raise rental prices. As an example of what has happened in practice, over the life of the current controls, CSI connection prices have fallen by 18% and fixed rentals by 21%, while CSI per km rentals have increased by only 3%.

## 7. Treatment of 21CN services

*Question 4.8:* Do you agree that Ofcom is not in the position to regulate BT's 21CN Wholesale voice services at this point?

7.1 BT agrees that Ofcom is not in a position to regulate BT's 21CN wholesale voice services at this point. BT notes Ofcom's proposal in the Narrowband Market Review to impose cost orientation obligations on BT in pricing our 21CN voice services where these fall in SMP markets. It is BT's intention to announce prices for 21CN voice services once launch dates have been established. Where appropriate, these prices will take account of any cost orientation obligations, and the technology neutral approach Ofcom has proposed for the charge control

## 8. Charge control framework – efficiency adjustments

#### Question 4.9 Do you agree with our proposed efficiency range of 1-3% annually?

8.1 Based on the benchmarking activity and on the estimation of the frontier shift by both NERA and Deloitte, the efficiency challenge should be set at or below 1% to reflect the fact that BT is now above the top decile benchmark level of efficiency.

8.2 In any evaluation of proposed efficiency challenges, the required level of efficiency improvement can be divided into three elements:

- "Catch up", being the improvement of efficiency to match the level of efficiency of the relevant benchmark
- Frontier Shift, being the underlying improvement in efficiency as a result of technical progress or improved methods of working, and
- Economies of scope and scale, being the decrease in unit costs that comes about as a consequence of volume growth. In times of falling volumes, these effects may be negative.

It is important to consider these elements, as they can be used to evaluate what level of efficiency is reasonable for BT to be targeted with. Too tight an efficiency

challenge may be counter productive, whilst too lax a target may mean costs are higher than necessary.

8.3 Ofcom has assessed the first element through the NERA benchmarking report, supplemented by Deloitte's report. In the past, BT has always been assessed to be somewhat behind the benchmark level of efficiency, and hence a "catch up" component of efficiency challenge has been imposed. On this occasion, NERA conclude the BT Network is at least 2% and up to 6% above the benchmark (the top decile of US Local Exchange Companies).

8.4 The second element has traditionally been evaluated by use of past trends in unit costs. This is difficult to do as the impact of catch up and economies of scale may make it difficult to identify the element of unit cost change due to frontier shift. Both NERA and Deloitte have used econometric techniques to estimate the scale of the frontier shift. Deloitte's econometric analysis indicates that the frontier is moving at an estimated rate of between 0.5% per annum and 2% per annum, depending on what method is used<sup>4</sup>. NERA conclude "A point estimate for recent productivity growth would be 2% per year".<sup>5</sup> Alternatively, a range that is consistent with the two sources of evidence is 2.0 to 2.5%.

8.5 The final element is allowed for by Ofcom in its modelling through the use of Cost Volume Elasticity and Asset Volume Elasticity parameters.

8.6 When considering the level of achievable efficiency improvement, it is important to recognise that many of BT's costs are not readily "compressible", so that an efficiency challenge will fall more heavily on those elements of cost which are compressible. Some costs, whilst they might be variable, require considerable investment in order for the cost savings to be realised. It is also the case that costs are usually removed in a step-wise fashion.

8.7 However, adjustments should be made for the following factors:

a) BT's level of efficiency is above the benchmark level. Some allowance must be made for the benchmark to "catch up" with BT; otherwise the implication is that there is a tightening of the benchmark.

Economic theory suggests that companies with a superior efficiency performance should be able to make a superior rate of return until such time as competitors are able to match the level of efficiency of the leading firm. For this reason a lower level of efficiency improvement should be modelled (unless an upward adjustment to the cost of capital is allowed as an alternative.

b) Within the cost model are implicit assumptions about real asset price changes. A contributory factor to real unit cost reductions (or "frontier shift") is the

<sup>&</sup>lt;sup>4</sup> From Deloitte, Further Analysis of the efficiency of BT's Network Operations, 20 February 2009, <u>http://www.ofcom.org.uk/consult/condocs/llcc/responses/BT2.pdf</u> Section 2.2.5 – summarised in Table 3 (p16 of report)

<sup>&</sup>lt;sup>5</sup> NERA's Analysis of the Efficiency of BT's Network Operations, 19 December 2008. NERA's conclusion can be found in section 6

contribution made from a decline in real input costs. This is modelled explicitly in the cost model, meaning there is a real risk of double counting efficiency improvements, once in the efficiency requirement and a second time in the asset or input factor price.

c) BT is faced with a substantial ongoing cost to finance its pension fund deficit. Adjustments have been made to the scheme to limit future exposure, but again care is needed to ensure the removal of costs is not disincentivised by an attempt to claw-back any savings BT might make immediately once an initiative is announced

8.9 Both Deloitte and NERA suggest BT's efficiency is up to 6% above the benchmark – and productivity has been improving at around 2% per annum (plus or minus 0.5% per annum). A figure of around 1% per annum is consistent with ensuring that the benchmark efficiency measure is not made more onerous, and that BT is given some credit for the level of efficiency achieved by allowing the benchmark level to "catch up" with BT.

# **9.** Charge control framework – compliance and mechanics of the NCC

**Question 4.10:** Do you agree with Ofcom's proposal that BT be required to provide all data necessary to monitor compliance with the NCC within three months of the end of each NCC year?

9.1 BT agrees with Ofcom's proposal that BT be required to provide all data necessary to monitor compliance with the NCC within three months of the end of each NCC year on the basis that a submission based on the format currently used will meet the requirement.

## 10. RPI, Use of prior year revenue weights, provision for carry over

**Question 4.11:** Do you agree with Ofcom that NCC charges should be set using RPI as the measure of inflation for indexation, prior year revenue weights to calculate charge changes, and with provision for carry over?

10.1 We agree that RPI is generally a suitable price index and that RPI-X controls can provide benefits for customers and good incentives for suppliers. To the best of our knowledge, all UK price caps to date have used the RPI as the price control index. This reflects the basic idea behind RPI-X that prices are controlled against all other prices in the economy, and that these are appropriately measured by the RPI. However, this form of price regulation needs modification in circumstances where RPI is negative, because the Controlling Percentage ought not to include a negative value for RPI. This should default to zero.

#### **Basis of RPI-X controls**

10.2 If X is set at 0, this would mean that prices would not need to change relative to those in the economy – i.e. they could be held constant in "real terms". If X is positive, then prices need to reduce against all other prices in the economy, by X% a year. In effect, RPI is the component of the Controlling Percentage (RPI-X) which provides an allowance for inflation on the basis that, if there is inflation in the economy, the regulated supplier's costs will also tend to be increasing for this reason (and so prices can be increased by this amount). For example, the RPI allowance allows pay levels to be maintained in real terms before efficiency considerations central to "X" are made. Thus, were X to be 0, prices could be increased by RPI on the basis that this is the general economy wide trend in prices, which itself will reflect the general economy wide trend in underlying costs. The Ofcom cost models which underlie the derivation of X are invariably also in real terms, so no view needs to be taken on RPI itself.

#### **Negative inflation**

10.3 Ever since privatisation of BT, RPI has been positive. We are now entering an extraordinary economic period in which at the time of writing RPI has been negative for 2 months and the expectation is that this negative inflation, as measured by headline RPI, may continue in the short term. This means that, in addition to any efficiency and unit cost driven changes required by X, nominal prices of the services in the price control baskets would in addition also be required to fall by the recorded decreases in retail prices.

10.4 Were RPI to be less than zero, the Controlling Percentage ought not to include a negative value for RPI. This should default to zero. This would mean that the price control in nominal terms would never be larger than X. We consider that this is justified because many of our costs will not actually decrease in nominal terms even if inflation as measured by the RPI is negative. Such costs include, for example, property rentals which have "upwards only" reviews and fixed rate capital financing of debt. Staff pay costs may also be difficult to reduce in nominal terms. In effect, when it is negative, RPI is not a good measure of the nominal movement in costs because of the asymmetry which occurs when RPI is negative and not positive. Other measures of inflation, such as CPI and RPIX (which excludes mortgage interest payments) remain positive. In the most recent statistical release, while RPI fell by 1.2%, CPI rose by 2.3% and RPIX rose by 1.7%. It is only when measured by headline RPI that negative inflation is apparent. Other measures of costs are still rising.



10.5 It is also the case that the cost modelling which underlies the derivation of X uses real input prices. In a deflationary world this will underestimate capital costs which will need to reflect higher depreciation (reflecting unrealised holding losses) due to lowering annual capital prices.

10.6 These factors all combine to make it far more difficult to meet any price control formula, and at the same time maintain a fair return on capital employed, if RPI becomes negative. Were the Controlling Percentage to be amended in the way suggested above, this effect (which is clearly not intended by Ofcom) would be avoided.

### **Prior Year Weighting**

10.7 BT agrees that the use of prior year revenue weighting should continue.

10.8 The provision for carry over is an appropriate mechanism to ensure compliance over the life of the control. The mechanism is symmetrical, so that small amounts of under or over delivery of revenue changes relative to the price control in one year are carried forward into the next year.

## 11. Setting cost oriented charges under the next NCC

*Question 4.12* Do you agree with Ofcom that NCC charges should be aligned with modelled FAC at the end of the NCC period using a RPI + X glide path?

11.1 BT disagrees with the approach suggested by Ofcom as this would mean BT's charges would be below its efficiently incurred costs throughout the 2009-2013 charge control, thereby distorting the market and failing to provide BT and industry with the appropriate incentives to invest. BT has already suffered from NCC controls set below its efficiently incurred costs in recent years and it would be unjust and unreasonable for this situation to be imposed for a further four years when Ofcom has scope to make a readjustment.

11.2 This situation has occurred because of what has transpired to be massively over optimistic volume forecasts that were used by Ofcom when the current charge control was set. There are three main reasons for this:

• BT's share of exchange lines, which directly affects call volumes passing over BT's network, has declined as operators migrate customers to full LLU. This reduces the volume of calls carried over BT's network.

	BT 2009/10 market share NCC Consultation 2005	BT Market Share December 2008 <sup>7</sup>		
	Ofcom Assumption <sup>6</sup>			
Business Access	78.9%	58.6%		
Lines				
Residential Access	82.2%	65.3%		
Lines				

- The attractiveness of Broadband means that dial-up internet access is no longer a realistic option for most households, especially as bandwidth heavy applications have become more popular and as average bandwidth over broadband has increased. Dial-up internet access call minutes have therefore almost entirely disappeared.
- Voice over IP was forecast to grow rapidly and be carried over the PSTN network. This has not happened as VoIP traffic has grown less rapidly than anticipated. What traffic there is has been mainly carried over the broadband infrastructure rather than over the PSTN.

11.3 A key reason behind this over-optimistic forecast is that the regulatory regime towards PSTN access dramatically changed during the NCC period. The Strategic Review of Telecommunications (TSR) led to the creation of Openreach and a large price cut in fully unbundled local loops, intended to stimulate the development of LLU. This was completely unanticipated at the start of the price control, but has had a major impact on volumes and hence unit costs. The step change in the rate of Broadband growth was stimulated by the price reductions to LLU, which also made fully unbundled local loops commercially attractive, reducing BT's market share of exchange lines.

Historical Data showing how LLU volumes have grown rapidly following the TSR<sup>8</sup>

<sup>&</sup>lt;sup>6</sup> Review of BT's network charge controls, Table A8.9, Ofcom, 23 March 2005

<sup>&</sup>lt;sup>7</sup> Telecommunications Market data tables, Q4 2008, Table 7 & Table 9 Ofcom, May 2009

<sup>&</sup>lt;sup>8</sup> The Communications Market 2008, p 315, Ofcom



#### Figure 5.31 Fully and partially unbundled fixed lines

11.4 For example, in 2005, Ofcom assumed in its modelling "*Ofcom has assumed that total broadband take up doubles from 2003/4 to 2009/10*"<sup>9</sup>. As UK Broadband connections passed 5 million in March 2004, this indicates a forecast of around 10 million lines by March 2010. Market data showed that by December 2008 broadband connections totalled 17.3million<sup>10</sup>. By March 2010 total broadband lines could be around 19 million, some 90% higher than that which Ofcom had in mind.

11.5 An under-forecast of this scale is clearly driven by exogenous factors (i.e. those outside BT's control). BT accepts that this could not have been predicted in 2005, but this is no reason to now ignore the implications of such developments.

11.6 An approach which is appropriate and proportionate in these circumstances would be to recognise that the shortfall in volume is entirely due to exogenous factors. BT therefore suggests that Ofcom derives NCC charges from 1 October 2009 Ofcom using the same set of parameters used in 2004/5 but with actual volumes to 2008/9. The resulting prices will be consistent with BT achieving the same operational efficiency targets as set in 2005. In this way, incentives will not be distorted and the incentive properties of the RPI-X regime are retained whilst at the same time BT will not be faced with two successive 4 year controls during which it is prevented from fully recovering its efficiently incurred costs.

11.7 Such a procedure will result in a material increase in starting charges (and correspondingly lower Xs during the period of the charge control). However, this must be seen in context. UK termination rates are significantly below the level charged in major EU economies – as shown in the Figure below - and even with a one-off price increase on such a basis, BT's interconnect prices would remain among the lowest within the EU.

<sup>&</sup>lt;sup>9</sup> Review of BT's network charge controls, A8.51, Ofcom, 23 March 2005

<sup>&</sup>lt;sup>10</sup> Telecommunications Market data tables, Q4 2008, Table 16 Ofcom, May 2009,

## Call termination rates since 2003<sup>11</sup>



#### source: Cullen International research

The table below illustrates how one off price increases could be applied and the effect on the range of Xs.

	Glide path		Step change			Ofcom Range	
X Factors	BT High	BT Low	BT High	BT Low		High	Low
Call Termination	10.75%	9.25%	4.75%	3.25%		10.50%	3.30%
Call Origination	9.75%	8.25%	3.75%	2.25%		9.50%	2.50%
Interconnect Services	7.00%	5.75%	7.00%	5.75%		6.50%	1.50%
PPP	15.50%	14.25%	9.25%	8.00%		6.8%	0.0%

# **12. DLRIC floors**

**Question 4.13:** Do you agree with Ofcom that, in the event that starting charges for the next NCC are below DLRIC floors, the NCC should allow increases in the first year of the NCC to align charges to DLRIC floors?

12.1 BT does not agree. Ofcom is placing undue emphasis on the concepts of DLRIC and DSAC (distributed long run incremental cost and distributed stand alone cost.) There is a valid theoretical case for treating LRIC as a test for a price floor and stand alone cost as a price ceiling. Prices below the floor or above a ceiling may in some circumstances be deemed to be not cost-oriented. The true measures though are LRIC and SAC without any distribution of common costs. DLRIC and DSAC are a construct created by Oftel that do not appear in the economic or competition law literature.

<sup>&</sup>lt;sup>11</sup> Cullen International, <u>http://www.cullen-international.com/documents/cullen/prindex.cfm</u>

12.2 Even when they are applied, ceilings and floors should be used as a first order test of cost orientation, not additional and binding price controls. In its response to the Leased Line Charge Control BT set out why the use of ceilings and floors should at most be considered to be a "rebuttable proposition", in that the specific circumstances of each case need to be taken into account in deciding whether prices falling outside the ceiling and floor range for a sustained period of time raise competitive problems.

12.3 Elsewhere in this response BT has argued that one off price increases are justified, but for different reasons than that cited here by Ofcom.