



Quality of Service assumptions in BCMR 2016 charge controls

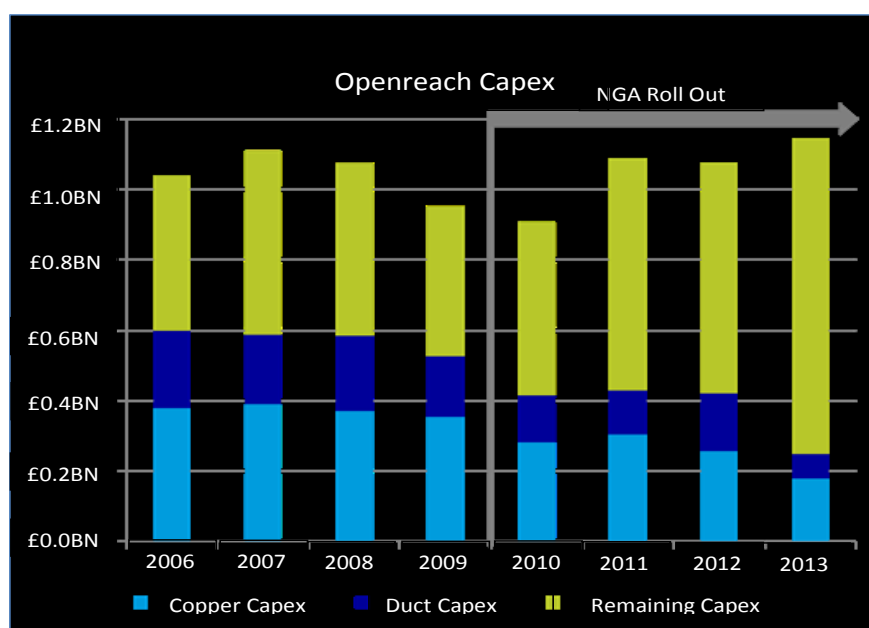
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1. Introduction

Charge controls are designed to act to constrain pricing where there is market power whilst ensuring that the regulated business maintains an incentive to act efficiently. It leaves the provisioning and maintenance of the regulated products in the hands of the business being regulated. Problems arise when the regulated business takes action to reduce costs that either harms QoS in the short term (such as under-resourcing planning) or results in a longer term deterioration that will be felt late in the charge control or even during the next control period (such as reducing or eliminating proactive investment in the network).

In the Ethernet market we've seen both of these problems emerge since the last BCMR:

- (1) In 2012/13 BT embarked upon a program which in their own words resulted in them 'spending less time planning'¹, saving them £39M in the short term, but leaving them with a planning crisis that is now needing to be reversed.
- (2) A retreat from historic levels of general network investment designed to renew, expand and safeguard network infrastructure, such as reducing investment in preventative maintenance or new fibre (outside of the NGA deployment)².



Source: BT reported KPIs, Ofcom RAV model, Frontier Economics³

¹ Slide 9: http://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q413_slides_update_part2.pdf

² In 2008, Openreach invested around £35 million in a proactive maintenance programme, which reduced the number of access network faults by 10%. At the same time, the number of high-bandwidth services carried rose by around 20%. In addition to Openreach's business as usual provision and repair activity, preparing telephone exchanges for 21CN meant it had to replace and recover 2.5 million jumper wires.

<http://www.btplc.com/report/Report08/Reportofthedirectors/Businessreview/openreachandtheukaccessnetwork.htm>
However, since 2009 investment in the copper network has fallen off (despite a moderate increase in the number of lines):
Overall Capex dropped from £3088M in 2008/9 to £2438M in 2012/13 (See slide 3)

https://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q413_slides_update_part2.pdf

³ Reproduced from: http://stakeholders.ofcom.org.uk/binaries/consultations/fixed-access-market-llu-wlr-charge-controls/responses/Sky_-_FAMR_Charge_Controls.pdf

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These two issues occurred at a time when BT was rolling out NGA, its largest scale deployment for many years. While BT labelled these action at the time as efficiency savings (something they are actively encouraged to seek within the charge control), hindsight has made clear that these were cost cutting measures that had implications for QoS in both the short and long term and did not result in efficiency savings.

2. Charge Control Theory Vs. Practice

In the case of Openreach, a theoretical charge control incentive to improve efficiency actually played out as a blunt incentive to increase profitability by letting quality fall. To date we haven't seen Openreach introduce any material efficiency measures in Ethernet provisioning, with Differential Order Journey (DoJ) the first real initiative which is currently awaiting trial before being introduced.

The service crisis means that minimum standards are now being actively discussed to ensure that BT is compelled to improve the service offered on its SMP products through a range of new non-pricing remedies, hopefully resulting in BT having to balance both a desire to cut cost with the necessity to hit the standards set out. This however this does leave questions around what baseline costs should be assumed for the next charge control to recognise the resources needed to provide adequate levels of QoS.

3. Drawing the line for future controls

In setting future charge controls a number of questions need to be addressed around the appropriate cost benchmark to use:

- How should historic cost cutting that resulted in extra profitability but a deterioration in QoS be treated going forward?
- Where BT removed cost at the direct expense of quality in pursuit of short term profitability, should an adjustment be made to reflect this?

A simplistic approach would be to make an upwards adjustment to the cost base to reflect the fact that more resources maybe needed to meet the minimum standards, however this would fail to acknowledge the additional profit and corresponding service impact that has already occurred. It would also ignore the need for the regulated business to convert those previously taken cost savings into genuine efficiency improvements in order to provide the same output more efficiently. If an upwards adjustment is made to the cost base in conjunction with the introduction of minimum standards it significantly waters down the very efficiency incentives that are being promoted within the charge control, akin to a reverse application of rate of return regulation, where all costs are allocated through to regulated charges regardless of how efficiently they have been derived.

If market failure is to be addressed in a meaningful and sustainable way then BT must be forced to transform its business into an efficient provider of services. In a market that is dominated by enduring bottleneck services this business transformation will only come about through the correct regulatory approach. BT has considerable room to remove excessive costs from its business and it therefore has sufficient scope to invest in service performance if direct commercial pressure was brought to bear. Ofcom should not seek to either excuse BT for its past poor service performance, or seek to cushion it from commercial reality through taking any action that ring fences inefficiency.

BT has in effect drawn its profit early through cost cutting measures incorrectly labeled as efficiency savings. In reality this cost cutting resulted in BT being unable to meet existing demand, but resulted in immediate benefit for shareholders, though an increase in profitability. Efficiency savings only occur when existing and expected demand can be met through the application of fewer resources. In BT's case, fewer resources were deployed, but existing demand was not met leading to the current service crisis. It also resulted in a virtual cessation of preventative maintenance, as all operational headroom from time spent fulfilling customer orders was eliminated and teams were no longer able to dedicate sufficient time towards preventative maintenance tasks. This in turn has stoked up problems for future years, with more network issues as a result and more problems encountered by customers when they come to place orders on parts of the network that might have benefited from the preventative maintenance program.

It would therefore be perverse if BT were to seek additional funding through the subsequent charge control to restore its ability to meet current and future demand, having already reallocated these funds to shareholders in the form of enhanced profitability. Given BT took resourcing away and converted it into additional profitability, it is only right that

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February 2015

they should not receive a future charge control enhancement to return resourcing to previous levels. Instead the baseline should be drawn to acknowledge the cost base reductions with the assumption made that this level was sufficient to deal with current demand levels at pre-2012 service standards and preserving the strong charge control incentive for BT to act efficiently by using fewer resources to deliver current and future orders. If more resources are required to meeting new minimum standards, then BT should self-fund this. If Ofcom do not acknowledge past profitability and the very specific circumstances of the Ethernet market since the service crisis commenced, then BT will have every incentive to cost cut in the future to provide immediate shareholder benefit without any corresponding efficiency gains, safe in the knowledge that Ofcom will allow any resulting short fall to restore service standards to acceptable levels to be funded through subsequent charge controls. Even when minimum standards are a consideration for BT, they will try to cut costs close to where the minimum standards lies, rather than behave in a manner that maximises consumer welfare through rational investment in networks and efficiency.

Another significant question in setting the charge control is:

- What level, if any of SLG should be assumed within the cost base?

If it is accepted that an efficient business will make some SLG payments, what level should be assumed? A rational business may decide not to resource all peak load orders, it may instead be more cost effective to resource 95% of the maximum order load and pay SLGs out when the peak demand exceeds 95% at particular points in the year. These types of question can only be answered in the full knowledge of both the minimum standards and the level of SLG payments. However, if a level of SLG payments are included within the charge control; this in itself must not act as an incentive to favour a greater preference for SLG payments over adequate resourcing. If it did so then it would ignore the wider costs associated when SLGs are triggered. While the regulated business may only factor in the absolute cost of the penalty, end users and their CP customers face consequences when SLGs are triggered and these costs should be considered when designing the charge control. This would point to minimal levels of SLG costs within a charge controls baseline cost base.

4. Conclusion

We have previously highlighted to Ofcom BT's level of enduring profitability in business services. It is simply wrong for BT to benefit from these additional profits over a number of years while underinvesting in adequate service provision: a situation which then sees CPs foot the bill to rectify underinvestment in successive charge controls and merely gives regulatory approval to BT's actions.

The risk is that we fall into a reverse rate of return regulation by inflating the base line costs of a charge control to effectively fund BT out of a service crisis of its own making. BT has taken these cost savings as excess profit over successive years while its end consumers endured the service crisis. The efficiency incentives of the charge control are paramount and a control must be set that makes the distinction between blunt cost cutting that diminishes output capability and genuine efficiency savings, where costs can be removed from the business safe in the knowledge that current and future demand can be satisfied effectively with fewer resources.