LEASED LINES CHARGE CONTROL – CABLE&WIRELESS RESPONSE – NON CONFIDENTIAL

6TH MARCH 2009

Cable&Wireless

EXECUTIVE SUMMARY

Ofcom estimate the UK market for retail business connectivity services is worth about £2.1bn per annum but in practice the services covered in the charge control are worth far more than that to the UK economy. The wholesale services within the control are fundamental to all telecommunications services in the United Kingdom, providing capability to enterprises and supporting the services that consumers rely on. It is vital that Ofcom get this right, the consequences of not doing so will have far reaching implications for UK consumers and the competitiveness of the UK economy.

Cable&Wireless is a major provider of connectivity services to business on both a wholesale and retail basis. We aim to provide great value and great service to all our customers; however in the majority of cases we remain reliant on products from BT and Openreach to make that final connection to reach our customers. It is vital that we have access to the right products from BT at the right price.

In this charge control we are looking for Ofcom to reduce BT's prices for wholesale connectivity products to the point where they are truly cost oriented, today we believe that in aggregate those charges are too high. We also need Ofcom to remove discrimination in wholesale prices, in particular to address prices that unduly favour the rest of BT over other operators including Cable & Wireless. Looking forward to the future we need Ofcom to ensure that BT doesn't take advantage of changes in technology to entrench its market position by locking out its competitors. Ofcom must create a pricing structure that promotes infrastructure competition at the local exchange level, where it can be effective and sustainable.

If Ofcom can deliver these things it will help us to meet both the challenges and opportunities that technology change brings, stimulating innovation and product development. UK enterprises need Cable&Wireless to be competitive in all material retail and wholesale markets, breaking down the stranglehold that BT retains in certain markets, providing both innovation and choice.

In ensuring BT delivers services at truly cost orientated prices we need to have access to reliable and transparent regulatory accounts. The regulatory accounts are the bedrock of Ofcom's proposals

for charge controls on BT for business connectivity services; however the recent problems have given rise to considerable doubt over the figures that Ofcom relies on.

We recognise that Ofcom has made some attempts to check the information and has made its own adjustments, however many of the issues remain. The information is still not fit for the purpose for which it has been used. Ofcom need to take steps to help resolve these issues before finalising the charge control.

In the TISBO market we do not believe that Ofcom has yet got to the bottom of BT's returns. Once existing returns in this market are properly understood it will be apparent that BT is currently able to make a return of over 20% on mean capital employed. This harms end users who also pay too much and creates a competitive imbalance in the market; however instead of reducing the price of PPCs BT has put forward its own set of price changes that would actually increase the price of PPCs to its external customers.

BT is dominant in these wholesale markets and if it is allowed enough freedom to set its own prices it will, of course, do that in a way that maximises benefit to its own business and targets its biggest competitors. BT's price changes cannot be allowed to stand.

We recognise that in some circumstances some charges may have to increase, however, it is no-one's interest, apart from BT's, for these to double overnight. A gradual increase in prices does not mean that BT is forced into making a loss. Our analysis of BT's returns suggests that BT can reduce its prices where they are excessive without having to make immediate price increases elsewhere. Once that is done the remaining changes (both up and down) amount to rebalancing of prices and that can be done gradually over the course of the charge control period.

One of the most important issues for Ofcom to address in this review is the local end adjustment. This is an adjustment that directly impacts BT's external PPC customers not BT itself and therefore directly holds back competition. It is time this surcharge was re-examined, ensuring the cost components are accurately and efficiently recovered. In our view the adjustment is not required at all; the costs should be recovered over all circuits. It unjustifiable for BT to face a lower cost for internal use compared with the price paid by external customers.

We very much support Ofcom's objective of infrastructure competition to the deepest level where it can be effective and sustainable and in support of this we recommend Ofcom pays particular attention to the price of both PPC handover infrastructure and local end rentals and WES Local Access. We believe a separate sub-cap should be placed on the price of PPC local ends to prevent them from being increased above the level that is absolutely necessary and that a separate RPI-X sub cap is placed on WES Local Access.

New lower starting charges should be introduced from the 1st of October 2008. Had it not been for BT's restatement of its regulatory financial statements Ofcom would have been able to complete this work by September 2008 and the new lower starting charges come into effect on 1st October 2008. Instead BT has had many additional months of the current high prices and it should not be allowed to profit from this delay. In AI alone we estimate that BT would pocket an additional £44M, of which around £17M would be funded by their competitors. Ofcom must take action to prevent this manipulation of the regulatory process.

Cable&Wireless

TABLE OF CONTENTS

1 INTRODUCTION

Cable&Wireless is a major provider of connectivity services to business on both a wholesale and retail basis. Our aim is to provide great value and great service to our customers. Where we can we do that using our own infrastructure and we invest heavily in the UK to enable us to do that. However, we remain reliant on BT and Openreach for the final connection to the majority of our customers. As a result we are BT's largest external customer for connectivity services and BT's largest competitor in the downstream markets.

Getting to the bottom of the issue

In this response, and our response to Ofcom's market review, we have highlighted some of the many competition problems in the business connectivity market. In a market where one operator has such scale and history it is not in itself surprising that competition problems exist. The bigger problem is the time that it takes to resolve these problems.

The following table shows a brief history of some of the problems relating to PPC prices and transparency.

May 2005	Energis (now part of C&W) referred a dispute to Ofcom over the price of PPC Trunk. In the end the dispute was withdrawn and Ofcom opened an own investigation
July – Oct 2005	Ofcom consults on Leased Line Replicability where the true scale of the local end factor starts to become understood. It becomes clear that CPs cannot replicate BT's low speed leased lines
December 2005	Ofcom close their own investigation into trunk and the cost information is inadequate and in any case they believe the issue would be better dealt with in the next market review

From 2005 through to 2007	Following Ofcom's replicability consultation there were numerous meetings attempting to understand and improve BT internal reference offer and regulatory financial statements
Early 2006	Ofcom run a consultation on geographic analysis and start preparation for the Leased Line Market Review
June 2007	Ofcom issues a paper 'Replicability and the PPC charging model' that confirms suspicions that the regulatory financial statements significantly understate the revenue from PPCs
December 2007	RGL complete a report estimating BT's returns in the TISBO markets are well in excessive of what could be considered reasonable in a regulated market
January 2008	Ofcom publishes its Business Connectivity Market Review with draft findings that restate the concerns from the replicability project
June 2008	A group of Operators refer a dispute to Ofcom over the level of BT's PPC charges having failed to reach agreement with BT
July 2008	BT announces that they have found errors in their regulatory financial statements that will mean they will restate the figures for 2006/7. This delays Ofcom's charge control consultation beyond the end of the then existing charge control. This further extend the time when the competition problems can be properly addressed

These problems are far from resolved. The asymmetry of information between BT and other operators means that there are many areas of concern that are just not understood. Where information is available concerns continue to exist meaning that it cannot be relied upon. BT has consistently frustrated the regulatory process through the provision of incorrect and misleading information. Ofcom is making progress, but these proposals fail to address some of the most significant issues; and those that are addressed take too long.

We cannot wait for the next market review to tackle them again, they must be addressed now. End users have already suffered for far too long through the lack of choice, service and price.

Outline of this response

This response contains the following sections:

- In section 2 we describe Cable&Wireless' objectives for the Business Connectivity Market Review and specifically this charge control project;
- Section 3 considers the reliability of BT's regulatory financial statements as the starting point for this review;
- Section 4 considers the proposals in the TI markets in more detail;
- Section 5 covers the Ethernet proposals; and
- In section 6 we provide answers to Ofcom consultation questions.

2 CABLE&WIRELESS OBJECTIVES FOR THIS REVIEW

2.1 INTRODUCTION

Our response to Ofcom's consultation on the market review highlighted some of the competition problems in these markets and we have addressed some of these issues in more detail in other submissions to Ofcom. Fundamentally, our objective is to level the playing field, both now and for the future.

In summary those objectives are to:

- Reduce BT's prices for wholesale connectivity products to the point where they are truly cost oriented – today we believe that, in aggregate, those charges are too high;
- Remove discrimination in wholesale prices; in particular to address prices that unduly favour the rest of BT over other operators including Cable & Wireless;
- Ensure that structure of prices promotes infrastructure competition to the deepest level where it can be effective and sustainable - we believe this is the local exchange, at least for many of the large local exchanges in the UK;
- Ensure that competition can be effective in all the material retail and wholesale markets – as an example, today, BT retains a stranglehold in the provision of backhaul services to mobile operators;
- Address the changing economics in connectivity markets arising from new technology and products already on the horizon.

2.2 TODAY PRICES ARE TOO HIGH

Cable&Wireless believe that BT's wholesale prices for many individual connectivity services and for connectivity services in aggregate are too high. We believe that if the true costs and revenues from these services are properly understood then BT's returns are

substantially greater than those that could be considered reasonable in a regulated market. This opinion is in part based upon evidence from BT's own regulatory financial statements but also based upon our own experience of the costs for similar services to those sold by BT.

The evidence from BT's regulatory financial statements is based upon the belief that the statements have not, and still do not, properly record all the costs and revenues associated with all the internal and external sales of all the relevant products. Ofcom itself has uncovered many of these issues in its previous work, in particular its replicability project. BT's restatement of its 2006/7 regulatory financial statements and revised methodology has addressed some of these concerns but many remain and we address them throughout this response. Later in this document we set out the issues that we consider still to be outstanding and adjustments that we believe need to be made in order to arrive at a more accurate view of BT's returns.

However the evidence does not stop there. A simple look at some of BT's prices shows that many cannot be truly reflective of cost:

- 2Mbit/s trunk prices that are more than twice as high at terminating segment prices and sub 2Mbit/s trunk prices that are 4 times as high as terminating segment prices;
- In central London, where there is some competition, BT prices for local ends are over 40% lower for both 2Mbit/s and 45Mbit/s. Clearly there will be some economies of scale in such a dense metropolitan area but given most of these services are sold in metropolitan areas and BT can share the costs of its duct between copper and fibre we do not think they will be as significant as this;
- Until recently operators would dig up to several hundred metres at a cost of tens of thousands of pounds in order to avoid BT's PPC charges. However, the last mile is a natural monopoly where BT's scale and scope economies give them the lowest cost base, and so if prices had been truly reflective of cost much of this investment

would not have been made. This is not just a result of trunk prices being too high, it is PPC prices in general that are too high;

- Equipment costs have fallen significantly over the past seven years and yet the price of PPCs, where the cost of electronics is very significant, has barely fallen at all.

The result of these high prices is that they are directly passed on to consumers in the retail market, but the problems do not end there. They will have encouraged inefficient market entry draining investment that would have provided greater value to end users if more efficiently targeted. Further, the profit that BT will have made will in part have been used to help BT compete against its major competitors in other areas of the market. Ultimately, excessive prices will have held back competition from delivering its true potential to provide greater choice, innovation and value to end users.

2.3 PRICE DISCRIMINATION

There are a number of aspects to the current prices for PPCs and Ethernet that are at best odd, and in many cases we believe they are discriminatory.

2.3.1 THE LOCAL END ADJUSTMENT

The price BT currently charges to external customers for a PPC local end is higher than the assumed charge for internal usage of the same local end. In the regulatory financial statements internal use is set at a price 23% lower than that for PPCs, this is equivalent to external customers paying 30% more than the price assumed for all internal use. Cable&Wireless believe that BT has misunderstood the original Oftel decision that led to this adjustment and as a result the adjustment has been implemented incorrectly. If the

implementation were correct then we believe it would amount to undue discrimination in favour of BT and it would be a major barrier to effective competition.

It is first necessary to look back at the origins of the adjustment. In 2002 when Oftel was considering its PPC phase II determination Oftel recognised that BT were not recovering the overheads associated with Points of Handover (PoH) in their charges for these elements. Oftel decided to make an adjustment to the local end rental price in order to ensure that BT did not under-recover as a result of this. This issue is discussed in paragraphs 3.31 to 3.48 of Oftel's PPC Phase II determination.

It is clear from that discussion that there was no data covering actual network overhead costs associated with the PoH. Instead Oftel considered the ratio of per circuit cost of equipment at the local end compared with the PoH. It was found that the per circuit cost of equipment for the PoH is 38% of that at the local end for circuits under 1Mbit/s and 31% for circuits of 1Mbit/s and above. Therefore Oftel decided to increase the overheads included in the local end costs by these percentages in order to ensure that BT recovered the overheads associated with the PoH.

The issue is an element of ambiguity in the Oftel determination as the document confuses the issue of whether to increase the overhead by the relevant percentage or the whole cost by the relevant percentage. BT's assumption, implicit in the adjustments it has made in its regulatory financial statements, is that the whole cost, and hence the whole price, was increased by 30%. While it is possible to read this into Oftel words it is plainly incorrect. The adjustment was made to address the overheads associated with the PoH, the ratio of equipment costs was used to set the level of the adjustment, and therefore it should be the **overheads** associated with the local end that should be increased and not the whole cost. If the whole cost of the local end is increased by the calculated ratio then the result is the whole cost of the PoH equipment will be recovered in the local end charge. However, it is

clear that the equipment costs, and some of the overheads, are already recovered directly in the charges made for the PoH.

A proper consideration of the methodology used by Oftel makes it clear that BT must have misunderstood the adjustment that it has made. This is further reinforced by an understanding of the level of efficiently incurred PoH overheads that BT does not cover in its PoH charges. Later in this document we look at BT's estimate of costs and show that they could not be as high as the BT adjustment suggests if they are efficiently incurred.

The conclusion is that the difference between internal and external local end rentals should, in fact, be much smaller than that actually made by BT. There are two implications of this issue:

1. BT has understated the revenue from internally supplied local ends in its regulatory financial statements. A proper application of the adjustment would have increased the price and hence the revenue from internally provided local ends;
2. Other Communications Providers have been unable to effectively compete with BT in the market for end to end leased lines because they have not only faced the additional cost of the PoH (which BT does not) but also they have faced an unjustified premium over BT for the local end itself. This was one of the key issues that came out of Ofcom's 2005 review of replicability and is borne out today by BT's very high market share and profitability in low speed retail leased lines.

This is one of the most important issues for this market review and charge control. It goes to the heart of the competition problems in low speed retail leased lines where the purchase of a PPC is often the only viable method of access open to competing operators.

There is a second problem with BT's current treatment of the local end adjustment. While it is quite clear that in the case of end to end retail leased lines BT does not make use of any form of Point of Handover, this is not the case for all of BT's internal use of private circuit

components. Communications Providers, such as Cable&Wireless, also use PPCs as the access capability for access to data platforms such as IP-VPNs, Frame Relay networks and ATM. BT too makes considerable use of private circuit components for this same purpose, and when it does so its own use is very similar to the manner in which PPCs are used.

The situation is illustrated in BT's internal reference offer for PPCs where it shows BT's network configuration for the provision of access for VPN services. The diagram shows a 'VPN dedicated ADM' that provides the interface between the BT transmission network and the platform. The configuration shown is virtually identical to that used in the provision of In-Span Handover (ISH) PPC interconnects where the mux (paid for by the CP through the PoH charges) provides the interface between the BT transmission network and the CP. The majority of the cost is the same, the only real difference is that in the BT example the connection to the platform is a number of lower speed connections whereas in the ISH example the connection to the CP is a fibre extended to the jointing chamber just outside the BT building.

Further details of this configuration can be found in BT's internal reference offer and in the RGL report. It was also discussed at length in a meeting between Graeme Hodgson and Nick Harding on January 29th 2008.

It follows that where BT use private circuit components for this type of usage it will be driving similar costs to those that result from the points of handover supplied for PPCs and including the overheads that have been discussed above. However, currently BT's regulatory financial statements do not distinguish its downstream use of PPC components between those used for retail leased lines and those used to provide access to BT platforms. It appears that BT gives itself the same (in our view too high) discounts on the local ends that it uses for platform access as it does for retail leased lines. Also, it is not

clear that it takes account of the cost of the additional 'VPN dedicated ADM' in the charges it makes to its downstream business.

Ofcom should make it clear that where this type of use is concerned BT must apply the same price for local ends as it does for PPC local end sold externally and also BT should apply an internal charge for the additional equipment in a manner consistent with the pricing of the equipment when sold as a PPC ISH. Ofcom should also adjust its base year revenues in the TISBO markets to reflect this. If these changes are not made then either:

- BT has a material and unjustified advantage over other CPs when it comes to competing in the markets for IP-VPN and other similar connectivity markets; or
- BT's regulatory financial statements are incorrectly recording the revenue from BT's internal use of these components that will result in the charge control not being set correctly.

2.3.2 TRUNK PRICING ACROSS THE DIFFERENT BANDWIDTHS

BT's price for PPC trunk segments is in general significantly higher than its price for terminating segments except for the case of 155Mbit/s where the trunk price is significantly lower.

However the pricing gives rise to an odd situation where the price of trunk for 155Mbit/s is £260 per km per year whereas the price for 45Mbit/s trunk is £552 per km per year. This does not make logical sense, if it really is more costly to route 45Mbit/s through the trunk network then why would it be done, instead the circuit would be routed in its own 155Mbit/s bearer over the trunk network.

A closer look at the internal and external volumes may prove insightful. In 2007/8 BT's internal use of 155Mbit/s trunk was 95% of the total sold by volume. Add in their use of 622Mbit/s trunk (for which the price is nearly as low as 155Mbit/s in a per Mbit/s basis) and

it can be seen that external use is less than 3%. On the other hand 22% of 45%Mbit/s trunk was sold externally. It appears from the volumes that BT use internally that it is able to direct its own use of trunk towards the low priced 155Mbit/s and 622Mbit/s whereas other CPs, buying PPCs, have no choice but to purchase the bandwidth relevant to the specific circuit.

This pricing certainly suggests that the price of 45Mbit/s trunk is too high. It also illustrates the way in which BT will use the pricing flexibility that it has in order to make price reductions where they are most beneficial to its own business in relation to those of its competitors. In the circumstances any business can be expected to do the same, however, in a regulated market arguably BT should have reduced trunk prices over all bandwidths rather than just the very high bandwidths that are predominantly supplied internally.

Ofcom must find a balance between giving BT some pricing flexibility and ensuring that it is not free to act in a way that gives its own business a material advantage.

2.3.3 PRODUCTS ONLY SOLD EXTERNALLY

There are a various products in both the PPC and Ethernet markets that are only sold externally, point of handover products are the most obvious of these.

Cable&Wireless order In Span Handovers at either STM-4 or STM-16 when new handovers are required. Traditionally this has required BT to provide an SDH mux as the interface between its network and Cable&Wireless, the space and power to accommodate it, and connections both into the BT network and via fibre to a joint chamber just outside the BT exchange. In 2004 at the start of the PPC charge control the SDH mux was the most costly aspect in the provisions of these handovers. Over the past five years the cost, size and power consumption of the equipment has fallen very significantly. In fact today

the same services could be just as effectively provided using a small plug in optical interface on a device shared over many users.

The following example illustrates the point:

- In 2004 an SMA-4 mux providing an STM-4 handover would have cost about £22k and taken up half a rack of space
- The equivalent mux today costs about £11k and can fit into a quarter of a rack of space
- A mux capable of supporting 24 STM-4 interfaces (so 12 STM-4 handovers) can be bought for £15k and each additional STM-4 interface costs less than £700.

In that time the price of an STM-4 ISH has reduced from £32k (Oftel phase II direction price) to £21.6k, a significantly smaller reduction than could be expected based upon equipment price trends. Furthermore we note that now BT proposes to put it up to £26k.

Similarly the price of an STM-16 ISH has reduced from £70k (Oftel phase II direction) to £55k, and now BT proposes to increase that to £57k.

The key point is that BT will naturally tend to price the items that are only purchased by external customers in a way that enables them to recover more of their common costs on those items than on others. These are therefore the areas where Ofcom must put the greatest attention on the prices being charged.

2.4 PROMOTING INFRASTRUCTURE COMPETITION

Cable&Wireless shares Ofcom's vision to encourage infrastructure competition to the deepest level in the network where it can be effective and sustainable. Effective competition will provide the greatest benefits to end users in terms of quality, choice and

value in the long run. Ofcom has consistently signalled this view to the industry and we firmly believe that it remains valid today and that Ofcom should set charge controls that are consistent with this policy.

The deepest level

The first key question is where is this level. We believe that it is the local exchange when it comes to the major exchanges in key business districts. However, for smaller exchanges, and those in rural or residential areas, competition will not be viable beyond the trunk network, at least for the foreseeable future. We do not believe that competition for business connectivity will be viable to all of the same local exchanges as it is for LLU due to the different profile of end users on each exchange.

There are various factors that influence the economics of infrastructure competition:

- The last mile (or few miles beyond the local exchange) is all about economies of scale; it is probably a natural monopoly. BT's existing infrastructure combined with its ability to share duct between its copper and fibre networks mean that it is highly unlikely that incremental investment can be sustained on a general basis. Some competition may be viable by leveraging existing written down investments or in greenfield locations but it is insufficient to form effective competition to BT;
- The backhaul network from the local exchange to the trunk network (either BT's or another CP's) depends very much on the specifics of individual exchanges. BT's investment in its Orchid backhaul network demonstrates its ability to reduce the cost of backhaul and it now appears that the majority of viable new backhaul investment has been made. However, existing backhaul investment does reach a material number of exchanges and still has an important role to play in providing competition to BT;

- Aggregation of different traffic types is vital if operators are to keep pace with developments in the market. Many operators have built or bought backhaul capacity for their LLU network, having done this the cost of expanding bandwidth is low and therefore it is vital that they have the opportunity to take advantage of this fact rather than be forced to buy backhaul on a piecemeal basis from BT;
- The trunk network should be competitive. Ofcom's previous and current SMP finding on BT arises mainly because of the very specific definition of trunk in the definition of BT's PPC product and the assumed routing of PPC circuits. Ofcom has gone some way to addressing this in the market review through the re-definition of trunk although some PPC routing issues remain that might need addressing in the future.

These economics, and hence the potential for effective competition, are very important factors in the level and structure of the charge control that Ofcom places on BT and the freedom that it gives BT to vary its charges. The most complex issue for Ofcom is how to balance the requirement to encourage competition to the local exchange level where it is viable but not to give BT undue advantage in exchanges where competition is not viable.

✂

Implications for TI

Ofcom can encourage efficient infrastructure competition at the local exchange level through a number of measures including:

- Ensuring that the price of local ends is kept low – this does not mean below LRIC floor, but Ofcom should err on the side of recovering more of the common cost on the components that are potentially competitive rather than the local ends that are not. We make further points on the costs of local ends later in this document;

- Ensuring that the price of point of handovers is not excessive. As a item that BT itself does not have to purchase it is particularly important that BT is not able to recover large amounts of its common costs, or inefficiently incurred costs in these charges as these directly impact a competing CP's ability to exert competitive pressure on BT in downstream markets. An even more efficient handover solution would provide in exchange handover and avoid the need for the fibre to the jointing chamber at all;
- Ensuring migration and re-arrangement products are made available and at a price that encourages change where it is efficient to do so. The request is not that prices should be below LRIC cost, but that recovery of common costs recovered in these components should be kept to a minimum; and
- Providing price stability, and in particular to ensure that recovery of common costs will not move from contestable items to less contestable items (like the local end) during the charge control.

Implications for AI

Ofcom can encourage infrastructure competition in AI by:

- Ensuring the price of WES Local Access is kept low – once again this specifically relates to the level of common cost recovered in WES Local Access prices and does not suggest that prices should be below LRIC floor;
- Ensuring that the exchange space and connectivity products are flexible and affordable. We welcome the changes Ofcom has made on equipment space in the market review that assist in this objective;
- Migration and re-arrangement products are available and priced at a level that encourages change. In particular the re-arrangement products must give other operators, for whom the existing circuit might be a WES to a non-BT location, the same capability as if the original circuit already terminated in a BT exchange;

- Providing price stability. However, it is important that this is balanced with the need to ensure prices are reflective of efficient costs. The AI market is rapidly changing and provides the opportunity for very significant further efficiencies, albeit that their extent is very difficult to predict. If price becomes significantly out of line with costs then this clearly risks inefficient investment (or at the other extreme the failure to invest); and
- Ensuring that Openreach aggregation products do not undermine exchange-based infrastructure competition by, for example, providing a capability that cannot be commercially replicated by those CPs who invest in access into the exchange.

2.5 EFFECTIVE COMPETITION IN ALL DOWNSTREAM MARKETS

The BCMR covers much more than just leased lines. Historically BT's competitors have had varying degrees of success when it comes to competing in the different parts of this market. Ofcom's review of the market has shown that in some areas, such as high bandwidth TI services and long distance services competition has been effective. However, a closer look reveals a number of areas where competition has not been as successful as Ofcom may have hoped. The combination of the BCMR and this charge control work is the opportunity to address this.

In low bandwidth (less than 2MBit/s retail services) Ofcom found BT's market share to be very high and profitability strong. The cost and inefficiency of moving circuits has prevented other CPs from placing effective pressure on BT. However, with BT planning to close its DPCN network and also signalling an increase in wholesale prices for these services now is not the time to address this issue using the existing network platform. Instead, we must look to SDSL, EFM and NGA and ensure that the wholesale products

providing these capabilities can better facilitate competition in the retail market as it evolves.

In CCTV and wireless street access BT has the dominant position as a result of the benefits that it gave itself prior to the EoI undertakings addressing these services. Although BT now uses its underlying infrastructure through EoI services it still retains a dominant position in the downstream markets and it is not clear that other operators are being successful in breaking into them. Openreach's proposed price changes to remove main link distance charges for CCTV rentals would make competition based upon any other form of input even less likely.

The market for mobile backhaul is very large and vital for this fundamental aspect of today's communications and yet BT has a very dominant position in this market. It is a crucial time for mobile operators as they continue to roll out 3G coverage and increase bandwidth to cope with the growing demand from data based services. The fact that BT has managed to retain its dominance in this market is a particular concern. There is a lack of transparency in the regulatory financial statements when it comes to the RBS product which should be addressed but a more targeted review of this market is required.

✂

Competition in mobile backhaul markets can only be given a chance if:

- BT is prevented from using artificial barriers, such as product names, to make migration between operators uneconomic;
- The price and capability of the generally available regulated wholesale input (e.g. PPCs) is the product that underpins all mobile backhaul; and
- Transparency is improved so that competing operators can properly challenge BT's behaviour in competing for this market.

2.6 THE CHANGING ECONOMICS OF BUSINESS CONNECTIVITY

This review is being conducted at a time when many operators, including BT, have recently or are currently investing in next generation networks. BT's plans remain far from clear but over the course of this charge control period there will clearly be much change.

As we understand BT's plans today they will invest in an Ethernet network that will provide the capability of connecting customers using Openreach WES Local Access or EFM, provided over Openreach LLU capability. In places this capability will be in direct competition with other operators running their own national networks and offering their own connectivity solutions. However other operators will not be able to compete on a national basis with this network. In wholesale broadband LLU operators can compete with BT in some areas of the country, but in others there is not effective competition based upon the wholesale local access market. Similarly, in business connectivity it does not look likely that the products provided by Openreach will be capable of providing BT's competitors with suitable wholesale inputs throughout the country.

As we stand today it is not possible to determine either the geographic scope or how that varies between different types of connectivity solution. It certainly does not follow that it will mirror the geography where LLU based competition has so far failed to address. However competition will only be effective in business connectivity markets if there are viable solutions, from the point of view of capability and commercial viability, in all parts of the country.

Although Ofcom may feel that there is too much uncertainty today for it to address this issue it remains a vital issue for this review.

Firstly, it is most likely that it will need to be addressed during this charge control period; it has the potential to be too significant an issue to be left unchecked until the next review

comes around. Therefore in setting this charge control we ask that Ofcom ensures that it retains the ability to deal with this type of issue if and when it becomes necessary.

Secondly, there will effectively be two separate Ethernet networks being built by BT; one in Openreach to provide regulated wholesale inputs to all operators and another, by BT Operate, that will provide capability predominantly for BT and its downstream customers (retail and wholesale) by making use of the Openreach inputs. The latter is 21CN. There will surely be a temptation to load costs from 21CN into the Ethernet products provided by Openreach and so it is essential that Ofcom is very careful to review the costs used in setting these charge controls to ensure that none of BT's 21CN Ethernet network costs end up being recovered in the regulated charges unless they are truly driven by the regulated Openreach products.

3 REGULATORY ACCOUNTS AS A STARTING POINT

3.1 INTRODUCTION

The regulatory accounts are a fundamental part of the proposals to place charge controls on BT for business connectivity services but the recent problems have given rise to considerable doubt over the figures that Ofcom relies on. Although Ofcom has made some attempts to check the information and made its own adjustments many of the issues remain. In our opinion the BT information, even after the Ofcom adjustments, is not fit for the purpose for which it has been used.

In this section we consider the reliability of BT's regulatory financial statements and the extent to which they should be used. In particular we have concerns that:

- BT's restatement does not appear to have addressed one of the fundamental issues that drew attention to the problems in the first place, that the regulatory statements understated the external revenue;
- The 2006/7 information, which Ofcom make use of, is particularly unreliable because the restatement was not complete and did not consider the impact on cost allocation;
- There are 17 issues that were raised by Analysys Mason that they considered could be material and needed further investigation;
- The LRIC information, which is an important part of these proposals, is even more unreliable than the fully allocated costs;
- There are some important areas where the transparency is particularly poor and that leads us to a concern that no proper assurance has been completed. These include sub 2MBit/s circuits, RBS and the extent to which all relevant downstream uses are properly captured; and

- The restatement was done against a background of a very significant dispute between BT and other operators concerning the price of PPCs. Against such a background there is a risk that more of the errors in BT's favour will have been uncovered and corrected than those that were not in their favour. The asymmetry of information prevents us from checking this.

In truth the regulatory accounts are not currently fit for use in setting these charge controls. Ofcom should develop bottom up LRIC models for business connectivity services in the way it does for Mobile Termination rates. We recognise that the lateness of BT's restatement made this impractical in the required timescales but this remains a potential solution to the problem. In the alternative, Ofcom should base these charge controls on 2007/8 information and not before further investigation on the outstanding issues and making the appropriate adjustments.

3.2 THE FUNDAMENTAL PROBLEM

The original problem with the regulatory financial statements was uncovered by Ofcom in 2006 within its work on leased line replicability. Operators had observed that significant items of cost in the purchase of PPC did not appear in the financial statements where BT had confirmed that the cost was included. The regulatory statements do not use actual revenue as BT's internal use is not invoiced on a traditional basis and so revenues are reported using a price time volume calculation. Ofcom asked BT to provide a comparison of its actual revenues from PPCs in 2005/6 with those reported in BT's regulatory financial statements.

Ofcom found that several significant areas of external PPC revenue were not included within the statements including 3rd party equipment, resilience and ancillary services and there were some other differences. However, the important finding was that in 2005/6 BT's actual revenue from PPCs was 10% higher than the revenue reported in the regulatory

statements. Although the errors and omissions explained this difference in part it was not possible to account for all of the difference.

It was this finding that led to the problems with the regulatory financial statement being uncovered and ultimately to BT's restatement of the 2006/7 statements. The restatement covered both internal and external volume and hence revenues, but for external sales of PPCs the net change was very small, it increased from £261m to £262m, an increase of only half a percent.

There are two possible explanations; maybe the difference Ofcom found in 2005/6 was a one off, not a recurring problem with the statements. Alternatively the restatement has not solved the underlying problem that the regulatory statements understate the real revenue. If that is the case then it is possible that whatever causes the problems run throughout both the internal and external revenue calculations.

Ofcom must look into this issue. It is the fundamental symptom that drew attention to the problem in the first place and it must be fully investigated before there is any hope of restoring any confidence in the regulatory financial statements. We note that last time BT prevented full details of this reconciliation being published by Ofcom but this is basic regulatory accounting information and there is no possible reason for BT not to publish it apart from the fact that it may indicate yet further problems with the regulatory statements. Ofcom should publish a detailed reconciliation between actual billed revenues and reported revenues for each of the last three years in sufficient detail that it can be properly checked.

Analysys Mason reconciliation

We note that Analysys Mason did undertake a partial reconciliation for 2006/7 in its recent work. That reconciliation was not complete in that it only compared the billed revenues for services where there was a revenue figure published in the regulatory financial statements. Although that information was useful it does not address the fundamental problem.

There are reasonable suspicions that the regulatory accounts still fail to capture all the revenue associated with PPCs. For example they do not explicitly breakout the sub 2MBit/s trunk which is priced very significantly above that of terminating segment transmission although it is possible that it is included in the terminating segment in 2006/7 figures.[1] There is no mention of the revenue BT gains from the rental of DPCN bearers which will certainly be material. Furthermore there are quite clearly many other chargeable services (for example circuit re-arrangements) which whilst they may be individually small could add up to a material amount.

In its report RGL considers the Analysys Mason reconciliation and finds that even on the basis of the comparison as it stands billed revenues were 3% above reported revenues. It is likely that additional revenues not included in that reconciliation will result in that difference being over 5%. If that difference then follows throughout BT's price time quantity calculation then it amounts to a very significant improvement in BT's returns over and above that reported in the regulatory statements.

The analysis undertaken by RGL also highlights the differences between billed and reported revenue when considered on the basis of individual PPC elements, they are considerable. It is clear from this analysis that price times quantity calculation used by BT is far from accurate and hence so are the statements themselves.

[1] Although it looks likely it may not be included in 2007/8 statements

BT's statutory accounts

BT's restatement of its regulatory financial statements did not result in any restatement of its statutory accounts. This is suspicious. It is clear that the errors were in the price times quantity calculation used for regulatory accounting purposes and therefore it would not have impacted BT reported revenues. However, BT reports gross margins at its business unit level and it is not clear why these gross margins did not change.

If the business unit gross margin is calculated using the regulatory reporting information then quite clearly that gross margin must have changed along with this restatement. Alternatively, if a different method is used in the calculation of gross margin for statutory reporting then there is quite clearly an alternative source of information to assist in the reconciliation for the internal sales.

An explanation of this inconsistency is quite clearly required from BT and in view of the sensitivity of the restatement a full investigation is needed if indeed there is more information available to check BT's figures.

3.3 THE 2006/7 RESTATED STATEMENTS ARE UNRELIABLE

The 2006/7 restated regulatory financial statements are very unreliable because the restatement only related to the volumes, prices and revenues and did not restate costs. This has led to two problems:

- The overall cost allocated to the BCMR markets will have changed as a result of the volume changes; and
- The individual element costs simply do not add up as a result of BT's failure to properly re-run the cost models

The first problem is the most serious. Many overheads are allocated based upon volumes or revenues and the reductions in those figures in the TISBO markets relative to all other parts of BT's business will have a material impact on that allocation.

In addition the very significant costs of duct and fibre are allocated based upon the volume of local ends. In TISBO markets the number of local ends of 2MBIt/s and above has fallen from 337,000 to 208,000 as a result of the restatement whereas the volume in AISBO markets in increased by 5000 circuits.[2] This change in volume must have had a material impact on the allocation of duct and fibre costs between these two markets.

BT may suggest that it is only the number of circuits that earn revenue that has changed and not the number of circuits actually in situ and therefore the impact on cost allocation is less significant. This would not follow. The BT changes have quite clearly resulted in changes to both the number of circuits and the number of physical local ends and if the cost allocation methodologies have been working properly that will result in a change to the costs allocated between different markets.

It is quite clear from RGL's analysis of BT's unit costs between 2006/7 and 2007/8 that the changes resulting from the restatement are significant. Even if it is possible to recalculate the unit costs in order to make them add up the work is meaningless without a full re-run of the cost allocation system.

The fact that the 2006/7 cost information is unreliable is one reason why Ofcom should not use this information to calculate its base position. However we also note that some of the volume information could not be revised from the normal systems as they no longer hold it for 2006/7.

[2] Presumably a even greater increase in number of local ends

Whilst we continue to have doubts over the 2007/8 information it has quite clearly been generated on a consistent basis and it is the most up to date information available which makes it vastly superior to the 2006/7 information. The charge control will not start until 2009/10 and if it is based upon the information published by BT for 2006/7 that would mean it is three years out of date.

The 2006/7 information is clearly not suitable as the basis for this charge control and Ofcom must now redo its analysis using the 2007/8 information which has now been available for nearly 6 months.

3.4 ISSUES RAISED BY ANALYSYS MASON

Ofcom commissioned Analysys Mason to investigate the reliability of BT's restated regulatory financial statements and in the light of the failure of the current assurance system to pick up the significant problems this was clearly an important check. The report provides some useful commentary and analysis on BT's restatement.

While the report certainly helps build confidence in the statements it does not provide all of the answers. In particular it appears that Analysys Mason did not approach any of BT's customers to ask them for their views on the figures. Aside from BT itself it is BT's customers who best understand the PPC product, what they are provided and what it is they pay for. Although Ofcom played a key role in uncovering the errors in the statements it was BT's customers who first raised the suspicions with their questions to both BT and Ofcom. That would have enabled Analysys Mason to investigate some of the other issues of transparency that remain unresolved.

Analysys Mason has indentified 17 issues they considered could be material but was not able to properly investigate in the time available. We understand from Ofcom that they are continuing to work on these issues during the consultation phase and we look forward to the outcome of that work. Resolving these issues are an important part of building confidence in the statements but there are many other issues discussed in this response and RGL's report which must also be addressed.

3.5 LRIC INFORMATION

The BCMR proposals appear to attach considerable weight to the LRIC floors and ceiling published by BT. In particular BT's proposals are to increase charges where they are currently below the published LRIC floors. Ofcom also comments that it expects BT to ensure that in due course all prices sit between the LRIC floor and ceiling.

Cable&Wireless supports the use of LRIC in concept and notes its importance within the EU directives. However, we have even less confidence in the published LRIC information than we do it the fully allocated cost information and based upon Ofcom own comments it is quite clear that that Ofcom shares that view. There are a number of issues.

Firstly the LRIC information has very little attention paid to it currently. Ofcom has questioned the value in publishing it and it is no longer audited. Cable&Wireless is not aware of any Communications Provider that looks closely at the information. This makes it very unreliable.

Obviously there will be an issue with all 2006/7 LRIC figures in that the costs have not been restated and therefore the figures are meaningless. However a quick look at the 2007/8 LRIC figures shows some very odd results:

- The LRIC floor for a 155MBit/s local end is over £10,000 per year. This has to cover only a local access fibre, and STM-1 port in the local exchange and the

associated overheads. The LRIC floor for a whole WES100 circuit including two local ends is £1,132 pa and so the LRIC cost of a fibre local end cannot be more than half that. The cost of and STM-1 port is now less than £500 per year and the overheads cannot be significant. Therefore it is inconceivable that the true floor for this service can be over £10,000 per year;

- The LRIC floor for a 155MBit/s trunk km is stated as being £192 per year and yet the LRIC floor for a 45MBit/s trunk km is stated as being £258 per year. If it really was more costly to route a 45MBit/s than a 155MBit/s then all 45MBit/s circuits should be routed in that way, the efficient cost would be the same. In practice SDH provides an efficient manner for sharing bandwidth and there will often be cases where it is more efficient to carry 45MBit/s as 45Mbit/s rather than 155MBit/s and so one expect the cost to be less. But it certainly should not be more;

These results cannot be explained purely by the fact that the LRIC figures do not take into account Ofcom's adjustments. Clearly that is a factor and we note that the 3rd party equipment costs that are included in these statements under the cost of rental services when they are actually recovered through one off up front charges will skew the number considerably. If these costs are included in the local end rental costs as we suspect then they must clearly be removed.

This demonstrates a further problem; the LRIC figures require significant amendments for them to be useful and it is not clear who does that and how the information is made transparent. If BT is required to change its prices to ensure that they fall between floors and ceilings but the published information is of no use then quite clearly BT's customers do not know what to expect when it comes to PPC price reviews.

If LRIC floors and ceilings are to form an important part of BT's price control then it is essential that we first build confidence in the LRIC information that will actually be used, and second, that the figures are clearly transparent to the purchasers of PPCs.

3.6 IMPROVED TRANSPARENCY REQUIRED

There are a number of areas where the transparency provided by the regulatory financial statements is inadequate. Several of them, sub 2MBit/s circuits, RBS and the capture of downstream uses, are particularly crucial within this review and stakeholders cannot properly understand the issues and provide input without improved information.

3.6.1 SUB 2MBIT/S CIRCUITS

The transparency of sub 2Mbit/s circuits has always been a problem and it is clear that the number of different circuit bandwidths make it impractical to provide completely separate reporting for each one. However Analysys Mason was clearly not able to get to the bottom on the calculations that convert the volumes of different speed circuits into the published figures. Confidence must be built in this conversion.

The problems with sub 2Mbit/s circuit however go much deeper than this calculation and make it impossible for stakeholders to see what is going on. The most significant issues are:

- The sub 2MBit/s trunk segments are not broken out. This means we are unable to see how much trunk is sold and how the sales of trunk differ between internal and external supply. Given that sub 2Mbit/s trunk is about four times as expensive as terminating segment transmission there is a real concern that external customers are treated fairly in comparison to BT's own downstream business;
- The sub 2MBit/s trunk revenues may not be included at all in the 2007/8 statements. It appears, although is not absolutely clear, that in previous years the price of terminating segment was a weighted average between trunk and terminating but

this does not appear to be the case in 2007/8 and so it is not clear that these revenues are included at all;

- The volumes of sub 2MBit/s circuits appear to be too low. BT's quality of service statistics show that in 2007/8 there were about 29,000 circuits on the DPCN falling to 25,000 by the end of the year but the published statements only show 17,606. ✂; and
- PPC customers have to buy DPCN bearers from BT in order to carry sub 2MBit/s circuits from the DPCN nodes to their points of handover. There are many of these circuits and BT's revenue from them must be in the order of millions of pounds per year. However we cannot see them in the regulatory statements. It is not clear that the revenue is included at all and neither is it clear whether or not BT buys similar bearers. This is of particular concern given that one of the changes made by BT in its restatement was the remove of bearers from the volumes when quite clearly the DPCN bearers are revenue generating circuits.

This is a vital area within this charge control. The structure of the sub 2Mbit/s charging model means that many existing circuits are inefficiently routed through BT's network but it is very difficult to find a path to optimise these routings. This optimisation is further complicated by the fact that BT plan to close their DPCN network by 2014. Discussions are ongoing.

In view of the fact that BT propose to double the price of sub 2MBit/s overnight Ofcom must be absolutely certain that these issues have been fully investigated and that the true situation is properly understood by all stakeholders. Price increases of the magnitude proposed too significant to be made on the back of such inadequate information. Furthermore the concerns that it is not clear how BT itself uses sub 2MBIt/s become even more serious as prices increase.

Communications Provides have been asking BT for greater transparency in this area for at least three years. This is more than adequate for BT to provide proper information about the usage and cost of sub 2MBit/s circuits and they should not be allowed to increase prices until they have properly justified such increases.

3.6.2 RADIO BASE STATION BACKHAUL

RBS is virtually the exact same product as a PPC, the only differences are the contractual restrictions around who can buy each one and specific price structure. When other Communications Providers compete with BT in the provision of mobile backhaul they buy PPCs as the wholesale input into their own solution. However, currently despite RBS revenues being £130m in 2007/8 there is no transparency.

The lack of transparency means that it is not possible to see if, for example, the local end adjustment is applied for RBS circuits. It is not possible to see if the cost allocation between PPCs and RBS is fair or if the total component volumes in the TISBO market do properly add up.

Stakeholders want to understand why it is that other Communication Providers have not been more successful in competing with BT in the provision of mobile backhaul and greater transparency here is the first step to achieving that. Furthermore, because of firm link between PPC and RBS the charge control starting position must take into account the current returns made by BT on these services.

3.6.3 DOWNSTREAM USE OF PRIVATE CIRCUIT COMPONENTS

Communications Providers use PPCs for many different uses but in particular some of the most popular uses are:

- Private circuits (both national and international)
- Wholesale connectivity (dedicated circuits sold to other CPs)
- Voice services (ISDN30, call centres, voice VPNs, Centrex, etc)
- Corporate data services (IP-VPNs, Frame Relay, ATM)
- Internet access (high bandwidth symmetric access)
- Dial Internet access (at the ISP end)

BT uses private circuit components in much the same way. It is possible to look through BT's websites and get a good idea of the products that will use the same components. These include:

- Private circuits (kilostream, megastream, netstream, international, etc)
- Other dedicated connectivity (Site Connect, Links from a Point of Connection, BT Prime, Flexible Bandwidth)
- Voice services (ISDN30, Featurenet, Contact Centres)
- Corporate data services (IP Clear, Metro IP-VPN, Framestream, Cellstream, Switched Multimegabit data service, BT EquipIP)
- Internet Access
- Dial internet access (BTnet)
- Interconnect Products (Datastream or IPStream handovers)

In addition to these services there will be many others that use some of the same underlying components, particularly the duct and fibre. These include products such as Broadcast Services, CCTV, Wireless base station and DWDM. Although some of these

services are now subject to EoI obligations and should be reported on in the future prior to the IBMC dates there will be usage that will probably not be captured by this reporting.

In the light of BT's restatement of its volumes in the regulatory statements it is even more important that confidence is built in those statements and an important part of that is a close look at all of these BT downstream uses to ensure that they are fully captured in the figures. Furthermore, where components, such as the duct and fibre, are used by other services it should be make clear how the costs of those are removed from the costs reported under the TISBO market.

3.7 BACKGROUND TO BT'S RESTATEMENT

It is relevant that BT's restatement of its regulatory financial statements was done in the light of a very significant dispute of the charges for PPCs since June 2004. Against this background it is likely that when BT reviewed its methodology and data used in the preparation of the statements it put much more focus on looking for the errors that would be in its own favour than those that may not.

3.8 OTHER KNOWN ISSUES

There are some other issues within the regulatory financial statements that Cable&Wireless would like to draw Ofcom's attention to:

- We understand that Ofcom is investigating whether the cost of the 3rd party infrastructure that has already been paid for by PPC customers up front has been capitalised and included in the cost of the local end elements. The price of the local end is particularly sensitive as it is unavoidable in the purchase of a PPC and so if this is the case its essential that it is removed;

- The amount of copper cost included in the 2MBit/s local end cost appears to be excessive. We note that the majority of 2MBit/s local end are provided on fibre and yet the average amount of copper included in the unit cost of every local end appears to be roughly equivalent of two MPFs. This cannot be correct; it is more likely that this value of copper should only be applied to the minority of local ends that are provisioned on copper. The impact of this error will be to overstate the unit cost or the 2MBit/s local end;
- As previously highlighted in our comments on LRIC the unit costs reported in the statements may not be efficiently incurred costs and this can be seen particularly when looking at the relative costs of different bandwidths; and
- The allocation of 21CN costs in the 2007/8 accounts looks particularly odd. There are very significant 21CN costs included in the TISBO markets but PPCs are provided using 20CN technology and BT has never told us that PPCs were being provided use 21CN, or indeed that the network was being built to do that. In the AISBO market there are significant 21CN costs included in the cost of the WES main link. However, WES main link is just a piece of fibre between two BT serving exchanges; there is no reason for this to be considered as 21CN. It appears that 21CN costs are finding their way in the TISBO and AISBO regulatory financial statements without justification.

4 THE PPC PROPOSALS

4.1 INTRODUCTION

Cable&Wireless believes that the current PPC proposals, specifically the starting charges, are not justified and would not meet Ofcom's duties or objectives for this review.

Ofcom has not yet got to the bottom of BT's returns in the TISBO markets:

- There are a significant number of concerns that remain over the accuracy of the restated regulatory financial statements that need to be addressed;
- The 2006/7 information is particularly unreliable and Ofcom must based their charge control on an analysis of the 2007/8, not only is it more robust but it is also vital to use the most up to date information available; and
- There are further adjustments that need to be made to the figures in order that they can be used to provide the correct starting position for this charge control.

Once BT's existing returns in the TISBO markets are properly understood it will be apparent that BT currently makes well over 20% return on mean capital employed in these markets. The prices are too high. Not only are these high prices passed on to end users who also pay too much but the competitive imbalance created by BT's returns prevents effective competition which would further benefit end users in the downstream markets.

Instead of reducing the price of PPCs BT has put forward its own set of price changes that would actually increase the price of PPCs to some of its external customers. BT is dominant in these wholesale markets and if it is allowed enough freedom to set its own prices it will, of course, do that in a way that maximises benefit to its own business and targets its biggest competitors. BT's price changes cannot be allowed to stand.

Cable&Wireless does understand that some charges may have to increase, in particular as sub 2MBit/s volumes decrease the costs are increasing and the correct signals to both wholesale and retail users of these services must be provided. However, it is no-one's interest, apart from BT's, for these to double overnight. Investment in networks and equipment by Communications Providers and end users is based upon the price signals that were put in place by the last charge control. If the prices have to rise then they must do so slowly in order that customers have the opportunity to make efficient business decisions including seeking alternative options to meet their requirements.

A gradual increase in prices does not mean that BT is forced into making a loss. Cable&Wireless' analysis of BT's returns suggests that BT can reduce its prices where they are excessive without having to make immediate price increases elsewhere. However, if on proper analysis that turns out to be incorrect then the reductions in starting charges should be less, and the remaining reductions brought in gradually just as any required increases should be brought in gradually.

The biggest risk that Ofcom's action could drive losses for particular stakeholders comes from rapid change in prices. The risk there is that the losses are forced upon stakeholders who are least able to cover them. In the case of BT, Ofcom is able to look in detail at its real returns and ensure that it does not act in a way that is likely to cause disproportionate harm on BT. Where BT is making excessive profits as a result of its dominance in a particular market it is important to act quickly to protect consumers and competitors interests, where it is just the balance of prices that is wrong then they should be adjusted over time with clear signals being provided.

One of the most important issues for Ofcom to address in this review is the local end adjustment. This is an adjustment that directly impacts BT's external PPC customers not BT itself and therefore directly holds back competition. It provides BT with an ideal opportunity to protect its own interest above those of its competitors and end users.

Therefore it is essential that Ofcom looks very closely at this adjustment indeed. Ofcom should consider:

- Is it really justified to have a different charge for BT internal use compared with the price paid by external customers?
- If it is, then exactly which types of internal and external use should be eligible for the lower charge?
- Is the difference set at the absolute minimum that is required for BT to cover its efficiently incurred costs associated with external supply?
- Is the charge structured in a manner that it does not discriminate between different stakeholders and that it provides them with the best signals to make use of BT's network in the most efficient manner possible?

The proposals as they stand do not properly consider these issues. The price difference is not justified and it is not consistent with Ofcom's duties under the Communications Act. In our view the adjustment is not required at all; the costs should be recovered over all circuits. However, if Ofcom finds that some difference is justified then it must be much less than the current proposal and recovered in a more appropriate manner.

In this section we expand on the arguments above and set out our views on the charge control proposals. We very much support Ofcom's objective of infrastructure competition to the deepest level where it can be effective and sustainable and in support of this we recommend Ofcom pays particular attention to the price of PPC handover infrastructure and local end rentals. We believe a separate sub-cap should be placed on the price of local ends to prevent them from being increased above the level that is absolutely necessary following proper analysis of the underlying costs.

Finally, we note that had it not been for BT's restatement of its regulatory financial statements Ofcom would have been able to complete this work by September 2008 and the new lower starting charges would have come into effect on 1st October 2008. Instead

BT has had many additional months of the current high prices and it should not be allowed to profit from this delay.

4.2 BT'S CURRENT RETURNS IN THE TISBO MARKETS

Ofcom starts its analysis by considering BT's current returns in the TISBO markets. The basis for this analysis is the regulatory financial statements and we have already highlighted our outstanding concerns over these in this response. There are a number of issues that still need to be addressed. However, we understand that Ofcom is continuing to work on those during this consultation period.

4.2.1 2007/8 INFORMATION MUST BE USED FOR THE BASE YEAR

One of the important issues that we have raised is the reliability of the 2006/7 accounts. The nature of the restatement combined with the failure to re run the entire cost allocation tool means that even if confidence can be achieved in the revised revenues the costs will still not be correct. This, particularly when considered alongside the fact that the 2006/7 information covers a period three years earlier than the start of the charge control, makes the 2006/7 unsuitable as the base year information. The 2007/8 information is now available and has been for nearly six months and whilst it still requires considerable work it is certainly much more appropriate than the 2006/7 information.

In its report for UKCTA RGL has attempted to apply the adjustments that Ofcom made to the 2006/7 information to the 2007/8 figures. The transparency has not been available to do this with accuracy and RGL acknowledge that, but they have been able to make a reasonable estimate. The key differences to the adjustments are that the CCA normalisation for 2007/8 reduces returns rather than increasing them and the 21CN technology neutrality adjustment is much larger.

In its report RGL has not attempted to correct the revenue figures, particularly around the sub 2MBit/s issue where the trunk and DPCN bearer revenue appears to have been omitted. However, even without that adjustment RGL's estimate is that BT's return on mean capital employed in 2007/8 was 30%. We recognise Ofcom will have its own view on this number as it has far more information to work with than RGL but it is quite clear that BT's returns in 2007/8 are much higher than the flawed regulatory statements suggest for 2006/7, even after Ofcom's adjustments.

In setting final charge control Ofcom must use the 2007/8 to inform its opinion of BT base year returns. In doing this Ofcom should pay particular attention to the adjustments needed to properly capture the internal and external revenue from sub 2Mbit/s services.

4.2.2 FURTHER ADJUSTMENTS REQUIRED

There are three further adjustments that we believe are required to provide a proper view of BT's base year returns in the TISBO markets. Firstly, mobile revenues and costs should be included. Secondly, BT's local adjustment needs to be amended. And finally an adjustment should be made for BT's pension deficit charge.

Mobile backhaul services are absolutely linked to PPCs as we have already explained; they are essentially the same thing. Just as Ofcom has not attempted to consider BT's returns separately for PPCs and for BT's own internal use as it is impossible to reliably consider cost allocation between the two; the same case holds for the inclusion of mobile backhaul services. The cost allocation between the two is just not robust enough to do that.

The fact that the products are so closely linked at the commercial level also suggests the importance of considering them together. The price of RBS and PPC is linked. If the

analysis is done separately and the returns are dramatically different then which one sets the price change required? Should PPC prices be set to ensure sensible returns in the RBS products or should RBS prices be set to ensure sensible returns in the PPC products?

There are a couple of further observations. Firstly this does not mean that the charge control must include RBS, the observation is only that as the two are so closely linked the PPC charge control should be set on the basis of overall returns. The second observation is that this actually reduces returns in 2007/8 according to RGL's analysis. Clearly the figures that RGL uses for the adjustments and mobile returns are only estimates. In any case, the correct analysis of the base year should cover all TISBO services.

The second further adjustment that we consider necessary concerns the local end adjustment that BT makes for its internal use. We deal with the local end adjustment itself later in this section and we recognise that there are various ways that Ofcom could choose to deal with it going forward. However, if BT are to be considered to be compliant with their obligation not to unduly discriminate then an adjustment should be made to the base year returns.

We have already explained that the adjustment that Oftel originally made was specific to the fact that when BT provide end to end leased lines they do not need to interconnect. However, as BT have confirmed in their internal reference offer that they configure circuits for many internal uses just like the configuration of PPCs, then the adjustment cannot be applied to these uses. RGL's adjustment assumes that only 50% of BT's downstream usage is eligible for the local end adjustment and so the internal revenue should be increased accordingly on the remaining 50%.

We also believe that BT has misunderstood this adjustment and as a result it has applied an adjustment that is much greater than it should have. The Oftel adjustment related only to the overheads associated with the local end and not the whole price. RGL has reduced

the size of the adjustment accordingly and applied it to the 50% of BT internal usage that does not use any form of interface mux in the way that points of handover do.

4.2.3 BT'S REAL TISBO RETURNS

The restatement of BT's regulatory financial reports is very frustrating as they are a vital part of the regulatory regime and it transpires that BT has misled us, possibly for years. However, it does not change the fact that BT's PPC prices are too high. BT's real returns in the TISBO markets are much greater than could be considered reasonable in a regulated wholesale market and well in excess of Ofcom's view of BT's cost of capital. If the restated volumes are correct then the quantum of the excess is less than we first thought, and most certainly our confidence in the statements is much less, but it remains a significant issue.

RGL estimate that BT's 2007/8 TISBO returns after the adjustments described above are roughly 30%.

4.3 BT'S PROPOSAL IS A PRICE INCREASE

Ofcom asked BT to suggest a set of price changes that would reduce the price of TI trunk circuits. BT's proposal is that prices should be immediately re-balanced, offsetting the trunk reductions with significant increases in the price of sub 2MBit/s circuits and 2MBit/s local ends. BT's analysis is that this will provide downstream BT with a 4% reduction on its cost base whereas it will be revenue neutral for its external customers.

We do not believe that BT's estimates of the impact on external customers are correct when considered on a forward looking basis; they certainly do not reflect the situation for Cable&Wireless. However, before we address that we ask why BT would suggest a set of price changes that would be beneficial to its competitors, including Cable&Wireless?

There is no reason. BT has been found to have SMP in the wholesale TISBO markets, it has the ability and incentive to act in a manner that is detrimental to its competitors and its customers, otherwise Ofcom would not be putting in place the regulation that it is. In such a circumstance if Ofcom wanted to publish BT's view of appropriate charges as a proposal then it should have published them alongside its other stakeholder's views.

In annex A we show the impact on Cable&Wireless of the BT proposed price changes. They represent a material price increase; a price increase that will ultimately be passed on to end users.

However in reality the impact of these changes on other particular stakeholders will be even more significant. That is because different customers have very different profiles of usage. Some, those for example that still make extensive use of Frame Relay, will have large volumes of sub 2MBit/s circuits whereas some others will tend to use a larger proportion of higher bandwidth circuits. The utility companies are other big users of sub 2Mbit/s services and in some cases their own capex plans are locked down as a result of their own price controls which makes change out to alternative solutions even harder. It is not possible to look at an average Communications Providers' usage to determine the impact. Competition will ensure that end users who buy mainly long distance 2MBit/s services will see prices reduce. Therefore either the sub 2Mbit/s end user prices will have to increase or the Communications Providers who sell the services will be forced into loss making contracts.

✂

The alternative network operator market has been very competitive over the past few years and margins on the resale of BT PPCs are not high. Inevitably the £12m per year increase in sub 2MBit/s services would in part be funded by increased prices to end users and in part by losses in competing operators. This is not in the interests of either end users or

competition and Ofcom must be absolutely certain that it is essential before it approves such a proposal. It is not vital for changes of this magnitude to be implemented overnight.

4.4 BT'S PROPOSED SUB 2MBIT/S PRICE INCREASES ARE NOT JUSTIFIED

Cable&Wireless does understand that there is pressure to increase the price of sub 2MBit/s PPCs. Prices do appear to be below cost and as the volumes continue to fall that will only get worse. The debate is about the extent of the increases and the speed that they are implemented.

In this response we have already set out a number of issues concerning the transparency and the accuracy of the regulatory financial statements when it comes to sub 2MBit/s circuits. The information provided by BT is totally inadequate and until BT can present proper information that shows true revenues, costs and the comparison between internal and external usage it is impossible to know what, if any, price increases are justified.

It is a reasonable assumption that some price rises are justified; the figures certainly point in that direction. Once it is understood how much they must increase it is also necessary to consider how quickly. Communication Providers and end users have invested in network solutions using these products on the basis of the price signals sent out by the previous Oftel and Ofcom work on PPC prices. Ofcom has recognised regulatory certainty as being a vital part of encouraging investment and to suddenly double the price of these services in the way BT proposes, without warning, would destroy regulatory certainty. It would harm those who have already invested and harm confidence for future investment.

Instead, if prices must rise they should rise gradually with as much signalling as is possible to the customers. This does not mean BT makes a loss. BT is making very high returns in the TISBO market and on our analysis it is able to reduce the price of trunk very significantly without any immediate increase being required. But if Ofcom's analysis shows that this is not the case then the immediate reduction in trunk could be confined to those that are affordable to BT given its true returns. The remaining reductions could be phased in gradually over the period of the charge control and offset by gradual increases in the low speed services. Ofcom can clearly signal this to stakeholders in the price controls that it places on BT.

Gradual price increases, signalled in advance, and phased over the 3.5 years of this control will give Communication Providers and end users the opportunity to take mitigating actions. BT wants to close down its DPCN network as part of its 21CN programme and discussions about what will remain are still ongoing. But a clearly signalled gradual price increase will certainly help them achieve their aim of getting demand off of that network, but without disproportionate impacts on other stakeholders.

Communication Providers and end users do need alternatives and the time to move towards them. Currently the SLAs provided by LLU are not good enough to support the sort of service levels that are required by customers of leased line based services. LLU operators have been asking BT for years for better service levels for LLU and although Openreach is now starting to develop these better products it has taken far too long. It is clear from the time it has taken LLU to establish itself in the residential sector that it is a very long term process. Many barriers must be removed and developments made. It will take years and not months to establish LLU based alternatives to PPCs. Furthermore LLU alone will not be adequate for all services, both from the point of view of geographic coverage and specific type of end use. Additional alternatives need to be worked on.

End users may also take the signal and use the opportunity to move to other services. However these are not just simple purchasing decisions, they are major transformation projects which often require new CPE and cannot be implemented quickly. In the current tough economic climate the pressure on investment capex is likely to make such decisions even harder to take.

There are other alternatives. BT could develop its product to enable low speed access between the end user and the local exchange but then carry the circuit as a 2MBit/s over the core network as this will avoid continued use of the legacy DPCN network. This is an important solution. Some sites currently served by copper cannot support 2MBit/s services, the only option to provide 2MBit/s is to upgrade to fibre which can be prohibitively expensive. This might provide the answer. The TDM experts group in Consult21 is already discussing some of these options but the solutions have not yet been finalised.

In the light of all these issues it is quite clear that immediate and significant increases in the price of sub 2Mbit/s circuits will cause significant harm. A phased approach, signalled clearly by an RPI + X sub-cap, would at least give stakeholders some time to develop alternatives and need not penalise BT in the interim.

There is a further point that illustrates the unreasonableness of BT's proposed price increase for sub 2MBit/s services. The price of a 512Kbit/s circuit will be more than the price of a 2MBit/s circuit over many distances. It just does not stack up. Firstly that a customer who tried to save money by buying a lower speed circuit can suddenly find themselves have to pay more than they would have had they bought the higher speed option. Secondly, such prices could be justified when they are meant to be based on efficiently incurred costs.

4.5 ENDING BT'S COST ADVANTAGE – REFORMING THE LOCAL END ADJUSTMENT

We believe that one of the most important issues for Ofcom to address in this review is the local end adjustment. This is an adjustment that directly impacts BT's external PPC customers and not BT itself and therefore directly holds back competition. In this consultation Ofcom need to reach a conclusion on the following issues:

(1) What circuits should make a contribution towards the costs associated with points of handover?
(2) Once Ofcom has determined the pool of circuits that are required to make the contribution towards point of handover costs then what costs should BT be allowed to recover?
(3) Finally Ofcom need to consider what structure should be used to recover point of handover costs. Is a simple flat levy on all eligible circuits appropriate or should the regime allow for CPs to be able to reduce their PoH cost burden by moving circuits to more modern and efficient points of handover.

4.5.1 LOCAL END ADJUSTMENT – DISTRIBUTION OF COSTS

In seeking an answer to the first question Cable&Wireless do not believe that it is justifiable for BT to pay a different charge for BT internal use compared with the price paid by external customers. The current distribution of point of handover costs does not lead to a fair or efficient outcome for CPs who consume PPCs or UK private circuit consumers. In the regulatory financial statements internal use is set at a price 23% lower than that for PPCs, this is equivalent to external customers paying 30% more than the price assumed for all internal use. There is an overwhelming case for the costs associated with the local end adjustment to be spread over both external and internal supply. We believe Ofcom's six principles of cost recovery and the specific cost drivers associated with point of handover local end costs should inform its proposals in respect of cost recovery.

If Ofcom were not to take this opportunity to review the distribution and costs associated with the local end adjustment it would go against Ofcom's own established principles of

cost recovery and be at odds with the clear precedent set when Ofcom redistributed the PPP charges associated with voice interconnection on both internal and external minutes back in 2004 and Oftel's decision to spread the cost of establishing CPS via the CPS surcharge on both CP and BT minutes. There are even parallels with the introduction of INCA CLI billing for NTS where BT's billing development costs were charged to both CPs and BT alike. BT's current local end adjustment is almost directly comparable with BT's PPP costs as they both relate to the costs associated with network interconnection, the only difference being that one service is designed to carry switched voice traffic, the other relates to the provision of private circuits.

Ofcom's Principles of cost recovery

Ofcom's decisions on the recovery of costs are guided by the following six principles:

- cost causation – costs should be recovered from those whose actions cause the costs to be incurred at the margin;
- distribution of benefits – costs should be recovered from the beneficiaries, especially where there are externalities;
- effective competition – the mechanism for cost recovery should not undermine or weaken the pressures for effective competition;
- cost minimisation – the mechanism for cost recovery should ensure that there are strong incentives to minimise costs;
- reciprocity – where services are provided reciprocally, charges should also be reciprocal; and
- Practicability – the mechanism for cost recovery needs to be practicable and relatively easy to implement.

Application of the principles of cost recovery to the Local End adjustment.

Cost causation

This principle suggests that costs should be recovered from those who cause point of hand over costs to be incurred. It can be argued that BT has incurred point of handover costs due to the activities of those providers wishing to purchase private circuit interconnection services and, therefore, that these providers should bear the totality of these costs.

However, it can also be argued that all communications providers need to interconnect their networks in order to facilitate end users being able to connect with other networks or geographic locations (based on the current competitive market where a number of network providers compete for the business of end users). This is even true for BT who need to make use of other networks (albeit to a limited extent – for example in Hull and certain business parks) to fulfil their own customers private circuit requirements. Indeed BT too makes considerable use of Point of Handover private circuit components to provide the platform interface between the BT transmission network and platforms such as its IP-VPNs, Frame Relay and ATM Networks. It is therefore the overall need for interconnection that causes local end adjustment costs to be incurred and in that respect BT should contribute to their recovery like any other provider.

In 2005 when Ofcom reviewed the issue of INCA CLI charging for NTS, Ofcom required all CPs to contribute to the cost of BT's billing development, even although it only related to the billing of BT's own NTS services, while at the same time CPs had to exclusively fund their own billing development to enable them to use CLI principles to bill for their own NTS services. Ofcom believed an enhanced BT billing platform was likely to bring benefits to the market and that for competitive neutrality to be maintained BT's INCA/CLI costs should be shared by all NTS CPs including BT itself.

It is also worth considering the case of cost recovery for CPS system set up costs, as this raised similar issues. In the CPS case it was argued that the primary causal factor was a regulatory obligation following from BT's market power, rather than the demands of CPS CPs. Oftel noted that both arguments had some validity but on balance Oftel concluded that the method of cost recovery should reflect current practice for apportioning costs associated with other regulations imposed for SMP CPs. This meant that all CPs including BT should bear a proportion of costs.

Distribution of benefits

This principle suggests that local end adjustment costs should be recovered from all communication providers, including BT, because the customers of all providers benefit from being able to connect to other networks for the distribution of both voice and data. In addition the provision of interconnection services underpins competition in downstream markets which benefits all private circuit customers in terms of increased choice of services and lower prices. Hence, all private circuit customers can be expected to benefit from the provision of interconnection services. Cable&Wireless is of the view that the distribution of benefits principle suggests recovering PoH costs from all providers.

Effective competition

From a downstream perspective, this principle points towards a charging mechanism that guarantees a level playing field for all communications providers. From this perspective, the recovery of local end adjustment costs from interconnecting communications providers only will not deliver this objective, as BT does not incur the same costs for its purchase of equivalent services. If interconnecting providers face higher charges than BT in the provision of downstream services, the differences in their respective cost bases puts the former at a competitive disadvantage.

Since local end adjustment costs and the costs that BT incurs in providing wholesale private circuit services to own customers are different, achieving a level playing field would involve requiring an equal contribution towards the recovery of these costs across all circuits that are provisioned on BT's network. This approach would eliminate any differential between internal and external supply.

Point of handover costs are a fundamental component of all interconnection services and a distribution of costs across all providers would ensure that there is no distortion in competition between BT and other providers.

Cost minimisation

This principle suggests that cost recovery should be structured so as to provide incentives towards cost efficiency. To the extent that the activities generating point of handover costs and the costs that BT Wholesale/Openreach incur in providing interconnection services to BT Retail /Global Services are different, BT's incentives to minimise these costs are currently limited. Therefore, this principle suggests that, where these activities differ, BT should contribute to their recovery

However, even where BT contributes to the recovery of PoH costs, BT would have less incentive to minimise costs if they could be passed on to customers. Accordingly, for reasons of cost minimisation BT should be required to bear a fair proportion of PoH charges.

Practicability

The principle of practicability requires that any cost recovery scheme adopted should be easy to implement. It is only in circumstances where the effort required to redistribute a charge out-weights the benefits that the practicability principle should have a bearing on the outcome. We believe that it would be very easy for BT to change its pricing to

redistribute local end adjustment costs (in fact far easier than in the case of PPP, where a billing system enhancement was required). Local end adjustment cost redistribution could be achieved at virtual no cost and implemented for the start of the new charge control period with very little fuss.

Reciprocity

Where services are provided reciprocally, charges should be reciprocal. While reciprocity for the local end adjustment would be an appropriate arrangement, this principle does not by itself provide any useful guidance on the recovery of Local end adjustment costs.

Ofcom's Principles of cost recovery: Conclusion

We firmly believe that there is an overall need for interconnection that causes local end adjustment costs to be incurred and therefore BT should contribute to the recovery of PoH costs like any other interconnecting network. If the status quo remains then it would conflict sharply with the other principles for cost recovery, in particular, it would undermine effective competition as competing providers would be unable to compete with BT on a level playing field. When the issue of the local end adjustment is considered against Ofcom's six principles of cost recovery it strongly indicates that PoH costs should be recovered across all circuit connections, to do otherwise would go against the precedents set down by Oftel and Ofcom and result in the abandonment of these established regulatory principles of cost recovery.

4.5.2 LOCAL END ADJUSTMENT – FOCUS ON EFFICIENTLY INCURRED COSTS

The second question that Ofcom must consider in respect of the local end adjustment is which costs should BT be allowed to recover for points of handover?

The current mechanism for PoH cost recovery isn't structured to provide incentives towards cost efficiency and the charge itself hasn't been subject to an appropriate level of scrutiny since it was introduced. As a result we believe there is significant scope to remove or reduce many of the individual cost elements that make up the charge. If Ofcom do not reform this charge then BT will gain a mechanism for over-recovering during the lifetime of the next charge control period.

We remain concerned that BT does not separately account for the costs of PoH links from third party local end rentals. As a result it is not able to isolate the costs currently recovered by the local end adjustment directly using regulatory accounting data. BT has instead estimated the total cost to be recovered by identifying the volume of PoHs (both types) and multiplying by its estimate of the associated unit costs. We disagree with Ofcom assertion in A7.26 that the local end adjustment costs of ~£11m per annum are *not particularly significant in terms of overall external circuit costs of approximately £150m per year*. We believe these costs are extremely significant and have a material bearing on the competitiveness of alternative providers and their ability to offer cost effect private circuit products to UK end users.

✂

Double Counting: PoH surcharge

As the CP making the largest contribution towards BT's Point of Handover costs we are very sceptical about the cost estimates BT have used. A quick sanity check of these cost categories points to systemic over recovery and we would ask Ofcom to re-examine the cost components and drivers in each category before finalising the control.

Before we review each cost category in turn we would like to seek an assurance from Ofcom that BT isn't recovering PoH costs twice. In 2001 when the PPC product was

launched BT provided an insight into the cost elements that make up the In-Span and Customer-Sited handover charges. These include the following cost elements:

- Duct & Fibre
- Network Support Costs
- Cost of Sales Uplift

It would therefore appear that BT has already factored in all (or at least a substantial proportion) of these costs within its existing price list charges. While Ofcom acknowledges in A7.8 that BT recovers a proportion of the PPC PoH costs through connection and rental charges it remains unclear why a further surcharge is required.

It is also relevant that BT's own reporting of technical areas (point of handover) show current costs of £3m in 2006/7 and £5m in 2007/8. How is it that suddenly £11m of cost as appeared? These costs are just completely out of proportion with those that BT has reported on to date.

We also require Ofcom to confirm that other similar products which utilise the same base components as PPCs (such as Site Connect and RBS) are also making a contribution towards these costs. In the next section we provide more detail on the adjustment itself, however we would urge Ofcom to investigate these issues before concluding the charge control.

Urgent need for a review of the constituent parts of the POH cost adjustment

In our review of the cost elements that make up the local end adjustment (not withstanding our belief that these costs maybe already be recovered elsewhere) we believe BT has substantial overestimated the individual cost elements associated with points of hand over.

Accommodation Service Costs

✂

We therefore believe BT has allocated an uplift of well over 100% on accommodation costs by allocating excessive amounts of space to the point of handover cost line, safe in the knowledge that its competitors will meet the costs of this in full (or even twice over if these cost are already built into existing price list entries). We would ask Ofcom to investigate this apparent over-recovery.

Access Fibre/Copper/Duct

✂. We do not believe this number stand up to first order scrutiny and we would urge Ofcom to investigate these costs.

Equipment Maintenance

There are two distinct types of handover, PoH links and migrated links. In the case of migrated links the cost of handing over a circuit depends, among other things, on what other (often non-PPC) circuits BT has supplied to the communication provider over that handover. In the case of migrated links, the majority of these circuits relate to retail circuits migrated when PPC where first launch in 2001/02. According to BT's estimates we are responsible for just over ✂ of annual maintenance costs, we believe this may over represent BT's true cost of maintaining migrated circuits and we would ask Ofcom to review BT's assumptions in deriving these cost estimates.

PoH Selling Costs

As a CP customer we are unaware of any significant sales effort from BT that would result in BT incurring ✂ PA worth of cost when selling Points of Handover to Cable&Wireless. Unfortunately we have no visibility as to what activity is included within this cost line. We believe there is a small amount of headcount within the BT's product team that manage the

in life PPC product, although not all staff are dedicated to PPCs. BT Wholesale's Account Teams are also supported by a small number of Sales Engineers that are able provide guidance on PPCs (amongst other things). We do not believe these people related costs should be admissible.

In the event that Ofcom does decide that these costs should be permitted going forward, then a review of the level of costs should be carried out (£1.2M PA of sales costs doesn't reconcile with the activity we see). We urge Ofcom to remove this item from any future PoH related cost stack.

We understand Ofcom's desire to avoid creating a more complex recovery regime than that currently in place, however instead of proposing a regime where BT identifies the relevant costs & revenues separately from third party local ends in future through newly created PoH rental charges, we believe Ofcom should move to a regime that properly accounts for both legacy and modern PoH variants. This would then create the opportunity to price modern efficient handover at a more cost reflective lower price than legacy handover points.

In common with some other CPs, Cable&Wireless are in the midst of migrating a large number of circuits (both former THUS and existing C&W circuits) on to lower cost local access infrastructure. This initiative will also help to reduce point of handover costs from the BT network as we move to more efficient types of interconnection. Ofcom therefore need to recognise that as point of handover buying patterns change, with CPs moving to more efficient forms of circuit delivery then BT's costs will also fall. Ofcom should incorporate an efficiency factor to ensure BT doesn't get to recover PoH costs based on current interconnect profiles.

4.5.3 POINT OF HAND OVER – A WAY FORWARD

Once Ofcom has reached a conclusion on; (1) What circuits should make a contribution towards the costs associated with points of handover – and – (2) what PoH costs should BT be allowed to recover, Ofcom must then considered the final question of what charging mechanism should be used to recover these costs.

Cable&Wireless believe Ofcom's conclusion on questions (1) and (2) should influence the answer to the question (3), what charging structure to adopt. If Ofcom, having reviewed the six principles of cost recovery and the underlying cost drivers related to points of handover, conclude that both internal and external circuits should make a contribution towards PoH costs and that only genuinely incurred costs should be recovered then we would agree that it wouldn't be sensible nor practical to reform the current charging structure as the local end adjustment charge per circuit is likely to fall significantly and a simple flat levy on each and every circuit would suffice (as the effort required to adopt a more complicated charging structure is likely to out-weight the benefits).

If however Ofcom conclude that only external circuits should bear the costs relating to points of handover and that a substantial reduction in the cost components that make up the charge isn't required (resulting in the charge to external CPs being maintained at current levels) then Ofcom should take action to reform the recovery regime to enable CPs to avoid the higher costs associated with older types of handover. Ofcom need to create the correct investment incentives, presenting CPs with the opportunity to minimise costs by investing in the most modern points of handover. Without these incentives (which are designed to reflect the lower underlying costs associated with efficient handover) Ofcom would be passively rewarding inefficiency which would undoubtedly result in higher pricing to consumers.

Ofcom's desire to avoid creating a more complex recovery regime must be balanced with the needs of the industry to reap the benefits of investment in efficient handover. A reform

of the charging structure can only be avoided if sufficient changes are made to both the cost elements within the local end adjustment and the distribution of the charge itself. It should only be at the point where the charge becomes a less material cost element for individual CPs that reform to the structure of the charges is adjudged to be undesirable due to the limited benefit that would result.

4.6 ✂

5 DEVELOPING A LEVEL ETHERNET PLAYING FIELD

Cable&Wireless share Ofcom's vision of encouraging infrastructure competition at the deepest level in the network where it can be effective and sustainable. For competition to flourish in retail Ethernet services Cable&Wireless must have equal access to the appropriate wholesale inputs on equivalent terms without discrimination. As an infrastructure provider we are committed to investing to ensure we can supply services to enterprise customers on competitive terms. To do this we need regulation to level the access infrastructure advantage that BT retains.

Cable&Wireless are excited about the opportunities that next generation Ethernet will bring to UK enterprises and we are continually investing in both infrastructure and product innovation. We know BT are also developing their network and pricing plans, however it is clear that investment is focused to meet the needs of BT Group. For example Openreach's focus for Backhaul is on its Orchid network, which may be of value to all Communications Providers, but is specifically designed with BT in mind, others may wish to continue to buy more traditional BES circuits that BT itself may not.

The importance of Local Access

We see WES Local Access (and the evolutionary EAD product) as key to helping competition flourish. BT has no commercial incentive to sell Local Access services as if BT's wholesale customers have access to WES Local Access not only will their wholesale revenues reduce but their retail revenues will come under pressure as the CPs who use local access services will offer lower prices to consumers. Delays in 21CN have resulted in BT not being able to take advantage of these local access products themselves. We believe it is no coincidence that BT made it very difficult for wholesale customers to buy Local Access products in the initial period after product launch.

All that is about to change as BT's own investment plans involve rolling out to around 600 exchanges, far more than any other CP. As you might expect we are concerned that BT could leverage its size and scale to make it very difficult for other CPs to compete. In any price control Ofcom must be mindful of the inherent advantages BT has by virtue of its size and its legacy position in the private circuit market. To combat the scale of BT's advantage we believe that Ofcom should go a step further to encourage competition at the exchange level. In the price control we believe Ofcom has scope to do this by having a particular focus on Local Access services.

A new RPI-X sub cap for Local Access Services

There is a strong case for Local Access to have a separate RPI-X sub cap thus ensuring the differential between WES and WES Local Access services. This will create the correct investment incentives in the market and will bring competitive supply closer to consumers. A sub cap that applies a modest downward pricing trajectory will help create the correct investment incentives. Reduced pricing is also justified in the provision of Local Access due to the nature of the product. Local Access lacks a significant distance element (WES LA services do not attract the backhaul charge) making it possible for BT to drive efficiency savings in more of the product's cost stack. It is only by encouraging investment at this level will it be possible to move away from a fully regulated approach for all lower bandwidth Ethernet services in future charge controls. To that end alternative providers who make use of Local Access must be able to commercially replicate the WES products.

We know the economic case for local exchange competition is not justified at every location and if CPs are to compete with BT and offer competitive services to enterprise customers throughout the UK then a competitive WES offering needs to be available to fill the gap when a local exchange access solution isn't economic. Ofcom must strike a careful balance between encouraging competitive investment in local access infrastructure while ensuring that BT as the CP with the widest local access reach isn't able to leverage its competitive advantage to the detriment of other CPs. The charge control should look to

deliver an outcome that maintains or modestly increases the gap between WES and WES LA pricing, while ensuring that the gap isn't so wide as to make BT the only CP able to offer competitive services to Ethernet consumers.

The pricing of aggregation services

Ofcom also have to carefully consider the implication that an inappropriately priced Openreach Aggregation product is likely to have on Local Access investment. If aggregation services are priced at too low a level then this will deter future local access investment and potentially undermine existing investment. While Cable&Wireless recognise the need for aggregation services any price control should not hand BT the ability to manipulate its aggregation pricing to undermine past or future local access investment. Ofcom need to ensure appropriate safeguards are in place to prevent Openreach from making price changes that undermine the sensible investment plans of alternative providers.

New Starting Charges

While Cable&Wireless welcomes the proposed reduction in Ethernet pricing we have concerns about the process that derived the new pricing. With such high levels of Ethernet over recovery reported in previous regulatory Financial Statements it is no surprise that Ethernet pricing has been reduced substantially, however BT has exercised far too much control in setting those starting charges. Yes these are BT charges and we know Ofcom doesn't have a desire to micro manage the BT price list, but as the pricing relates to starting charges for a new four year price control we would have expected Ofcom to have had a far greater role in formulating individual pricing. Ofcom should not delegate the job of setting starting charges to BT.

Cable & Wireless is supportive of the concept of charge controls recognising the certainty that a charge control can provide to both purchasing CPs and the incumbent and the

efficiency incentive a charge control creates. What we find surprising in this case is the apparent free hand that Openreach have had in determining the initial level of the charges. BT have therefore been free to target the expected £80M PA of savings to suit their own purchasing plans. The imposition of sub-caps within the control is helpful in preserving certainty, but it is insufficient to address any concerns that we may have about the relative difference in starting charges and as a result BT can maintain current pricing differentials throughout the entire control period.

1st of October 2008: the Effective Date

Given the level of Ethernet over-recovery identified by Ofcom we believe that BT should be required to back date the new charges, making them effective from 1st of October 2008. This is the date that any new charging should have been effective from had the regulatory process followed the original timetable outlined by Ofcom (which allowed the new charge control to follow neatly on from the previous PPC charge control). It would be an absurd outcome if BT were allowed to delay the introduction of the new charges as a result of their own actions (through restating the regulatory accounts) in delaying the regulatory process. This approach is entirely consistent with the position outlined by BT Group (inc. Openreach) in its communication with industry on the 28th July when it said:

> ***Publication of the 2007/08 Regulatory Financial Statements***
>
> *BT today confirms that it will publish its regulatory financial statements for the financial year 2007/08 in the Autumn. Following an internal review, BT believes it is necessary to revise the methodology it uses for estimating turnover for partial private circuits within these statements. Any revisions made in this area will not impact on the BT Group's statutory financial results. Should this timetable impact the setting of any price controls for partial private circuits and wholesale Ethernet products, BT accepts that such controls would have effect from 1 October, retrospectively.*

If Ofcom don't require BT to backdate the new starting charges then based on the 07/08 financial statements we would expect BT to generate around £146M worth of AI turnover in the four months from 1st of October 2008 to the 31st of January 2009, generating a return of 31.1% on mean capital employed. If the price changes had taken effect on the 1st of October 2008 and assuming Ofcom's estimates of a 30% reduction in revenue, then AI services would have generated BT turnover of ~£102M in the same period, with a return on mean capital employed of around 15.5%[3]. By agreeing to any reduction in the effective date of the price changes BT are pocketing an additional £44M, of which around £17M is funded by their competitors which they can then plough back into their business to compete more aggressively against alternative providers. Ofcom must take action to prevent this manipulation of the regulatory process to secure higher returns for BT Group businesses.

Expected migration from TI to AI

We acknowledge that technology change and BT's 21CN plans are likely to drive a significant customer migration between TI and AI services within the control period. The assumptions made about this migration within Ofcom's charge control model will have a significant bearing on the costs for both TI and AI services during the control. We have concerns that Ofcom have over estimated the extent of the migration between TI and AI. With BT's 21CN programme having already suffered a number of false starts it is unlikely given BT's track record that BT's current migration plans will be completed in full by the forecasted date. As it stands BT have not resolved the issues relating to latency and jitter which impact telemetry equipment and other types of CPE. These issues are likely to deter or prevent many enterprises moving off TI based services.

We welcome Ofcom's decision to adopt the adjustments proposed by Analysys-Mason to lessen the cost impact of the migration on TI circuits which remain on the DPCN. By

[3] BT RFS 07/08 AISBO Turnover of £439M on Capital Employed of £862M, with return of £266M. C&W estimates based on equal proportion of turnover generated throughout the year.

ensuring that a proportion of TI non-marginal costs are passed over to the AI cost basket within the model it avoids an unacceptable rise in fixed costs being recovered from an ever-smaller volume of TI circuits.

We would however urge Ofcom to look again at the assumption around the total number of circuits expected to migrate. Given BT's track record on 21CN migrations and the ongoing technical issues relating to CPE we believe that a 70% migration figure is unachievable and we would urge Ofcom to revise this number downwards to nearer 50%.

Need for a Cost Effective Migration Path between TI and AI

The proposed charge control appears to supports BT's 21CN plans reinforcing BT's agenda but ignoring the need for a clear migration path that doesn't allow BT to over recover when migrating circuits from TI to AI. There is an absence of any discussion on cost effective migration products in the consultation, with Ofcom appearing to pin their hopes on BT actively encouraging migration on the premise that BT will be able to leverage cost savings early by re-providing circuits on the Ethernet network. Yet with SMP in both TI and AI it doesn't necessarily follow that BT will make a cost effective migration path available.

There remains a risk that BT will view migration (even forced migration) as just a revenue opportunity and will seek to manipulate rental charges to take advantage of the situation. Early year migration may see BT trying to impose high connection charges (off set by lower rentals to meet price control requirements). As Ethernet products mature BT may well try to reduce connection and seek to recover more on rentals. We would urge Ofcom to consider this matter before concluding the charge control, with a view to imposing additional sub-caps on connection charges.

Guarding Against Over-recovery

There are a number of aspects of the new AI charge control which we believe build in the potential for over recovery. Collectively these issues would allow BT to make very high rates of return on Ethernet services while still being charge control compliant. The additional margin generated would then be used to help BT compete aggressively in the private circuit market or other product areas. We outline these concerns below:

Technology Neutral approach

While we support the principle of adopting a Technology Neutral approach to the charge control we have concerns that the hypothetical network model developed by Ofcom fails to make adequate allowance for general technology changes that would occur in the absence of a programme like 21CN. Ofcom hasn't addressed the issue of how to separate 21CN gains from Ethernet technology changes / falling equipment cost savings that would be delivered in the absence of 21CN. This background technology 'creep' is a reality in all competitive telecommunications providers, as new more cost effective equipment is installed to replace old or obsolete technology. This gradual technology changeover drives cost savings over time and is a feature of any competitive market. Ofcom's current approach includes any savings generated by this technology creep within 21CN. By allowing BT to retain all the benefits of the lower costs of its 21CN network for the duration of the charge control, Ofcom is providing BT with an opportunity to price its services significantly above cost for the duration of the charge control period. Ofcom must adjust its charge control model to take account of the background efficiency savings that arise in the normal course of business. At the moment Ofcom hypothetical network model assumes network technology doesn't advance in the period with all efficiency gains attributed to 21CN. If Ofcom fail to adjust the model to take account of the background level technology efficiency gains it will be failing consumers as BT will not pass on any benefits to customers over the length of the control.

Forecasting of Administrative Costs

We would urge Ofcom to look again at the distribution of AISBO related Administrative costs. As Ofcom do not have suitable CVEs applicable to administrative costs (BT's RFSs do not report these values) Ofcom have assumed constant real unit administrative costs. We believe Ofcom should not model constant unit charges but should instead incorporate a sensible CVE assumptions to reflect the reality that administrative costs do not have a direct linear relationship to unit volumes. As it stands this assumption favours BT, doesn't encourage efficiency and will contribute to product over-recovery over the life of the control. We assume that internal sales incur the same level of administrative charges as external sales (this isn't clear from the consultation). If this isn't the case we would urge Ofcom to remedy this in the final statement.

Adjustment to X for EAD Aggregation

In section 9.105 Ofcom state that an adjustment has been made to the value of X in the AISBO charge control to recognise the inclusion of EAD aggregation services in the charge control's WES LA volumes. However Ofcom state that in recognition of the fact that EAD aggregation is priced at a flat rate per annum for both connection and rental, regardless of bandwidth (which is significantly different from the WES LA pricing structure) this has been taken into account in the value of X calculations for the AISBO basket.

As pricing for EAD aggregation hasn't been published we were unaware that EAD Aggregation services would be charge at flat rate regardless of bandwidth. We would request more information on this adjustment and seek an assurance that such a move isn't going to favour BT's downstream business.

Pricing for 1Gbit BES

We would ask Ofcom to look again at the pricing gradient for higher bandwidth services and in particular the pricing of 1Gbit BES. We do not believe that BT's current pricing for 1Gbit BES is cost reflective, with two factors pointing to potential over recovery:

(1) BT have reported consistently high returns on their BES product line, with a high level of return anticipated even after BT's recent price changes.
(2) Openreach has now made available the comparable EBD product to other CPs at a much lower price. Given these products are viewed as potential substitutes it is surprising that BES 1Gbit pricing remains so high.

We would urge Ofcom to either address this issue through revised starting charge for BES or by creating an RPI-X sub cap for BES which will place BES pricing on a downward trajectory that eliminates any potential for over recovery during the control period.

6 ANSWERS TO OFCOM'S QUESTIONS

In the following section we provide brief answers to the specific questions posed by Ofcom in the consultation.

Question 3.1 Do respondents agree that RPI is the best index for the charge control?

Given the historical use of RPI in previous charge controls and the number of other significant issues which Ofcom need to address in this consultation we believe that RPI should be retained as the charge control index.

Question 3.2 Do respondents agree that an RPI-X control is the appropriate form of charge control for the regulation of TI terminating, trunk and Ethernet services?

Yes, however we would expect Ofcom to adjust starting charges to remove over recovery from the outset, particularly for the charges that were not previously subject of a charge control. Where the evidence points to under recovery and prices need to increase there should be a strong preference for those increases to be implemented gradually using an upward glide path (thus preventing a consumer price shock).

Question 3.3 Do respondents agree that a four-year duration for the charge controls on TI terminating segments, trunk and Ethernet services is appropriate?

Yes for TI services. For AI there is a great deal more uncertainty and it is hard to have confidence that the products, volumes and costs can be predicted with sufficient certainty to be sure that prices will remain reasonable for a four year period. However, we acknowledge the benefits of certainty that a four year control provides and therefore it is

very difficult to balance these conflicting objectives. Please refer to the main body of our response for further discussion on this subject.

Question 3.4 Do respondents agree with our proposed technology neutral approach to modelling?

While we support the principle of adopting a Technology Neutral approach to the charge control we have concerns that the hypothetical network model developed by Ofcom fails to make adequate allowance for general technology changes that would occur in the absence of a programme like 21CN. The risk vs reward from such an investment must be balanced and if target efficiency improvements are not reasonable then competition and end users will be disadvantaged. Please refer to the main body of our response for further discussion.

Question 3.5 Do respondents agree with Ofcom's proposal to continue to use prior year weights to assess compliance with the proposed control on charges for TISBO and trunk services?

We have concerns about the potential to game charge controls as a result of the use of prior year weightings and there is currently concern that some mobile operators are using the prior year weights in their charge controls to increase revenue in a manner that is detrimental to consumers and other operators. This clearly needs to be understood to ensure that it could not be the case here.

Question 3.6 We would welcome views on the merits of an average revenue control for AISBO services and on whether this could be combined with a prior year weighted price cap on the AISBO basket as a whole

We would welcome further dialogue with Ofcom on this subject as the information presented in the consultation document doesn't provide us with a sufficient level of detail. We have concerns that Ofcom's proposed approach may result in unintended consequences.

Question 3.7 Do respondents agree with the application of the "k factor"? We would also welcome stakeholder views on the appropriate level of the interest and penalty rates to be applied.

We support the inclusion of an adjustment factor and we believe that under such circumstances BT's WACC should be the basis of any penalty, with LIBOR +4% used as the default interest rate.

Question 3.8 Do respondents agree that CCA FAC is the appropriate cost basis for setting the proposed charge controls?

Yes, we support in the use of CCA FAC over LRIC plus EPMU although we have very significant concerns about the quality of the FAC data being used. Please refer to the main body of our response for discussion on this topic.

Question 3.9 Do respondents agree with our proposal that, in principle, costs truly incremental to 21 CN should be excluded from our base year 2006/07?

There are two issues with 21CN costs. Firstly, where short term costs of 21CN are higher than 20CN equivalent then the difference should not be included in line with the technology neutral approach. Secondly, Ofcom must be very careful that costs that are really associated with BT Wholesale's 21CN core network find there way into the cost components for Openreach Access and Backhaul services (including those actually sold through BTW like PPCs).

Question 3.10 Do respondents agree with the use of national costs to set the charge controls for the 34/45 and 140/155 Mbit/s in the non-CELA region?

Yes.

Question 3.11 Do respondents agree with our proposed ranges for the WACC for TI and Ethernet services?

We do not agree with the proposals for WACC and Ofcom should use the same WACC as is used in the setting of LLU and WLR charge controls. TI and AI costs are very heavily driven by the costs of the underlying duct which is shared with the copper used in LLU. The low speed TISBO services use the same copper as their basic infrastructure and in our opinion the level of risk around deployment by BT of fibre is no greater than it is for copper.

There may be a case for using the BT Group WACC for TI trunk services, but not for the remainder.

Question 3.12 Do respondents agree with our proposed approach to discounts, in particular the proposed treatment of geographic and term discounts under the charge control?

Yes.

Question 4.1 Do respondents agree with Ofcom's proposal of a single TI basket including TI terminating segments and trunk services?

Yes, on the assumption that appropriate sub caps are also incorporated in the control.

Question 4.2 Do respondents agree with a sub-cap of RPI-0% on the sub-basket of TI terminating segments in the TI basket?

Cable&Wireless believe that Ofcom should place a sub-cap on the local end rental services and that should have a value of X set at, or close to, the value of X used in the main TI basket. Ofcom may need to allow X to be slightly lower than the main basket in order to allow the sub 2Mbit/s local ends to increase over time if the analysis of costs does support that.

Question 4.3 Do respondents agree with Ofcom's proposal that sub-caps of RPI-0% are required for the sub-baskets of rental and connection charges?

Yes.

Question 4.4 Do respondent agree with Ofcom's proposal to include equipment and infrastructure charges in a separate basket of their own (the "Equipment and Infrastructure basket") and subject to an overall cap of RPI-0%? Do respondents also agree that each charge in this basket should not be allowed to increase more then 5% in nominal terms in any control year?

No. The most significant cost covered by equipment and infrastructure charges is the cost of the equipment itself and history shows that equipment costs fall significantly over time. Today's SDH based technology is significantly more compact, energy efficient and lower cost than it was when the last control was set and by the end of this control it will be much better still. In-Span handovers could be done today at a fraction of the cost suggested by the current price if a modern efficient solution is used. Prices in this basket should fall significantly over time.

Question 4.5 Do respondents agree that ancillary services are included in a basket of their own and subject to an overall basket cap of RPI - 0%?

Yes, as these are mainly labour based charges a price cap of RPI-0% is reasonable although we are not convinced that the starting charges are reasonable. UKCTA has been working on the issue of ECCs with Openreach and Ofcom should take account of that work before agreeing with the starting charges.

Question 4.6 Do respondents agree that RBS, SDSL and BT Netlocate should not be subject to our formal charge control?

It is important that RBS and PPC prices are linked, they are essentially the same service and PPCs are used to provide an alternative to RBS. As long as the prices remain linked then we are not aware of any reason why they would also need to be in the charge control. However, the costs and revenues need to be included in the assessment of the level of the charge control.

We note for SDSL, and in the future EFM, that the potential for other operators to provide LLU based alternatives is limited to a geographic area that can be economically justified. Ofcom may need to address the prices of these services in some areas during the course of this charge control. Please refer to the main body of our response for detailed discussion on this matter.

Question 4.7 Do respondents agree that holding gains/losses should be recalculated for the TI basket of services by using the historic five year average in the trend of real asset price changes? Do respondents agree that no allowance should be made for "other" holding gains/losses in the TI basket of services?

Yes.

Question 4.8 Do respondents agree that the RAV adjustment should be applied to the base year costs of the TI basket?

Yes.

Question 4.9 Do respondents agree that the direct costs relating to 21 CN should be excluded from the 2006/07 base year costs of the TI basket?

Please see answer to Question 3.9

Question 4.10 Do respondents agree that the debtors in the TI basket should be amended to reflect contractual payment terms?

Yes.

Question 4.11 Do respondents agree that 3rd party PoH costs should be recovered via separate per circuit PoH charges included in the TI basket?

Please refer to the main body of our response for discussion on this issue.

Question 4.12 Do respondents agree with the proposed approach towards prices for the TI basket of services during the period to 30 September 2009?

No. Please refer to the main body of our response for discussion on this issue.

Question 4.13 Do respondents agree with the proposed one-off adjustments to the starting charges of equipment prices as proposed by BT?

We disagree with BT's view on the future of equipment pricing. We anticipate further price reductions (our view is supported by both our own experience and previous pricing trends). We would therefore urge Ofcom to impose a RPI-X sub cap (rather that the RPI-0% safeguard cap currently proposed) on equipment pricing. If Ofcom remain in any doubt about the extent of any expected reduction in equipment costs they need to gather supporting information from other equipment purchasers and the vendors themselves.

✂

Question 4.14 Do respondents agree with the volume forecasts used in the LLCC model for the TI basket of services? If not, please provide your views on the future volume forecasts of services within scope of the charge control.

We have concerns relating to BT's forecasting of volumes migrating between TI and AI which are covered in our comments on Ethernet charges.

Question 4.15 Do respondents agree with Ofcom's proposed efficiency assumption range of 0% to 5% when forecasting BT's future costs in the TI basket?

In our response to Ofcom's consultation on Openreach financial framework we argue that Openreach efficiency improvements should be at least 3% per year and could be as much as 6% per year for copper based services. A similar assumption is reasonable for the underlying fibre. However the cost of TI services also contains a significant amount of cost relating to equipment where the year on year improvements provide even more significant efficiency opportunities. We assume these are captured by the asset price change assumptions but if not then they would suggest an even higher efficiency opportunity.

Question 4.16 Do respondents agree with Ofcom's assumptions on AVEs and CVEs when forecasting the costs of the TI basket?

We have not been able to review these assumptions in sufficient detail to provide meaningful comment.

Question 4.17 Do respondents agree with Ofcom's proposal to use the average historic five year trend in asset price changes as proxy to future prices when forecasting costs of the TI basket?

We have not reviewed in detail but it appears a reasonable approach

Question 4.18 Do respondents agree with Ofcom's approach of re-allocating fixed costs from the TI services to the AI services?

Yes, we comment further on this in section 5.

Question 5.1 Do respondents agree with Ofcom's proposal of a single AI basket with separate sub-caps of RPI-0% on each of the sub-baskets of WES and BES services? Do respondents also agree with the sub-cap of RPI-0% on each of the sub-baskets of connections and rentals?

We believe an RPI-X subcap should be introduced for local access. We also believe that the price of BES services is currently too high and that there are much greater opportunities to reduce them in line with the prices for Orchid based services. Please refer to the main body of our response for further discussion.

Question 5.2 Do respondents agree with Ofcom's proposal of linking the regulation of the Ethernet accommodation and LLU accommodation products in the manner

described and the overall price of RPI-X% (with X probably close to zero) proposed on the Ethernet accommodation products?

Yes.

Question 5.3 Do respondents agree with Ofcom's proposal to include ancillary charges in a basket of their own subject to RPI-0%?

Please see our answer to question 4.5

Question 5.4 Do respondents agree with Ofcom's proposal not to take the RAV adjustment into consideration when adjusting Openreach's base year costs for 2006/07?

There remains a case to implement a RAV adjustment for the AI costs but in view of Ofcom's comments on the likely materiality of such an adjustment we agree there are more important areas for Ofcom to focus on.

Question 5.5 Do respondents agree with Ofcom's proposal to exclude 21 CN "direct" costs from Openreach's base year costs for 2006/07?

Please see our answer to Question 3.9.

Question 5.6 Do respondents agree with Ofcom's proposal to amend debtors when adjusting Openreach's base year costs for 2006/07?

Yes

Question 5.7 Do respondents agree that there should be no further one off adjustments to the start charges for services in scope of the AI basket and that prices should be brought within the DLRIC floors and DSAC ceilings within the 12 months of implementation?

Openreach has not yet completed its review of all Ethernet prices and we expect a second set of price changes covering some of the less common services such as WES155 and we believe that some of these prices should be reduced.

We believe the starting charges should have been introduced from the 1st of October 2008 and backdating should occur.

In principle we agree with prices being brought in line with LRIC floors and ceilings however there are currently very material concerns over the accuracy of the LRIC information. Further work needs to be done by Ofcom to assess the true LRIC floors and ceilings in a manner that can be made transparent to all stakeholders in advance.

Question 5.8 Do respondents agree with the volume forecasts used in the LLCC model for AI basket of services? If not, please provide your views on the future volume forecasts of wholesale services in scope of the charge control.

We believe BT has overestimated the speed of migration from TI to AI during the charge control period.

Question 5.9 Do respondents agree with our proposed forward looking efficiency range of 1% to 3% to apply to services within the scope of the AI basket?

No, the potential for efficiency improvements is significantly greater than this range. We do not fully understand the relationship between asset prices and efficiency assumptions. We

see significant scope for improvements in equipment space and power requirements as well as the price of equipment itself.

Specifically in the AI market we are aware that the new equipment being deployed by Openreach uses on a single fibre whereas previously a pair has been used. This change alone has the potential to drive very significant efficiency improvements in AI over the next couple of years and we do not see where such improvements are included.

Question 5.10 Do respondents agree with the range of WACC proposed for services within scope of the AI basket?

No, please see our answer to question 3.11

Question 5.11 Do respondents agree with our proposed AVEs/CVEs for Ethernet services?

We have not been able to review these assumptions in sufficient detail to provide meaningful comment.

Question 5.12 Do respondents agree with our proposed use of the average historic five year trend in the real asset price changes when forecasting the costs of AI services?

We have not reviewed in detail but it appears a reasonable approach

Question 5.13 Do respondents consider that we should accept KCOM's commitment to reduce low bandwidth AISBO prices by RPI-16% a year over the period to 2102?

It is not clear whether or not this will ensure that KCOM's Ethernet prices will be reasonable in relation to their efficiently incurred costs but if Ofcom is happy that that is the case then the approach seams reasonable.

Question 6.1 Do stakeholders agree with our proposed charge control formulae for AISBO services? We would welcome stakeholder views on our proposed mapping of existing products on to Openreach's new products set.

We have found this particularly difficult to comment on. At this point in time we simply do not know enough about Openreach's plans for its AISBO services to be able to tell if this is a reasonable approach or not and we question whether Ofcom has sufficient information itself. If Ofcom finds that on balance a four year control is justified then further discussion on this issue would be valuable.

Question 6.2 Do stakeholders agree that the required notification period should be waived in respect of the proposed starting charge adjustments to some TI services?

Where there is a general over-recovery, as appears to be the case in TI, then competition is being held back, consumers are paying too much, and BT is able to use its excess profits to further increase its advantage. Reductions to remove this type of over-recovery should be made immediately, particularly when it comes to services that were not previously subject of a price control. In fact, where the over-recovery is in breach of regulatory obligation the issue of retrospective correction needs to be addressed in order to correct the competitive imbalance and ensure that the correct regulatory signals are sent.

The situation is different when it comes to changes, both up and down, that amount to the re-balancing of charges. It is not sufficient to look only at the overall effect of the rebalancing but the fact that it will impact different stakeholders in different ways. A further consideration is the extent to which the specific charges have already been subject of regulatory price controls and hence firm expectation set in the market. In the case of the

TI changes that amount to rebalancing we strongly believe that they should be implemented over time, with proper notice periods, in order to allow stakeholders to take make efficient business decisions as a result of them.

We cover this in more detail in section 4.

Question 7.1 Do respondents agree that the charge controls on AISBO services should run from the introduction of the new proposed controls to 30 September 2012?

Please see our answer to question 3.3

7 APPENDICES

✂