1 Summary

1.1 This note, and the accompanying paper from AlixPartners, set out TalkTalk's position regarding the manner in which intergroup common costs ('**IGCCs**') should be taken into account by Ofcom when setting regulated prices for leased line products in the context of the current Business Connectivity Market Review ('**BCMR**').

1.2 In this document, by IGCC we mean only costs which are common between regulated products and non-regulated products – IGCCs will therefore include some portion of group overhead costs such as Group CEO, treasury, audit and policy. They will not include (for example) duct costs in the access network, which are only common between regulated products.

1.3 TalkTalk considers that in the current BCMR, Ofcom should change the manner in which IGCCs are treated for the purposes of setting regulated charges. In previous charge controls, Ofcom has permitted a proportion of IGCCs to be allocated to regulated products, on the basis of cost allocation approaches such as those used in BT's Regulatory Financial Statements ('**RFS**'). Ofcom should no longer do so. Rather, IGCCs should only be recovered from non-regulated products (i.e. in competitive markets), and BT should therefore be prohibited from recovering IGCCs in markets where Ofcom has found that it holds SMP, including any leased line markets covered by the BCMR.

1.4 The first point is that it would be entirely possible to not recover IGCCs from regulated BCMR products. First, Ofcom has similarly not recovered IGCCs in setting other charge controls, most notably porting charges and network charge controls. Second, such an approach would not run any risk of BT being unable to recover its efficient common costs, as it would still be able to recover the same quantum of costs as downstream rivals such as TalkTalk.

1.5 The second point is that not recovering IGCCs from regulated BCMR products would deliver a number of economic advantages:

- it would create a more level playing field between BT and downstream competitor CPs, enhancing allocative efficiency;
- it would intensify competition in downstream retail markets, reducing margins and therefore further increasing allocative efficiency; and,
- it would improve dynamic efficiency since investments would be based on efficient pricing signals.

1.6 TalkTalk commissioned an independent report from AlixPartners on the topic of common cost recovery. AlixPartners' key points are that permitting IGCCs to be recovered from regulated products:

- may distort competition in the retail market, due to BT's non-replicable economies of scope (as it can split IGCCs across Openreach as well as its retail units) and BT facing a lower marginal cost of supplying retail markets than its competitors;

- will tend to reduce productive efficiency, as by allocating IGCCs to regulated products, BT's incentives to reduce IGCCs will be lowered;
- will tend to reduce dynamic efficiency, by distorting "build or buy" signals for CPs other than BT.

1.7 The remainder of this paper sets out these views in more detail.

2 Introduction

2.1 Common cost allocation poses certain problems for setting regulated charges. Common costs are not objectively allocable directly to any particular product, as they are not incremental to (or caused by) the output of any individual product(s). Nonetheless, efficient common costs need to be incurred, and therefore should be able to be recovered from some product(s).

2.2 However, that common costs should be able to be recovered does not mean that they should be able to be recovered from a particular product or set of products, only that a regulated firm should have *some* way of recovering the costs. Which products it will be optimal to recover common costs from depends upon a range of considerations, including the degree of competition in various markets, the impact on competition of different recovery schemes, cost minimisation considerations, elasticities of demand, and the incentives for efficiency created by various schemes for cost recovery.

2.3 We have particular concerns regarding the treatment of one type of common cost – specifically, costs that are common as between regulated and non-regulated services such as some portion of the cost of the BT Group CEO, BT Group Treasury and BT Group Investor Relations[1]. As we describe below we consider that it would be most

[1] It is important to bear in mind that in most businesses, including BT, many costs which are intuitively thought to be common will be variable to some degree. For example, consider CEO costs, which are often cited as a common cost. If a firm such as BT alleges that CEO costs are common, it is effectively making the claim that BT's expenditure on it CEO would be exactly the same as at present if BT divested Openreach and Global Services, and thereby became a much smaller organisation. This is implausible. It is well known that CEOs are paid more in larger firms. For example, see the non-technical summary of Girma, Thompson and Wright (2002):

... managers of larger firms get paid more... this view appears to be supported by empirical evidence which suggests that the relationship between executive pay and firm size dominates any that exists between executive pay and firm performance.

In effect, BT (or any other regulated firm) treating large cost categories as being entirely common is unlikely to reflect reality, and is likely to be more a matter of convenience than of reality. Most cost categories will be variable to some degree based on a driver such as market capitalisation, headcount, revenue, managed expenditure, or some other factor which enables costs to be allocated to different parts of the business on a causal basis.

The question of what portion of a cost item is common and what is variable is a question of fact not one of policy.

efficient, and in consumers' interests, if none of these common costs are recovered from regulated services.

2.4 It is important to recognise that we are only advocating that IGCCs should not be able to be recovered from regulated products, not any other type of common costs. In particular, we believe that costs that are only common as between different regulated products (e.g. duct costs or Openreach CEO) should continue to be recovered through regulated charges. If these costs were not permitted to be recovered from regulated products, they could not be recovered in a cost causal way at all, which would likely be inappropriate where costs are efficiently incurred.

3 It is possible for IGCCs to not be recovered in regulated charges

3.1 It would be entirely practicable for Ofcom not to permit BT to recover IGCC from any product which is regulated as part of the BCMR.

3.2 Firstly, it is useful to note that Ofcom has previously recognised that it is not appropriate for firms with SMP to recover common costs from each and every product – this indicates that there is precedent for the approach we are advocating.

3.3 For example, in its March 2011 review of Mobile Call Termination, Ofcom determined that it would be appropriate to set call termination rates at 'pure LRIC' rather than LRIC+, thereby disallowing any recovery of relevant common costs[2] through call termination rates.

3.4 Ofcom also found in the most recent Narrowband Market Review that common costs should not be recovered through call termination charges, stating that:

> *there are factors such as price discrimination at the retail level (e.g. non-linear pricing with upfront subscription fees and different usage charges) which mean that it is more efficient for common costs to be recovered on the retail-side of the market.*[3]

3.5 Ofcom has also recently proposed an even more strict approach in the case of Porting Charges under General Condition 18, where Ofcom stated that:[4]

> *Consistency with the cost causation principle suggests that common costs should be recovered from the services within the group to which they are common, but they do not have to be recovered from any one service... it is clear that number portability is not a contestable service ... This would point towards common costs being recovered from services other than porting.*

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[2] By relevant common costs we mean those costs which are common to mobile termination charges and other services. There are some common costs that will not be relevant to mobile termination charges

[3] Ofcom (2013), *Review of the Fixed Narrowband Services Markets*, February 5th, at paragraph 8.31

[4] Ofcom (2014), *Porting Charges under General Condition 18*, 24 March, at §4.24

3.6 Overall, therefore, TalkTalk considers that there is strong precedent for Ofcom to adopt a regulatory approach which does not permit IGCCs to be recovered from regulated products.

3.7 Second, we believe that it is clear that BT would be able to recover efficient IGCCs in full from other products, and as such there is no risk that BT would be left with efficient costs which were unrecoverable.

3.8 The same costs which would be categorised as IGCCs within BT's corporate structure are also incurred by BT's downstream rivals. TalkTalk, for example, has to recover investor relations costs, group HR costs, and its CEO costs from (only) its retail activities. There is no opportunity for TalkTalk to recover these costs from regulated products.

3.9 If BT were not able to recover IGCCs from regulated products then they would need to recover them from retail products. This would mean that BT would need to recover the standalone costs of its retail activities (both the incremental costs and the IGCCs). This puts BT in the same position as downstream rivals who (since they do not have upstream regulated products) have to recover all of their standalone cost from retail products. This situation arises since the upstream regulated business is a unique advantage that BT enjoys that is not replicable by rivals.

3.10 To the extent that BT incurs any IGCCs which are not incurred by its downstream competitors, one of two things must be true:

- BT is incurring an inefficiently high level of IGCCs. In this case there can be no argument that BT should be permitted to recover inefficient costs through charge controlled products; or,
- some of BT's IGCCs are not truly 'common', but are incremental to one of BT's other divisions (Openreach or Global Services). In this case, BT should amend its RFS methodology to be based on an appropriately causal cost driver, and should reduce the quantum of costs which are treated as common, and instead allocate some of these costs directly.

3.11 Furthermore, to the extent that there are economies of scope between BT's Global Services division and the rest of BT, BT retains greater flexibility in recovering its efficiently incurred common costs than its downstream rivals. This provides further headroom and flexibility for BT in recovering IGCCs that its main rivals do not, in practice, enjoy. We note in this regard that Ofcom stated in the final BCMR13 document that:[5]

> *BT therefore benefits from its extensive network infrastructure and* ***economies of scale and scope*** *which arises from its significant presence across business and residential telecoms markets. [emphasis added]*

[5] At paragraph 7.381

3.12 Finally, as Ofcom has recognised, IGCCs do not need to be recovered from *all* (or any) regulated products[6]. There is therefore no contradiction between our proposal and the principles of cost causation.

4 The case for excluding IGCCs from regulated charges

4.1 The previous sections have demonstrated that there is no barrier to removing BT's ability to recover IGCCs from regulated charges, and that BT will not be rendered unable to recover efficiently incurred IGCCs if there is such a regulatory change. This section now sets out TalkTalk's positive case in favour of ensuring that BT does not recover IGCCs from regulated charges.

4.1 Excluding IGCCs will increase allocative efficiency

4.2 The first positive reason in favour of excluding IGCCs when setting regulated charges is that it avoids a competitive distortion between BT's downstream activities that use or sell leased lines (e.g. BT Business and BT Global Service which provide leased lines to businesses, and BT Consumer which uses backhaul to provide broadband) and downstream competitor CPs.[7] As part of a vertically integrated firm, BT Downstream will (responding to economic incentives) set its retail prices on the basis of the underlying incremental costs of providing leased lines, rather than on the basis of the wholesale price which is an (irrelevant) internal transfer price. On the other hand, downstream competitors will set their retail prices (and profit margins) on the basis of the incremental cost that they face, which will be the regulated wholesale price. BT and its downstream competitors will therefore face different incremental costs.

4.3 Competition in the retail market will maximise allocative efficiency when BT Downstream and its downstream competitors face the same incremental wholesale cost, and consumers will therefore choose between retailers on a level playing field, providing a competitive advantage to the most efficient retailers. BT Downstream and other CPs will only face the same costs, and therefore the same incentives when setting retail prices, when the regulated wholesale price is set equal to LRIC. At that point, a level playing field is created between BT and its competitors. Further, a level playing field will ensure that the most efficient operators enter the market – if BT has an artificial cost advantage (resulting from being able to recover IGCCs from regulated charges) then BT can be less efficient than its competitors yet price lower than them.

4.4 This point is succinctly made in AlixPartners' accompanying paper at §3.8:

> *Since BT Group faces lower marginal costs than its competitors [if IGCCs are permitted to be recovered through regulated charges], it has greater incentives to*

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[6] FAMR May 2014 volume 2 footnote 54: "*[allowing common cost recovery] does not mean that it is necessary to include an allowance for common cost recovery in all charges. In some cases setting charges to recover incremental costs only may be appropriate*"

[7] We refer to the various downstream activities that use leased lines as BT Downstream.

lower retail prices in order to expand, increasing revenues and profits. An equally efficient non-integrated CP faces a higher marginal cost as a result of the IGCC mark-up in the wholesale charge, and therefore would have smaller incentives to do so.

4.5 There is also a second-order effect which will tend to increase allocative efficiency. Where BT faces a different incremental cost of offering a leased line from its downstream competitors, this implies that the leased line market cannot be perfectly competitive: if the leased line market were perfectly competitive, then a firm with a lower incremental cost than others would be able to drive all its competitors out of the market.[8] In such a situation, BT (and to a lesser extent its downstream competitors) will be earning supernormal profits. By aligning the incremental costs faced by BT with those faced by its downstream competitors, the total level of supernormal profits in the downstream market will be reduced. This reduction in supernormal profits will increase allocative efficiency.

4.2 Excluding IGCCs will increase productive efficiency

4.6 The second argument in favour of not permitting IGCCs to be recovered through regulated charges is the cost efficiency incentives that it will create. Although the regulated structure is designed to create incentives for cost minimisation through fixing the price for a number of years, since cost reductions are in time passed through into lower charges cost minimisation incentives are diluted (see AlixPartners §4.3). If BT makes a saving in a cost and that cost is included in regulated charges, it will retain some of the benefit of that cost reduction for up to five years[9].

4.7 Conversely, if the cost is not included in regulated charges then BT will enjoy the full benefit of its cost reduction in perpetuity. This means that if a cost is not included in regulated charges the BT will have greater incentives to engage in cost reducing activities.[10]

[8] This may not create a full monopoly situation: where there are low barriers to entry, there may be a form of market contestability, whereby BT (as the firm with the lower incremental cost) is able to earn profits that reflect only the difference in incremental costs, with attempts to set prices in excess of other firms' incremental costs leading to entry.

[9] Consider where BT makes a cost reduction of £100 in year 1 of a 3 year charge control. In this charge control period prices will be unchanged and BT will retain all of the cost reduction. The cost reduction will be reflected in the next charge control through a lower charge which, due to the impact of the glidepath will be introduced over the period of the second charge control until by year 3 of this second charge control the cost reduction will be fully passed through. Thus, BT's marginal profit from the cost reduction will be year 1 - £100, year 2 - £100, year 3 - £100, year 4 - £67, year 5 - £33, year 6 (and after) - £0

[10] Indeed, it can easily be shown that there are a range of cost reduction schemes which are both societally efficient and beneficial for BT if they are allowed to retain the benefit of the reduction in perpetuity, but will not be undertaken by BT (as they are unprofitable for BT) if subjected to regulation. For this to be required, the up-front investment cost to BT of the (variable) cost reduction scheme must exceed the discounted benefits where BT only retains the benefit of the scheme for five years, but be less than the discounted benefits when BT permanently retains the benefits of the scheme. For most plausible discount rates, this will encompass a range of cost reduction schemes.

4.8 TalkTalk therefore considers that not permitting any IGCCs to be recovered from regulated products within the leased lines charge control will increase productive efficiency compared to the current situation where a proportion of IGCCs is allocated to leased line products.

4.3 Excluding IGCCs will increase dynamic efficiency

4.9 Dynamic efficiency will be maximised where all companies face the correct incentives to invest. CPs should invest in capacity increases where the incremental costs of investment are less than the incremental profits which the CPs will derive from those investments. Furthermore, where a CP is facing a choice between renting capacity from Openreach, and constructing its own capacity, dynamic efficiency will be maximised by Openreach's rental prices being set in line with incremental costs. The CP considering investment can then ascertain whether it would incur lower costs by renting or by purchasing capacity.

4.10 If prices for rental of capacity are set in excess of incremental cost[11], this is likely to distort investment decisions. If Openreach's price for capacity is above incremental cost, then CPs will invest in some capacity enhancing projects which have a lower incremental cost than Openreach's price (therefore making them beneficial to the CP) but have a higher incremental cost than Openreach's incremental cost (therefore making them societally detrimental). This point is set out in detail at §§5.3-5.5 of the accompanying AlixPartners paper.

4.11 As such, removing the ability of BT to recover IGCCs through Openreach's charges for regulated products will lead to an improvement in dynamic efficiency.

4.4 Excluding IGCCs will reduce BT's incentive to game the RFS

4.12 The allocation of common costs (whether IGCCs or other types of common costs) to products generally occurs through BT's Regulated Financial Statements ('**RFS**'). TalkTalk believes that the ability to recover IGCCs through regulated charges creates incentives for BT to engage in gaming of the RFS, in order to maximise its profits and raise its downstream rivals' costs.

4.13 Where BT is allowed to recover IGCCs through regulated charges, it will have very strong incentives to allocate as great a proportion of IGCCs as possible to those regulated charges. By doing so, BT will be able to increase its profitability. By definition, BT holds SMP over products subject to price cap regulation, and so is able to act independently of its competitors and customers for those products. In other words, BT is profitably able to raise prices above the competitive level (which is the price level that regulation aims to emulate). It will therefore be profitable for BT to set a higher, rather than a lower, price for regulated products if it can be permitted to do so.

[11] Or equally is they are set below incremental costs

4.14 This means that BT will be able to increase its profits by gaming the RFS so as to allocate more costs to regulated products. By doing so, the prices of regulated products will increase, and this will be profitable given the lack of demand- and supply-side substitution.

4.15 At the same time, there is no cost to BT from reducing the allocation of costs to unregulated products. BT is free to set whatever prices it chooses for unregulated products, without any reference to the RFS. As such, a lower allocation of costs within the RFS does not imply that BT will lose any profits due to reduced prices on unregulated products.

4.16 In fact, even if BT could <u>not</u> increase its profits by increasing the prices of regulated products (implying that there had been an error in the SMP assessment), BT would still have strong incentives to game the RFS in order to allocate more costs to regulated products. By doing so, it creates the option to increase prices at some point in the future, if demand or supply conditions change. In the interim period, BT would be free to price below the price cap, at whatever level is profit-maximising.

4.17 Overall, therefore, TalkTalk considers that permitting IGCCs to be allocated to regulated products will create strong incentives for BT to game the RFS, in order to increase the quantum of common costs allocated to regulated products, and therefore increase BT Group's profits. Ofcom could eliminate this incentive if IGCCs were no longer permitted to be recovered from regulated products.

4.18 If IGCCs are (as now) allowed to be recovered on regulated products then it is necessary to select an allocation basis to allocate the IGCCs. There is often no obviously correct approach to allocate these common costs. Under the current regulatory system BT selects the allocation basis, and uses the absence of an obvious metric to select an approach that allocates a high amount of costs to regulated products. For instance, it allocates the costs of central group functions (such as CEO, investor relations, Treasury, HR, strategy, procurement) in proportion to the pay and weighted assets of the different businesses. This method applies to the portion of these costs that are incremental as well as the portion which is fixed and common.

4.19 If instead no IGCCs are permitted to be allocated to regulated products, then this problem of allowing BT to select a metric would disappear, thus removing BT's ability to game the system. This would also have the additional benefit of ensuring that more thought is put into the correct allocation basis for the incremental portion of the costs.