BT's response to Ofcom's consultation document

"Review of Wholesale Broadband Access Markets

Update on the impact of fibre roll-out and further consultation on the proposed charge control"

10 March 2014

Review of the wholesale broadband access markets: Update on the impact of fibre roll-out and further consultation on the proposed charge control

Executive Summary

1. The UK has the lowest retail landline and broadband prices among the largest developed economies, according to Ofcom's December 2013 International Benchmarking Report[1]. Investment in broadband continues to be essential to meet the increasing demands of UK consumers and businesses. However, the investment case is most challenging in rural areas. When setting the Wholesale Broadband Access (WBA) charge control it is crucial that Ofcom strikes the right balance between the encouragement of investment and consumer interests. Ofcom's latest proposals do not strike this balance because the range of X values is now too high. In our response we present a number of corrections and amendments with evidence to support a more appropriate range for this charge control.

2. BT supports Ofcom's proposed approach to setting the charge control on the basis of an anchor product, with a single basket and sub-caps. This approach is consistent with the previous control and with the July 2013 consultation. We also agree that the Hypothetical Ongoing Network (HON) approach is the right approach for valuing broadband assets, signalling the right investment incentives and a technologically neutral approach, in accordance with the six European Community requirements for regulation.[2]

3. BT welcomes Ofcom's proposal to use 2012/13 as the base year for cost modelling purposes. However, BT remains of the view that the most appropriate starting point for the WBA charge control is the published 2012/13 RFS, rather than the represented RFS. This is the most up to date and relevant data and its use is consistent with Ofcom's standard practice.

4. BT has a number of concerns with Ofcom's cost modelling and revised proposals:

<u>Ofcom's model overestimates end user volumes</u>

5. Ofcom's volume forecasts are overly optimistic. As well as using the latest available cost information, Ofcom must also take into account the most recent information on volumes and current forecasts which include an updated impact of copper competition and fibre roll out. The loss of volume to LLU (MPF) operators and fibre-based services is happening faster than anticipated in Ofcom's scenarios, driven by wholesale-level as well as retail-level competition. We provide evidence demonstrating the most recent information only supports Ofcom's "low" volume scenario.

[1] See Figure 2.7, page 111 of International Communications Market Report, Ofcom, 12 December 2013

[2] European Community requirements for regulation – sections 4 and 4A of the 2003 Act and Article 3 of the BEREC Regulation – see Paragraphs A7.36ff in Annex 7 of The Review of the wholesale broadband access markets of 11 July 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/review-wba-markets/annexes/WBA_July_2013_annexes.pdf

<u>Ofcom's assumed efficiency gains are unattainable and a lower target should be used</u>

6. Efficiency improvement targets are expected to be similar to those of corresponding declining legacy markets. The TISBO charge control[3] used a 1.5% per annum efficiency target. As WBA services rely on the same SDH technology as TISBO services, a similar rate of efficiency improvement would be expected. The NERA and Deloitte studies support this, which show a trend rate of efficiency improvement of around 2% per annum. Productivity improvements are challenging where equipment evolution is absent and where operations already reflect the accumulated lifetime experience of installing and maintaining thousands of DSLAMs. This is in no way compensated for by the HON, which relates to the capital employed and depreciation costs only.

7. There is no evidence that BT's WBA services are inefficient and so there is no "efficiency gap" that might justify a higher target. [✂]

8. Given this background, an efficiency target of 5% (or even 3.5%) per annum is excessive and the efficiency assumption should reflect the trend rate of efficiency improvement, as shown in the NERA and Deloitte studies, adjusted down to 1.5% to be consistent with the TISBO charge control.

9. Ofcom's model assumes that cost inputs increase in line with the Consumer Price Index (CPI). The latest information on actual cost movements (and Government cost forecasts) indicates higher cost inflation, which we estimate to average 4% per annum. Where better, more specific, cost projections are available Ofcom should use this information to forecast costs rather than adopt a general macroeconomic index as a proxy. The use of such a proxy also has the consequence that the choice of general index impacts outturn prices under the control, which Ofcom has stated elsewhere should not happen.

<u>Ofcom must be consistent in making adjustments to BT's costs</u>

10. Ofcom have made several adjustments to BT's costs. Some of these changes appear to have been applied inconsistently in Ofcom's model. In particular:
    - CCA costs are treated inconsistently. Holding gains included in the CCA operating costs are inconsistent with the zero asset price inflation included in modelling Capital Employed. Ofcom should apply a zero holding gain to correct for this;
    - Ofcom has retained CCA adjustments associated with 21CN costs that have been removed from the cost models. If 21CN costs are to be removed, then this approach must be applied consistently to all costs, including the CCA adjustments.

Conclusion

11. BT agrees that the exclusion of 21CN costs means the value of X should be higher than the July 2013 consultation range. However, CPI -2.5% to CPI - 9.0% is a more appropriate range. This

[3] See A12.90 to A12.96 of the Business Connectivity Market Review Statement, Ofcom, 28 March 2013

means that the central case should be CPI - 6.1% rather than Ofcom's CPI - 12.3%. We evidence this position in the remainder of this response.

This document is BT's response to the questions Ofcom set out in its consultation "Review of the wholesale broadband access markets[4]" published on 27 January 2014.

1. ***Question One - Do you agree with Ofcom's proposal to use 2012/13 as the base year but to exclude all BT's new allocation methodologies set out in its 2013 RFS?***

    1.1. We remain of the view that the most appropriate starting point for the WBA charge control is the published 2012/13 RFS. This is the most up to date and relevant data and its use is consistent with Ofcom's standard practice.

    1.2. Each year BT reviews its cost allocation methodologies, as was the case in 2012/13, to ensure that costs are allocated in the most appropriate way. Any methodology changes are only introduced following rigorous internal review by BT.

    1.3. Ofcom's normal or standard process is to take BT's most recent published RFS as the starting point for a charge control's base year, and to make such changes as it deems appropriate following a transparent review of those costs and cost allocations.

    1.4. BT's rationale for methodology changes has always been balanced, evidence led and guided by the regulatory accounting principles. For example, in 2012/13 54 methodology papers were approved. Of these papers 22% moved costs to non-regulated markets and a further 22% had no impact on regulated markets, reflecting an even-handed approach to methodology changes.

    1.5. There has been extensive engagement from BT with Ofcom regarding the 2012/13 methodology changes since January 2013, with Ofcom being provided with an independent report setting out the merits for each change and the 2012/13 RFS received an unqualified audit approval by PWC.

    1.6. Ofcom's blanket dismissal of all 2012/13 methodology changes fails to give proper and appropriate consideration to the merits of each individual change and the detailed information supplied by BT. As such, Ofcom's approach is arbitrary, inconsistent with Ofcom's standard approach to the principles of cost recovery and contrary to Ofcom's duties.

    1.7. Given the above, the 2012/13 RFS is clearly the most appropriate starting point for the WBA charge controls.

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[4] Review of the wholesale broadband access markets. Update on the impact of fibre roll-out and further consultation on the proposed charge control. (27 January 2014) http://stakeholders.ofcom.org.uk/binaries/consultations/wba-review-update/summary/wba-review-update.pdf

2. ***Question Two - Do you agree with Ofcom's proposal to make adjustments to SG&A Broadband and ATM Network Interface, Switching and Transmission costs presented in the October 2013 RFS Report?***

   2.1. Yes, BT agrees with Ofcom's proposed adjustments as we understand that they are designed to ensure the cost allocations are, as far as possible, based on usage. However, the logic for making these cost adjustments seems to be inconsistent with the treatment proposed for Accommodation costs. BT's accommodation allocations in 2012/13 were changed to correct the method of calculating accommodation floor-space usage to take into account the additional space requirements for equipment with a high energy density. However, this has been arbitrarily rejected in Ofcom's modelling because all methodology changes implemented in 2012/13 have been rejected. Ofcom should revisit this methodology change and the detailed information supplied by BT.

3. ***Question Three - Do you agree with Ofcom's proposal to update our one-off non-recurring cost adjustments, our market size adjustment and our DSLAM cost adjustment?***

   3.1. BT agrees with Ofcom's proposal to update their one-off non-recurring cost adjustments, their market size adjustment and their DSLAM cost adjustment. However, BT considers that Ofcom has not implemented this principle consistently because of the failure to adjust fully for CCA holding gains as explained in paragraphs 3.5-3.7 below. Ofcom should therefore make sure this change is fully implemented in Ofcom's modelling.

   3.2. BT agrees with the market size adjustment, but believes that Ofcom's volumes forecasts are overly optimistic, particularly given recent data on volume decline within Market 1 as set out in more detail in paragraphs 3.8-3.9 below. Ofcom should therefore amend its volume forecasts to align with the low volume scenario which is consistent with the most recent data.

   3.3. BT also agrees with the DSLAM cost adjustment implemented by Ofcom, but considers that Ofcom should also have taken into account the fixed/variable nature of DSLAM costs, with some costs varying with the number of customers. This is explained in paragraph 3.10 below. This issue should be recognised in Ofcom's cost modelling.

   3.4. BT also considers that Ofcom should incorporate the correction to accommodation allocations BT identified in the 2012/13 RFS which reflects the impact of power density on the exchange space required to accommodate WBA exchange equipment. This is explained further in paragraph 3.11 below. This change should be made to ensure Ofcom acts in a consistent manner.

   One-off non-recurring cost adjustments

   3.5. Ofcom has not "normalised" its treatment of CCA holding gains consistently with the removal of one-off non-recurring cost items. This inconsistency must be corrected. If the holding gain/loss in the base year was atypical, the use of an unadjusted figure would result in the one-off item being included as a cost (or cost deduction) in each year of the charge control. Ofcom has made no "normalisation" adjustment to the unrealised holding gain/loss in the base year cost base, meaning that the holding gain shown in 2012/13 results in a reduction in operating costs. There is no reason to believe that the holding gain in 2012/13 will be typical of the asset price changes over the next three years. However, when modelling the value of mean capital employed, Ofcom has assumed that asset prices will be held fixed in nominal terms, in other words there would be neither a holding gain nor a holding loss. This effectively means that the modelling includes no compensating adjustment to future depreciation costs through an increase to depreciation or the capital employed. This means that the calculations in the model are not based on an internally consistent set of assumptions.

3.6. In recent charge controls Ofcom has adopted the approach of removing the reported holding gain/loss in the base year costs and replacing this with a value recalculated on a basis consistent with a forecast of the future asset price changes.

- In the July 2012 Leased Lines Charge Control consultation[5] at paragraphs 5.110 to 5.113 Ofcom explains "*we [Ofcom] recalculate the effect of cost inflation based on the historic five year average in the trend of real asset price changes as a proxy for future asset price changes.*"
- Ofcom's 2013 Business Connectivity Market Review statement[6], which implemented the 2013 Leased Charge Control, confirms the approach to normalisation of the CCA adjustments. The consistent treatment of holding gains and asset price changes is explained in paragraphs 19.158 to 19.162 with Ofcom saying in 19.161 that "*Holding gains/losses were included in the cost stack as part of a CCA depreciation so that we had a forward-looking projection that was consistent with the asset price changes we assumed in the model.*"

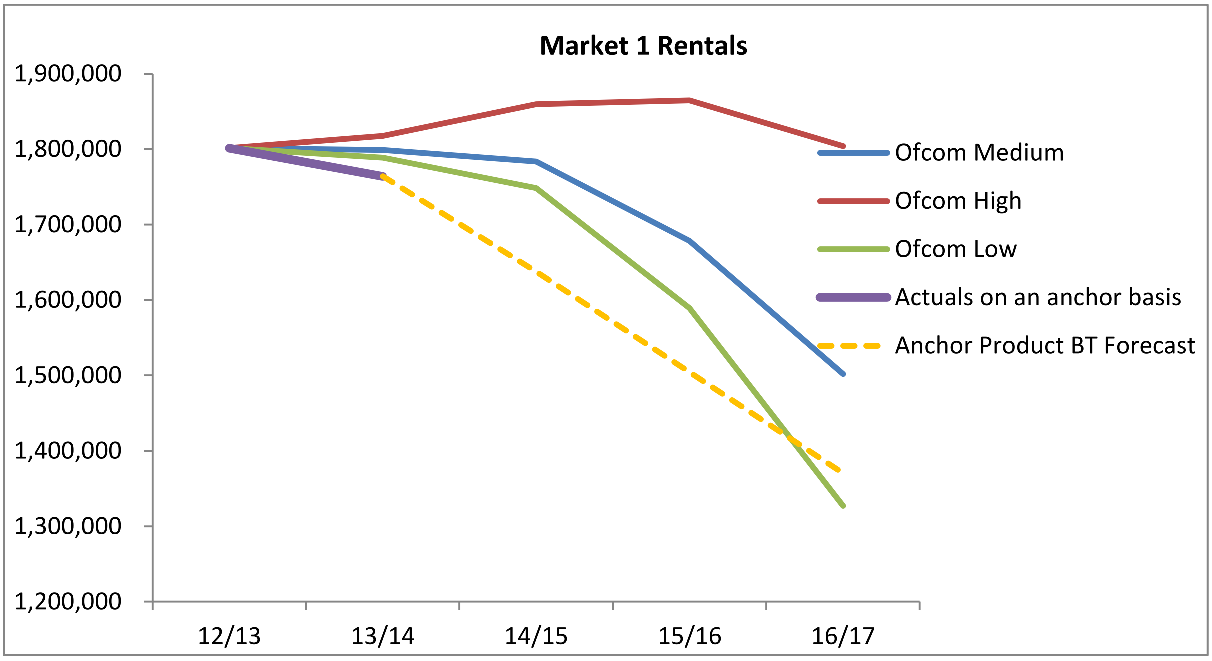
3.7. The simplest way to "normalise" the holding gain shown in the base year is to substitute a nil value. This would then ensure assumptions were internally consistent with asset price inflation in the modelling of mean capital employed being consistent with the CCA adjustments.

Market size adjustment

3.8. BT agrees with Ofcom's proposal to base the WBA charge control on the 2012/13 Market 1 RFS information. However, BT is concerned that Ofcom's volume forecasts for Market 1 are overly-optimistic. The loss of volume to LLU (MPF) operators and fibre-based services is happening faster than anticipated in Ofcom's scenarios, driven by wholesale-level as well as retail-level competition. We provide evidence demonstrating the most recent information only supports Ofcom "low" volume scenario.

[5] Leased Lines Charge Control consultation, Ofcom, 5 July 2012
http://stakeholders.ofcom.org.uk/binaries/consultations/llcc-2012/summary/LLCC_2012.pdf
[6] Business Connectivity Market Review statement, Ofcom 28 March 2013
http://stakeholders.ofcom.org.uk/binaries/consultations/business-connectivity/statement/Sections17-24.pdf

3.9. The decline in end user volumes assumed in Ofcom's central case is 0.1% between 2012/13 and 2013/14. However, the actual drop in volumes as at the end of January 2014 was 2.1%. This aligns most closely with BT's forecast shown in the chart below which necessarily has a lower actual starting point.



The above evidence only supports the Ofcom 'low' volume scenario.

DSLAM cost adjustment

3.10. BT agrees with Ofcom's use of the 2012/13 RFS DSLAM cost allocation data. Ofcom made a similar adjustment in the July 2013 WBA Consultation using 2011/12 data to allocate some DSLAM costs to bandwidth services. However, Ofcom has not adjusted the base year costs to reflect the improved allocation of DSLAM costs justified on the basis of cost causality. BT has identified a fixed / variable element of the DSLAM costs. In the past DSLAMs have been allocated to each market based on the number of DSLAMs. However, a proportion of each DSLAM is more closely related to the number of customers such as the power consumption, customer line-cards and customer service costs. For these reasons a proportion of the DSLAM cost should be allocated by reference to the number of IPStream end-users whilst the non-customer related cost should continue to be allocated based on the number of DSLAMs in each market. The improved methodology to account for DLSAM costs should be used because it more closely reflects cost causality.

Specialised Accommodation

3.11. Ofcom should take into account the correction in the 2012/13 RFS in relation to specialised accommodation. The revised allocation of specialised accommodation costs into WBA markets align RFS reporting with planning rules and best engineering practice. The previous allocation methodology looked at a fixed multiple of the footprint of the racks occupying exchange space when allocating space. However, this does not take into account the maximum power density of 500W per square metre that is allowed in BT's exchanges. This means the space occupied by WBA services is, in fact, a higher proportion than reflected in the 2011/12 cost allocations. The new method should be used because it more accurately reflects the exchange space actually used and improves the cost causality of the allocation of specialised accommodation costs.

4. *Question Four - Do you agree with Ofcom's proposal to update the HON adjustment in line with that made in the 2013 WBA Consultation but to adjust the asset lives?*

4.1. BT agrees with the proposal to update the HON adjustment to be consistent with the 2012/13 base year financial data

5. *Question Five - Do you agree with Ofcom's proposal to exclude 21CN costs from the charge control?*

5.1. Yes, BT considers that Ofcom's approach to use costs based on 20CN technology, supplemented by a number of HON adjustments, is reasonable. Given that Ofcom has included a HON, it is appropriate to exclude 21CN assets that are replacing the assets included within the HON.

5.2. However, in making the adjustment to exclude 21CN costs, Ofcom has only removed the HCA costs and appears to have inadvertently failed to remove the relevant CCA adjustments (holding gains, supplementary depreciation and other CCA adjustments). The change needs to be applied consistently.

5.3. There was a separate adjustment whereby Ofcom remove all "other CCA adjustments" from the base costs as part of the removal of one-off non-recurring costs. This means that any adjustment in relation to 21CN costs for "other CCA adjustments" is unnecessary (otherwise these costs would be removed twice over). However, Ofcom has not excluded the Holding Gain and Supplementary Depreciation attributable to the 21CN costs which is incorrect and inconsistent with the approach that all 21CN costs should be removed. Ofcom should therefore exclude the Holding Gain and Supplementary Depreciation associated with the 21CN components from the base year costs to ensure 21CN costs are properly removed.

6. *Question Six - Do you agree with Ofcom's proposed changes to the compliance formulae to reflect relevant EOI charges?*

6.1. BT agrees with the principle that EOI charges from Openreach should be excluded from the compliance formula as these elements are already subject to their own separate charge controls. However BT is concerned that the resulting increase in complexity of formula is likely to create practical issues for BT in setting prices to ensure compliance. This is particularly the case for the formulae which calculate the weighted average charge and prior year weighted average charge in the draft legal instrument (pages 75 and 76 of the consultation document).

6.2. For EOI inputs such as SMPF rentals and connections there is a 1:1 mapping of the SMPF input to the WBA service i.e. every IPstream rental uses one SMPF rental as an input. This means the formula is relatively straightforward to implement (and this is also how the previous WBA charge control applies).

6.3. However, with EOI inputs such as *Special Fault Investigations* and *Relevant Tie Cables*, the mapping is not a direct ratio and that volume of EOI inputs per rental will vary from year to year. This adds an additional layer of complexity to the formula and charge setting, especially as the prior year volumes per rental service may not be known until the RFS is produced in July in the current year. This may require an additional change to prices to ensure compliance. BT is also concerned that Market A will only be introduced into the RFS during the 2014/15 financial year, meaning that 2013/14 RFS will not report the volume of these inputs for Market A but will show figures for Market 1. This may mean that information on the volume of the EOI inputs per rental service within Market A is not readily apparent from the RFS until the 2014/15 RFS are published in July 2015, nearly half-way through the charge control.

6.4. This element of the charge control could be made simpler if the ratios were set out in the legal instrument and kept fixed throughout the charge control period, using the current ratio of EOI per rental. This would allow the compliance formulae to include a fixed proportion of EOI inputs per rental in the formulae rather than allow the value to vary from year to year.

6.5. A further advantage of this approach (of using a fixed ratio for the SFI and tie cable inputs) is that it also improves incentives for BT to improve efficiency (for example by reducing the incidence of SFI). This will allow prices to be lower in the medium to long term.

6.6. Using Ofcom's proposed formula, if BT reduces the volume of SFI, for example by investing in improving the quality of the broadband network, prices would have to be reduced in subsequent years to reflect the lower incidence of SFI. This leaves less reward from quality improvements (as the benefit of lower SFI costs is passed through in the following year), thereby reducing the incentive to invest to improve the network. Conversely, if BT allowed the network to deteriorate and this led to more SFIs, these additional SFI costs could be passed through to customers. The proposed formula therefore has an unintended consequence that there is limited financial reward from investing to improve the network, whilst the consequence of allowing a deterioration in the quality of the network is "rewarded" by BT being allowed to pass through the increase in volume of SFIs.

6.7. BT therefore suggests that Ofcom set out a fixed ratio of EOI inputs per rental within the financial instrument to simplify the charge controls and to ensure appropriate incentives are in place to invest to improve the quality of the network and optimise the level of EOI inputs such as SFIs and tie cables.

6.8. BT also has a number of comments on the compliance formulae in the draft legal instrument:

a) The term u_j has a different meaning on page 75 and page 76. A different term should be used to avoid confusion and prevent the same term having two meanings within the same legal instrument.

b) The legal instrument has been drafted on the assumption that the charge control will start on 1 April 2014. In the event that there is any delay in implementation of the charge control, the First Relevant Year will need to start on the day the new charge control comes into effect to prevent the retrospective implementation of a charge control (see definition under heading (u) on page 84. This also means that the term w_j on pages 73 and 74 will need to be divided by a number less than 365 in the First Relevant Year, to reflect the number of days the charge control is in effect during this "First Relevant Year" In other words the number of days in the First Relevant Year will need to be changed, as will its definition to reflect the date on which the charge control comes into effect and the number of days remaining in the first charge control period.

For example, if the first day of the new charge control were to be 1 July 2014, BT suggests the following changes

- the definition of the start of the first relevant year of the charge control[7] "(1) the year beginning on 1 April 2014 and ending on 31 March 2015 (the "First Relevant Year"); " is changed to "(1) the period beginning on 1 July 2014 and ending on 31 March 2015 (the "First Relevant Year"); "
- the definition of the number of days in the first relevant year is reduced from 365 days to 274 days so that the definition in 7.3 is redrafted as follows "… $p_{i,t}$ is the weighted average Charge made by the Dominant Provider for the specific service, I, during the Relevant Year : Where such Relevant Year Weighted Average Charge shall be calculated …

  w_j is the proportion of the Relevant Year in which each Charge, p_j is in effect, calculated by the number of days during which the charge is in effect and dividing:

  (1) for the First Relevant Year, by *274*;

  (2) for the Second Relevant Year, by 366; and

  (3) for the Third Relevant Year, by 365. "

The change needed in the legal instrument is shown here for the Relevant Year Weighted Average Charge, but the same change, from 365 days to 274, would also need to be made to

[7] This is defined in (u) on page 84 of the consultation

the w_j definition Second Prior Year in the Prior Year Weighted Average Charge definition.

In the event that a different start date from is implemented, corresponding adjustments to the number of days in the First Relevant Year and Second Prior Year should be made.

7. *Question Seven - Do you agree with Ofcom's proposal to include a carry-over provision within the legal instrument?*

7.1. BT accepts that clause 7.9 is a reasonable approach in dealing with the carry-forward of a Deficiency or Excess in adjusting the Controlling Percentage for the subsequent year in the event that price changes do not equal the Controlling Percentage in any Relevant Year. However, Ofcom also proposes in the Consultation in clause 7.10 that, should BT under-comply in a given year of the charge control, it would be obliged to contemporaneously refund the affected CPs.

7.2. Ofcom has offered no cogent rationale for why this change is necessary or proportionate (especially as historically the 'carry-forward' of over or under compliance has been tiny in relation to the total basket revenues).

7.3. BT has the following concerns about clause 7.10 in the draft legal instrument on the following grounds:

- It is impractical to implement: in a basket control it is impossible to say what products in the basket would be subject to price changes that should or would have been implemented in order to comply. Consequently, it is impossible to determine which CPs have been subject to excess charges and therefore how the Excess Revenues rebate is split across CPs. Moreover, given this complexity, the implementation of such a provision is likely to lead to extensive debates and/or disputes with CPs.
- It is disproportionate: historically, the level of over or under compliance carried forward has been tiny compared with the level of total basket revenues. Accordingly, applying an additional, impractical and difficult to implement provision to such a small issue is disproportionate. Ofcom has offered no cogent rationale for why this change is necessary.
- It is discriminatory: separately, it undermines the purpose of the existing carry forward provisions which adequately address issues of over and under compliance in a symmetric and non-discriminatory manner. In contrast, Ofcom's proposal discriminates against BT due to its asymmetry: it does not operate if BT over-complies with the control.

7.4 Clause 7.10 is unworkable and unduly burdensome - even if a refund per affected CP could be worked out, the mechanics of refunding a large number of CPs small individual amounts would require considerable effort and cost. Separately, it undermines the purpose of existing carry forward provisions and this discriminates against BT because it is asymmetric.

It does not operate if BT makes price reductions in excess of those required by the control. Ofcom should not impose such a disproportionate and unnecessary obligation.

8. *Question Eight - Do you agree with Ofcom's proposal to change the definition of cease charges that are to be set to £0?*

8.1. BT accepts Ofcom's proposal to change the definition of cease charges that are to be set to zero, but is concerned that no provision has been made for the recovery of efficiently incurred "left in jumper" costs. It is essential that these are included in the connection charge.

9. *Question Nine - Do you agree with Ofcom's proposal in relation to migration and connection charges?*

9.1. BT has no specific comments with regard to Ofcom's proposals.

10. *Question Ten - Please provide any further relevant evidence you may have in relation to the appropriate efficiency improvement target for BT for WBA markets.*

10.1. The Business Connectivity Market Review Statement published in March 2013 concluded that the efficiency improvement target for TISBO services should be 1.5% per annum. Ofcom observes in paragraph A12.96 of that Statement: *"… we regard 1.5% as an appropriate efficiency figure for BT Wholesale's provision of TI services. We note that this may be considered a relatively low target for efficiency improvements compared to those used in other charge controls on BT. However, TI services are a mature and declining set of markets and we believe that the evidence does not justify making a stronger efficiency assumption …"* BT's IPStream services rely on the same SDH technology as the TI services and so a similar rate of efficiency improvement in the operation of this technology is to be expected. The cost of operating these ageing assets is necessarily separate from the HON as this relates to the capital employed and depreciation costs only. In assessing future operating cost, the nature of these ageing assets must be considered when assessing the potential for future efficiency gains to reduce operating costs.

[✂]

10.2. The Deloitte and NERA studies[8] have consistently found a trend rate of efficiency improvement of around 2% per annum in real terms. BT sees no reason why Ofcom should impose a significantly higher rate of efficiency improvement, especially given the

[8] These studies are referenced in figure A12.23 of the Business Connectivity Market Review statement, page 308 of the appendices

technology used to deliver the charge controlled WBA services is mature and volumes are forecast to decline.

10.3. An element of the efficiency assessment is the input prices inflation assumptions that accompany the efficiency improvement assumptions. In moving from RPI to CPI, the inflation index applied to prices has declined by approximately 1 percentage point. There is no reason why the input prices that BT is subject to will also decline by the same amount, yet this is the implicit assumption made. Ofcom has itself pointed out that the choice of an RPI-X or a CPI-X glide path should not matter in terms of the end point for nominal charges.[9] If there is no correction in terms of the real input price assumptions used, the move from RPI to CPI, the control is effectively tightened simply on the basis of the choice of inflation indexation. This would be an error.

10.4. Turning to the assumptions themselves, the operating costs to which the efficiency assumption is applied are predominantly pay costs, power costs and accommodation costs, all of which are forecast to increase more rapidly than CPI. In particular pay cost inflation in the UK economy is now ahead of CPI inflation and is forecast to increase more rapidly[10], with a widening gap between the two expected over the course of the charge control. Power costs have increased very substantially since 2012/13 and are forecast to continue to increase much faster than inflation, whilst BT's accommodation costs are subject to price inflation of [✂] per annum, around [✂] faster than CPI inflation. BT therefore believes that an input price inflation assumption of 4% per annum in nominal terms should be used to reflect the future cost inflation of the key operating cost inputs needed to provide WBA services.

11. Question Eleven - Please provide any comments you may have on the proposed range of X values of -15.2% to -8.7%.

11.1 Ofcom's consultation range is too high, primarily because:

a) Ofcom should use BT's forecasts that more closely take into account the decline in IPstream users in Market 1. Ofcom must rebase its 2013/14 rental volumes on the BT's forecasts. BT's forecasts are in line with the latest Jan 2014 actuals and shows that the number of IPstream users in market 1 is below that which Ofcom have assumed for 2013/14.

[9] Fixed access market reviews: Approach to setting LLU and WLR Charge Controls Updated 20 August 2013 paragraph 3.168 http://stakeholders.ofcom.org.uk/binaries/consultations/llu-wlr-cc-13/summary/LLU_WLR_CC_2014.pdf

[10] See OBR economic forecasts at December 2013 shown on following website (for the average earnings growth forecast) http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/
The data is in the labour market tab (shown in table 1.4 of the spreadsheet) - See Economic and Fiscal Outlook – Supplementary Economy Tables December 2013

b) The efficiency challenge of 3.5-5% is excessive for a service provided over legacy technology where the scope for cost savings is limited. An efficiency assumption 1.5%, consistent with the TI charge control figure, is more a more appropriate figure to use.

c) Ofcom should remove CCA adjustments in relation to 21CN components the costs of which have been removed from the base year costs. Removing these adjustments will ensure consistent treatment of the 21CN costs.

d) Ofcom should normalise holding gains in the base year consistent with Ofcom's modelling of mean capital employed with the asset values held constant in nominal terms, meaning that there is no increase in the asset base.

e) Ofcom is required to take into account how input costs change in comparison with the chosen inflation index. In particular, pay and accommodation and power costs are all expected to move by more than CPI. BT suggests Ofcom use a weighted average input cost inflation assumption of 4% per annum over the four years from 2012/13 to 2016/17 instead of CPI which underestimates the extent of input price inflation relating to operating costs.

f) Ofcom should take into account the correction to the way specialised accommodation costs are allocated which brings the new method in line with planning rules and makes it more cost causal.

11.2 The above suggests that Ofcom needs to make a number of corrections to its model. BT agrees that the exclusion of 21CN costs means the value of X should be higher than the previous consultation range but, taking the foregoing into account, considers -2.5% to -9.0% to be a more appropriate range of X values. This means that the central case of -12.3% is not the appropriate level for X and that there is a strong case for a central case of -6.1%.

12. ***Question Twelve – Do you have any other comments on the issues raised in this consultation?***

BT has no other comments.