# BT's response to Ofcom's consultation documents

*"Fixed access market reviews: Openreach quality of service and approach to setting LLU and WLR Charge Controls"*

*(19 December 2013)*

and

*"Fixed access market reviews: Further consultation on notification periods, compliance with requirements on the VULA margin, and approach to pricing for TRCs and SFIs*

*(16 January 2014)*

18 February 2014

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**Reports provided with this response**

Plum Consulting report "*Mind the gap: why the MPF vs WLR+SMPF price differential should be aligned with costs immediately*", February 2014.

Deloitte report "*BT RFS Attribution Methodology Changes*", October 2013.

FTI Consulting report *" Ofcom's consultation on BT's Regulatory Financial Reporting",* February 2014.

BT report "*Illustrative attribution of Wholesale Current Cost 2013 restated on basis of 2011-12 methodologies except for the BT TSO methodologies*", Confidential between BT and Ofcom.

**Section 1 - Introduction**

1. This document forms the BT Group response to Ofcom's 19 December 2013 and 16 January 2014 consultation documents on the Fixed Access Market Reviews and the proposed LLU/WLR Charge Controls.

2. The response covers three key topics with implications across the BT Group and which impact BT in its role as a provider of retail services to consumer and business end-users:

   - Fibre regulation, with a focus on Ofcom's regulatory approach to VULA margin;
   - Copper regulation, in particular the differential in charges between MPF and WLR+SMPF; and
   - Base year data for cost modelling, and Ofcom's proposal to model costs using BT's Regulatory Financial Statements for 2012/13 but retaining the cost methodologies used in the 2011/12 RFS.

3. Along with the response, we are also providing an expert report from Plum Consulting on the charge differential between MPF and WLR+SMPF; a report from Deloitte on the base year data issue; and a report by FTI on Regulatory Financial Reporting.

4. Separately, Openreach has provided its own responses to the 19 December and 16 January consultations. These responses set out Openreach's answers to Ofcom's questions which relate directly to the regulation of Openreach service levels and charges, together with further evidence and argumentation relevant to a number of charge control issues.

## Section 2 – Executive Summary

### 2.1 Fibre price regulation

1. Ofcom's 16 January 2014 consultation includes a new proposal for BT to be required to provide information on the "VULA margin" every six months and on request. This proposal has to be viewed in the context of Ofcom's overall approach to regulating BT's provision of fibre services and the way in which Ofcom may seek to assess "VULA margin" in considering the fairness and reasonableness of VULA prices.

<u>2.1.1 Overall context</u>

2. We echo the points we made in our response to the July 2013 FAMR consultation that fibre is a UK success story. We have invested £2.5bn in rolling out fibre access across the UK. Over 18 million UK homes now have access to fibre based services over our network and we expect that over 25m homes will have access to fibre by 2018. Take-up is also good, with over 2m fibre connections over GEA services at the end of Q3. At the same time Virgin Media states that it has over 3m customers taking broadband services at speeds over 30Mb/s service. International comparisons show that retail pricing of superfast services is lower than US, Germany, France, Italy and Spain.
3. That success has been built upon a number of factors, but the regulatory framework has been key. Ofcom has recognised the commercial risks and uncertainties impacting on the provision of fibre services – e.g. overall level of demand and willingness to pay for faster speeds – and acknowledged the constraints on fibre pricing presented by the ongoing availability of regulated copper-based access services. Reflecting this, Ofcom has not sought to control the wholesale prices we set for VULA services. Furthermore, we committed from day one to make VULA services available on EoI terms to all downstream players, supporting ongoing competition.
4. However, we now see CPs demanding greater regulatory involvement on the terms on which we make both VULA and retail fibre services available to customers. CPs point to BT's current share of VULA connections to indicate a market entry problem and TalkTalk asserts that BT is currently engaging in abusive margin squeeze in setting its retail fibre prices. As a result, certain CPs are effectively arguing that we should be charging higher amounts to retail customers and that they should receive entry assistance in supplying fibre-based broadband services to their customers. Such calls cannot be justified.
5. The facts here are clear:
    a) BT's provision of fibre services is profitable at the retail level – i.e. at current VULA prices, BT is charging retail customers amounts which can reasonably be expected to generate incremental profit within the expected customer lifetime.
    b) In line with this, Sky and TalkTalk have publicly stated that they are able to provide fibre services (a) profitably and (b) at a discount to BT.

c) TalkTalk has stated that demand for fibre services from its customers "remains modest". TalkTalk clearly positions itself as the "value" provider of both broadband services and, now, TV services and has flagged the successes it has seen in providing its TV service over copper-broadband, recently outselling both BT and Sky.

d) Notwithstanding this, over the last six months TalkTalk, Sky and other CPs have increased their volumes of fibre customers as they have begun promoting their services above the line.

e) The overall retail fixed broadband market (properly defined as including both copper and fibre based services) remains effectively competitive with four major players and a large number of smaller providers.

6. The only logical conclusions that can be reached, therefore, are that (i) there is no evidence of an anticompetitive margin squeeze (an issue which is being actively investigated anyway and on which Ofcom should conclude before the FAMR is finalised) and (ii) current shares of fibre provision reflect the strategic choices of broadband providers which will be based on their perceptions of customer needs at this point and on their choice of commercial strategies in relation to use of existing assets or investment in new assets.

7. In simple terms, there is no basis to believe that a Sky or TalkTalk customer demanding higher broadband speeds would need to churn away to BT because Sky or TalkTalk could not profitably offer such services at prices which match BT's – the opposite is clearly true by reference to their own public statements.

8. Nor is there anything which suggests that the current competitive landscape is likely to change for the worse during the period under review. Indeed, there is no evidence to suggest, and it would be illogical to believe, that BT has any ability (or indeed any intent) to somehow "monopolise" the supply of fibre based broadband services in a way that would impact detrimentally on the ability of other CPs to compete with BT. Sky, TalkTalk and other suppliers face no barriers in competing in the supply of fibre services built on VULA inputs from BT and can therefore be expected to react to any demand from their customers for faster speeds, as and when such demand arises.

9. Ofcom should properly capture these facts in its final statement to ensure there is no doubt about the context in which it is making its regulatory decisions. There is no basis to support a more interventionist approach in relation to the regulation of fibre access services provided by BT in the Fixed Access market.

10. The real concern here is that an interventionist approach, based on an erroneous view of the current market, works against the success we have so far seen in the provision of fibre services. Risks and uncertainties remain as we seek to recover our upfront investments by encouraging customers at the wholesale and retail level to migrate away from copper-broadband services to the higher speeds available over fibre. Introducing retail constraints on our pricing and/or limiting upstream returns in order to artificially support the business cases of our successful and well-funded competitors will ultimately work against the interests of UK consumers and risk slowing the rate of take-up, as well as disincentivising further investment.

2.1.2 Regulatory approach to VULA margin

11. In the first Fixed Access Market Review consultation document published in July 2013, Ofcom proposed to maintain the SMP requirement on BT to provide network access, including VULA, on fair and reasonable terms, conditions and charges. Ofcom also proposed high-level guidance on how it would assess whether VULA charges were fair and reasonable by reference to the margin available between the wholesale price of VULA and downstream prices.

12. We set out our views on Ofcom's proposed approach and guidance in our response to the July consultation.

    a) Our primary concern was that Ofcom was looking to design an *ex ante* test of VULA margin that would go beyond the "access problem" defined by this particular market review. Critical details were missing from the proposed guidance in Ofcom's July document. But, overall, Ofcom appeared to be suggesting that it would define price floors for a wide range of BT's retail fibre broadband propositions – e.g. "dual play" bundles with narrowband services (lines and calls) and "triple play" bundles where broadband and narrowband services would be provided with pay TV access platforms and/or access to different forms of TV content.

    b) Our concern, therefore, was that Ofcom was proposing, as a consequence of its narrow finding of SMP in the provision of VULA services, to regulate VULA in a way that would in practice constrain our commercial options in supplying innovative solutions in downstream retail markets in which innovation and new offerings are hallmarks of the competitive nature of those markets. Indeed, these proposals were being made in a market review that had included no assessment of how those broader sets of downstream markets were actually operating.

    c) In this context, we believe that seeking to construct simplistic tests "on the numbers" alone would run significant risks of producing "false positives" – inappropriately prohibiting BT from setting retail prices for propositions which were pro-competitive when properly assessed in the context of likely effects on competition in appropriately defined markets.

    d) It was not clear to us why Ofcom considered that it could not rely on competition law to address any competition issues that may arise in relation to the pricing of retail propositions which used VULA as an upstream input. A proper competition law assessment of BT's pricing would necessarily need to consider the likely effects on downstream competition, taking full account of the way in which the relevant propositions were supplied. At the very least it was clear that any *ex ante* constraints would need to provide scope for a similar assessment of effects and not become crudely applied binary pass-fail tests of compliance.

13. Ofcom's approach in this area is not some arcane "conceptual" matter but something that could have a direct impact on future investment decisions and on UK consumers. In making strategic investments in, among other things, WiFi capabilities, TV delivery platforms, sports content and spectrum as well as in fibre, we are seeking to provide innovative and competitive solutions to address future customer needs. Imposing the wrong type of regulation on the regulated upstream VULA product – or interpreting it in an inappropriate way – will result in unfair constraints on our retail pricing which could reduce our longer term competitiveness, reducing the value of those retail investments which would in turn undermine the case for fibre

investment. It is therefore vital to establish a clear economic basis for imposing such constraints. While we understand the need to provide key SMP upstream access services on a non-discriminatory basis to its competitors, and at prices which are of themselves fair and reasonable, it is not apparent why Ofcom considers that is justified in imposing *ex ante* SMP regulations that would unfairly impose restrictions on our retail pricing freedoms across propositions. Nor, on the basis of the information provided by Ofcom to date, is it clear how any such restrictions will operate in practice.

14. Given that, at this moment in time, Ofcom's position on this issue remains unclear, it is surprising and completely inappropriate for Ofcom to consult on an extension to BT's SMP obligation to provide information every six months about the prices charged by, and the performance of, our downstream retail broadband in order to "monitor compliance". This is clearly putting the cart before the horse. Until we have clarity on how Ofcom intends to assess whether VULA prices are fair and reasonable, it is not possible to comment meaningfully on the reasonableness and proportionality of any particular proposed information supply obligation. To propose this change at this stage would not be consistent with Ofcom's powers.

15. However, even as a point of principle, we would highlight such a regular reporting obligation is bad regulatory practice as it will place an additional regulatory burden on us to demonstrate compliance even where no evidence to the contrary has been put forward. We fully understand the need to ensure compliance with the regulatory rules in place, but sees no benefit in proactively supplying retail information of the type proposed to Ofcom on a regular basis. Ofcom is unlikely to fetter its discretion by agreeing that evidence in relation to retail prices and performance "proves" compliance by BT with the obligation to price the upstream access product VULA on fair and reasonable terms at any six month juncture, and CPs could still raise disputes. Our position is that it is more appropriate for a formal request for the submission of retail information to be triggered by the identification of a specific concern, duly evidenced, about our retail pricing behaviour. In those circumstances, Ofcom should consider first whether it is more appropriate to use competition or regulatory powers and, if considers that the complaint passes the relevant test, open the type of investigation that it considers most appropriate in the circumstances and make its request for retail information in the course of that investigation.

16. The priority issue to consider now, however, is the detail of <u>how</u> Ofcom intends to assess whether VULA is being provided on fair and reasonable terms, including assessing whether there is sufficient margin between the price of VULA and the price of downstream services which consume VULA. The gaps in Ofcom's proposals need to be addressed and consulted upon before any final decisions are reached. Ofcom also needs to be clear about how, why, and the extent to which under the regulatory framework, a finding of SMP in the upstream fixed access market and the imposition of a requirement to price VULA on fair and reasonable terms may constrain our ability to provide propositions across a range of downstream markets. Once that has been achieved, we can then have a meaningful debate as to the extent to which information may be needed to enable Ofcom to police compliance with that obligation.

17. Clarity on Ofcom's thinking in this area <u>now</u> is crucial. Otherwise, Ofcom would be introducing an SMP remedy without a clear understanding of how compliance would be assessed. Issues

which need to be addressed include: the level of service aggregation at which margin would be assessed; whether/how Ofcom would make adjustments to our costs for scale effects; how Ofcom would consider common cost recovery; and whether/how Ofcom proposes to take account of "audio-visual" services in broadband propositions as part of this framework. It is not reasonable to effectively have a consultation on the scope of application of the remedy after it has been imposed.

### 2.2 Avoiding further market distortions by aligning Price and Cost Differentials for WLR, SMPF and MPF

18. This differential was introduced in 2005, when Ofcom was seeking to promote MPF-based competition following the conclusion to the Telecommunications Strategic Review (TSR). However, Ofcom's proposal is to persist with a price differential much larger than the cost differential up to 2016/17 and, we assume, into one or more further price controls. This is despite the fact there are now over seven million MPF lines and that this number is forecast to increase strongly. It is well established that the retail market for fixed calls and broadband is competitive in the UK. Virgin Media supplies just under 20% of fixed broadband lines, BT just over 30% and, between them, Sky and TalkTalk (the two principle MPF-based suppliers) just over 40%.

19. Analysys Mason has pointed out that Sky has been "the big winner" in the broadband market over the last two years, and Ofcom has noted that Sky is overtaking Virgin Media in numbers of lines supplied. TalkTalk meanwhile has been upgrading its guidance which represents an increase in earnings after operating costs of £65m-£70m between FY13 and FY17.

20. In effect the differential, to the extent it is not cost justified, is entry assistance which will have been in place for 15 years or longer. BT considers this to be totally disproportionate given that the differential which is not cost-based causes various economic inefficiencies and prevents "competition on the merits" in a number of downstream markets for which MPF is used. The downstream markets should be allowed to develop on the merits of suppliers' offerings and not on the basis of a regulatory intervention which is deliberately aimed at their further promotion.

21. Ofcom has also been signalling since 2009 that it will move to a cost-based price differential, which at that time it indicated would be by 2012/13. Yet, still by 2016/17, Ofcom is proposing that purchasers of SMPF will be bearing costs for which they carry no responsibility

22. As we explain fully in our answer to Question 8.1 in section 4 of this response, Ofcom offers no analysis which would suggest that removing the distortion would cause any material harm to these operators, or that they would not remain profitable were the distortion to be removed. It is, of course, the case that removing an advantage provided to an entrant will require it to make some small adjustments, and that profitability might be lower than it would otherwise have been. The unravelling of a distortion will inevitably cause some effects, but we show that these operators' profitability would not be "undermined".

23. Ofcom's central supposition, that moving to a cost-based price differential is likely to weaken confidence in the regulatory regime and thus discourage future investment, is just not credible on any objective analysis.

24. Given the importance of this issue, BT asked Plum Consulting to review the public policy case for maintaining an artificial differential, and we have attached their report as an Annex to this response. Plum find that:

- The impact of the market distortion is calculated at around £600m since 2005. Retaining the differential as proposed by Ofcom would increase this by around a further 59% and bring the cumulative total to around £1 billion.
- The objectives of the 2005 TSR have clearly been achieved, and no cross-subsidy is needed for established, scale operators. Ofcom should make an immediate reduction to bring the price differential into line with costs at the start of the next charge control, i.e. in 2014.
- The objective of the TSR to promote copper-based access competition has since been overtaken by a revised priority to encourage investment and innovation in fibre-based access services, so the original justification for the subsidy should have less weight.
- Plum suggest that, if there is concern regarding expectations in relation to prior investment, then one option could be to phase out the differential over three years by applying it only to MPF lines purchased under past regulation, and not to begin to subsidise those installed after 2013/14. After this three-year period, there should be no more assistance for MPF-based suppliers (i.e. TalkTalk and Sky), and competition should be entirely undistorted.

25. We therefore urge Ofcom to reconsider its proposal and the pace at which the distortion is removed. Competition is established, and all suppliers – whether in supplying current generation broadband, wholesale bitstream services or retail fibre services – should be able to compete equally on the merits of their offerings, to the benefit of consumers. There is no objective case for a continued subsidy to the two principal entrants which is paid for by WLR-based suppliers and their customers.

**2.3 Base year data for cost modelling**

26. We do not agree with Ofcom's proposal to use as the base year data for cost modelling adjusted 2012/13 RFS cost information, where those adjustments simply reverse out all the methodology changes made in 2012/13 without any proper consideration of those changes.

27. Ofcom accepts that fully allocated cost ("FAC") information provides an economically efficient basis for setting charge controls and that it should use the latest available information when making regulatory decisions. The cost information published in the 2012/13 RFS is consistent with the published Regulatory Accounting Principles ("RAP") and has received an unqualified audit report on this basis. However, it fails to follow that approach for these proposed controls. Absent a detailed review of BT's 2012/13 RFS and in particular a review of each methodology change, Ofcom should not depart from good practice and should use the published RFS as the starting point for the base year for these charge controls.

28. Cost causality is of key importance in setting cost allocation methodologies; this much is established by the RAP. Prices set on the basis of cost causal allocations send economically efficient signals to purchasers and suppliers. BT has explained the reasons for its allocation changes in 2012/13 were mad and why these new allocation methodologies are superior to what went before.

29. The preparation of the RFS are subject to a considerable amount of oversight, including, importantly, an audit to a fairly presents standard and for which in 2012-13 was unqualified, as it was in at least the previous four years. In addition to the audit, in respect of which Ofcom has significant involvement, Ofcom also has continuous oversight and involvement in the preparation of the RFS. This is explained in a report commissioned by BT from FTI Consulting and which accompanies this response.

30. In 2012-13, considerable detail – over and above what is normally published, including the publication of the external report from Deloitte on the changes – was shared with Ofcom and other stakeholders. Ofcom has therefore had ample opportunity to consider the merits of each change, and has raised no specific concerns with any methodology change. Ofcom's proposal not to use the 2012-13 RFS is therefore unjustified.

31. Absent a clear rationale for rejecting each changed allocation methodologies, Ofcom must conclude that the published 2012-13 RFS provides the most appropriate, up to date information on the costs of providing the set of services relevant to these charge controls. Ofcom's more general concerns with consistency with other controls, the interdependence of the methodology changes, the overall balance of the changes and timing are, in themselves, an insufficient basis to reject the totality of the changes and, in any event, Ofcom has failed to consider options to address its concerns.

32. To not use the 2012-13 published RFS, without clear and objective justification, will: (i) result in controls that are not economically efficient; (ii) leave costs to be unjustifiably recovered from unregulated services; (iii) and therefore risk the under-recovery of efficiently incurred costs moving forward. Ofcom should therefore use the published FAC data within the 2012/13 RFS as the base year within the model with any adjustments limited to areas where clear economic efficiency issues have been identified or other adjustments, specific to these control, are appropriate.

**2.4 Other Charge control Issues**

Caller Display

33. Ofcom is consulting on proposals to introduce a new individual charge control on Caller Display. Openreach has provided its own response on these proposals that highlights the capacity and customer experience problems that would arise from Ofcom's proposed large cuts in these charges if they were passed on to end-users.

34. In this response we would like to stress that BT shares Ofcom's wider policy concerns regarding unwanted or nuisance calls. We note that the availability of Caller Display is not a silver bullet to the problem and instead a range of actions are required involving industry and regulators. For its part, BT has invested considerable amounts in upgrading our switches to handle international

Calling Line Identification (CLIs) and in operating the Nuisance Call Bureau and Nuisance Call Advice Line.

35. BT has also launched products such as the BT 6500 nuisance call phone to help customers to block up to 80 per cent of unwanted calls, by giving them the power to block 'international' numbers, 'withheld' numbers or specific numbers.

Directory costs

36. As we explained in our response to the July 2013 consultation, we understand Ofcom's reasons for removing printed directory costs from WLR rental, but we do not think this should be done immediately. We note that Ofcom states in paragraph 8.67 of the 19 December document that it is still considering this issue. Whilst we agree that a glide path is not appropriate in this case, we refer Ofcom to our previous response. An abrupt removal of the directories charge will have a significant impact on how the directories industry operates, and all parties concerned need time, once the decision is finalised, to assess their options and put alternative arrangements in place so that they can still meet their obligation to supply printed directories to consumers on demand. We therefore urge Ofcom to delay the one-off adjustment.

## Section 3 Fibre regulation

### 3.1 Introduction

1. Ofcom's 16 January 2014 consultation includes a new proposal for BT to be required to provide information on the "VULA margin" every six months and on request. This proposal has to be viewed in the overall context of Ofcom's proposed approach to regulating BT's provision of fibre services and the way in which Ofcom will ultimately assess whether VULA has been provided on "fair and reasonable" terms by reference to the margin that can be made in selling retail services using VULA.

2. To this end, we also note the submissions made by other stakeholders both in response to the July 2013 consultation and as direct responses to the submissions made by BT. This section therefore sets out some further general comments on Ofcom's consideration of the need for *ex ante* regulation of "VULA margin" and our specific response to Question 4.1 in the 16 January consultation, before addressing specific comments made about the future regulation of fibre pricing (i.e. for subsequent market reviews).

### 3.2 Current provision of fibre-based broadband services

3. In our response to the July 2013 FAMR consultation, we highlighted that fibre is a UK success story. We have invested £2.5bn in rolling out fibre access across the UK. Over 18 million UK homes now have access to fibre based services over our network and we expect that over 25m homes will have access to fibre by 2018. Take-up is also good with over 2m fibre connections over GEA services at the end of Q3. At the same time Virgin Media states that it has over 3m customers taking broadband services at speeds over 30Mb/s service[1]. International comparisons show that retail pricing of superfast services is lower than US, Germany, France, Italy and Spain.

4. This success has been built upon a number of factors, with the regulatory framework of particular importance. Ofcom has recognised the commercial risks and uncertainties impacting on the provision of fibre services – e.g. overall level of demand and willingness to pay for faster speeds – and acknowledged the constraints on fibre pricing presented by the ongoing availability of regulated copper-based access services. Reflecting this, Ofcom has not sought to control the wholesale prices we set for VULA services. Furthermore, we committed from day one to make VULA services available on EoI terms to all downstream players, supporting ongoing competition.

5. We note that some CPs seek to paint a very different picture. In TalkTalk's submission on certain issues raised in our FAMR response[2] it makes reference to BT being a "nascent retail monopolist"[3] and seeks to use our retail share of VULA connections to indicate a market entry problem for competitors. On a very basic level, these assertions ignore the fact that the retail

[1] http://investors.virginmedia.com/phoenix.zhtml?c=135485&p=irol-newsarticle&ID=1899958

[2] TalkTalk reply to BT's FAMR response, non-confidential version, 11 December 2013, ("TalkTalk reply") http://stakeholders.ofcom.org.uk/binaries/consultations/fixed-access-market-reviews/responses/TalkTalk_Reply_to_BTs_FAMR_Response.pdf

[3] TalkTalk reply, para 2.6

market is wider than broadband services provided over "BT provided VULA connections" and therefore ignore the competitiveness of both the overall provision of broadband services and of Virgin Media's share of superfast connections. Nevertheless, to support its flawed thesis about BT's current, ongoing strategy, TalkTalk asserts that BT is currently engaging in abusive margin squeeze in setting its retail fibre prices.

6. In so doing, TalkTalk gives weight to the fact that Ofcom has opened a Competition Act investigation into its specific allegation that BT's pricing of certain Infinity propositions amounted to an exclusionary margin squeeze.

7. Such claims are without substance. The mere fact that Ofcom has opened an investigation which is ongoing cannot provide any weight to taking a view on whether BT is currently operating an anticompetitive margin squeeze or on whether the prices currently charged by Openreach for VULA are in any other respect unfair or unreasonable. By the same token the fact that an investigation is underway cannot provide the foundation of an argument that imposition of an *ex ante* margin squeeze obligation is required for the next three years in order to ensure that the regulated VULA service is offered on fair and reasonable terms. We have provided evidence within the investigation that shows that TalkTalk's claims that BT is engaging in anticompetitive abusive behaviour are, in fact, without substance. This shows that returns at the retail level are more than sufficient to cover input costs.

8. Furthermore, the available evidence from the market completely contradicts TalkTalk's claims that it cannot compete in meeting customer demands for superfast services. As we set out in our response to the July consultation[4], TalkTalk's own statements to the City state that they are able to provide fibre services profitably and their current pricing of fibre-based services (as a "bolt-on" to their standard copper services) is at a discount to BT's prices. Sky had also made similar statements about the profitability of fibre.

9. TalkTalk seeks to dismiss this as irrelevant.[5] But in doing so, it simply asserts that "any business can set a price that is profitable" and suggests the only relevant issue is what market share that price can deliver.[6] TalkTalk makes no reference to the fact that its profitable price is beneath BT's price and fails to address the obvious alternative explanation for its lower share of VULA connections at the current time: i.e. that it does not currently see fibre as a central part of its set of customer propositions. In TalkTalk's most recent results they state that demand for fibre services from its customers "remains modest"[7]. TalkTalk clearly positions itself as the value provider of both broadband services and, now, TV services and has flagged the successes it has seen in providing its TV service over copper-broadband.

10. Overall, therefore, the relatively low level of fibre connections should not be viewed as any more than a reflection of TalkTalk's chosen commercial, investment and marketing strategy. Notwithstanding this, over the last six months TalkTalk – along with Sky and other CPs – has increased its volumes of fibre customers as it has begun promoting its services above the line.

[4] BT's response to July 2013 FAMR consultation, para 7
[5] TalkTalk reply, para 2.12-2.13
[6] TalkTalk reply, para 2.14
[7] http://www.talktalkgroup.com/~/media/Files/T/TalkTalk-Group/pdfs/results/q3-ims-2014.pdf

11. It must be noted that overall the retail fixed broadband market (defined as including both copper and fibre based services) remains effectively competitive with four major players and a large number of smaller providers. If TalkTalk and Sky claim they can provide fibre services profitably and if they offer services at a discount to BT, there is no basis to believe that a TalkTalk or Sky customer demanding higher broadband speeds would need to churn away to BT in order to be able to take a fibre based service. All the evidence in fact suggests that CPs can now, and can equally be expected in the future to be able to, react to any demand from their customers for faster speeds moving forward. Suggestions that BT is gaining a "longer-term" advantage in the provision of fibre broadband propositions and that other CPs will be excluded from competing for customers wanting such services in the future therefore lack credibility.

12. It is important that Ofcom properly reflects these facts in its final statement to ensure there is no doubt about the context in which it is making its regulatory decisions in relation to fibre. The current state of competition provides no basis, of itself, to support a more interventionist approach in relation to the regulation of VULA.

13. In fact, it is clear that CPs such as TalkTalk are seeking artificial entry support for fibre services when none is required. The effect of this would be higher retail prices as BT is constrained in competing on the merits in offering customers a range of fibre propositions.

### 3.3 The role of *ex ante* testing of "VULA margin"

14. In the first Fixed Access Market Review consultation document published in July 2013, Ofcom proposed to maintain the SMP requirement on BT to provide network access, including VULA, on fair and reasonable terms, conditions and charges.

15. Ofcom also proposed high-level guidance on how it would assess whether VULA charges were fair and reasonable by reference to the margin available between the wholesale price of VULA and downstream prices.

16. We raised a number of concerns with Ofcom's assessment of the core "competition concern" and its proposed approach in our response to the July consultation. We also noted some significant gaps in fully understanding what Ofcom was specifically proposing. Perhaps most notably, Ofcom did not detail how, if at all, it would consider the provision of "audio-visual" services in any assessments of "VULA margin". Instead, Ofcom indicated that it was giving further thought to the issue. No update on Ofcom's thinking has been set out in the latest consultation.

17. We note that CPs, such as TalkTalk, are of the view that Ofcom should assess margins made across any and all retail propositions which include fibre-based broadband access. This would include propositions that included TV platform services and/or access to content, such as the BT Sport channels[8]. The implication is that if "insufficient" margin (i.e. margin as defined under any test) was made on any propositions then that would, in itself, be a clear competition concern related to the terms on which BT was supplying VULA services. But no real evidence has been put forward to support such an assertion.

[8] TalkTalk reply, para 2.52, etc

18. The July consultation provided very little analysis of retail markets and retail-level competition. The focus of the Fixed Access Market Review is on upstream wholesale markets. We do not dispute Ofcom's market definition or the provisional finding that (for so long as Ofcom finds that there is a single, national, geographic market) BT holds SMP. We therefore accept that BT will be required to provide VULA from that upstream wholesale market on a non-discriminatory basis on fair and reasonable terms – that is, on terms that support efficient entry and effective retail level competition in the supply of fibre broadband services.

19. We also accept that we should not establish retail and wholesale prices at levels which give rise to an exclusionary margin squeeze. However, we would also argue strongly that competition law provides a superior basis on which to assess whether such a margin squeeze existed.

20. Both copper and fibre-based broadband services are supplied in a range of differentiated and mainly bundled propositions by retail market players serving customer demand across a range of different downstream product markets - e.g. propositions vary by: headline upload/download speeds; usage limits; inclusive public WiFi access; inclusive calls; ability to access to a variety of inclusive, premium bolt-on and on-demand content; inclusion of mobile services; etc. The ability for any CP – including BT – to compete across the full range of propositions is not simply a function of BT's provision of VULA, or even of other BT SMP inputs, but of the terms on which they access a range of other inputs through direct investments or agreements with others. This will include the terms on which they are able to offer other access bottleneck services such as premium TV content (sport, movies, etc) – i.e. areas where we face access problems and where we are the retail market entrant seeking to compete effectively. Indeed, over time, VULA is becoming a smaller and smaller component of the overall cost stack for the retail offering.

21. Proper application of competition law in assessing allegations of exclusionary margin squeeze would require Ofcom to recognise that we are supplying fibre broadband propositions into a competitive and complex set of downstream retail markets. As we said in our response to the July consultation, there is a very real possibility that crudely designed *ex ante* testing of margin will be implemented in a mechanistic and flawed way that is solely focussed "on the numbers" and which fails to recognise the increasingly heterogeneous nature of the range of fibre propositions offered by BT and other competitors. This risk is that such *ex ante* regulation prevents BT from operating commercial strategies which are not, in truth, abusive – i.e. it gives rise to "false positives".

22. We note that TalkTalk[9] dismisses the risk of "false positives" and also cautions Ofcom against adopting a "full effects-based test". TalkTalk essentially argues that such an approach would be "very difficult" to prove, would be time consuming to implement and would not "promote competition". And yet TalkTalk also demands that Ofcom implement *ex ante* testing in a way that covers all bundles, including those with Pay TV content, includes all elements of the bundle and is based on a product-by-product analysis. In introducing *ex ante* testing in such a way TalkTalk then states that there is no need to conduct a specific review of triple play packages. So TalkTalk appears to want to argue that failure of such testing "on the numbers" <u>*infers*</u> harmful effects on competition.

[9] TalkTalk reply, from para 2.36

23. But, from what we understand, TalkTalk appears to support testing "on the numbers" at a granular level of proposition that would, among other things, inflate BT's costs of provision to allow for "slightly smaller scale" and other factors (such as perceived efficacy of BT's advertising relative to others), reduce BT's expected customer life and include specific (though as yet undefined) contributions towards common costs. Under such an approach, provision of a proposition that was incrementally profitable to BT could clearly be prevented because it would be *assumed* that downstream competition would be harmed. There may then be other dynamic arguments to support the provision of individual propositions that may appear incrementally unprofitable on a more static view.

24. Our position is that the more heterogeneous downstream offerings become, the less that can be inferred from any "failure on the numbers" as to whether there is any form of truly exclusionary abuse being undertaken. We also fail to see why the design of any *ex ante* tests should ignore the risk of such "false positives".

25. In this context, it is not clear on what basis Ofcom would seek to place constraints on BT's retail pricing of its propositions which include broadband as just one element of a much more complex offering. At the very least, Ofcom would need to ensure that any such test was able to give full consideration to the likely effects that would arise on competition in any downstream markets of BT's pricing of its retail propositions and only prohibit propositions if it could clearly be shown that there would be an exclusionary anticompetitive effect.

26. This is why we are concerned with any suggestion that Ofcom, on the basis of the upstream SMP analysis alone and without conducting any detailed assessment of the nature and scope of retail level competition in this market review, should implement a very broad approach to "testing VULA margin". Clarity on Ofcom's thinking in this area now is crucial. BT is entitled to know, at the point in time when a condition comes into effect, just what it has to do in order to comply with an SMP condition. This issue cannot and should not be left to be resolved further down the line, after the condition has come into effect, by Ofcom consulting on guidance on how it may interpret the proposed SMP remedy or by Ofcom deciding, in the course of a dispute, how it should assess BT's pricing and hence where the boundaries of acceptable pricing behaviour lie.

27. Clarity is needed not just on the basic concepts for assessing compliance, but also on other specific aspects of how Ofcom would test margin, notably the level of service/proposition aggregation at which margin would be tested, whether/how Ofcom would make adjustments to BT's costs and how Ofcom would consider common cost recovery. These are not trivial issues, and a failure to address them in advance of the obligation coming into effect will mean that the condition does not provide the degree of certainty of obligation that is required from the outset when such onerous financial regulation is being imposed.

**3.4 Response to Question 4.1 of January 2014 consultation**

***Question 4.1****: Do you agree with our proposals for BT to provide information on the VULA margin every six months and on request? Please provide reasons in support of your views.*

28. Given that significant detail around Ofcom's position on *ex ante* VULA margin remains unclear, it is surprising and completely inappropriate for Ofcom to consult on a proposal to require BT to provide information every six months to "monitor compliance". The provision of such information cannot be assessed in isolation from how compliance would ultimately be considered. – e.g. would we be required to provide information on our provision of the BT Sport channels or other services unrelated to our SMP in upstream markets? It is insufficient to simply state that such detail will be decided at a later stage, following discussions with us, as the proposal is to introduce this specific SMP remedy now.

29. We set out below why implementing the proposed additional SMP remedy at this stage would be inconsistent with Ofcom's powers and why Ofcom should therefore conclude its assessment of how it would assess VULA margin in a manner proportionate and consistent with the SMP framework before considering what information might be provided to support compliance.

30. However, on a more general point of principle, we are concerned that Ofcom considers it appropriate for us to provide detailed information as a matter of routine. Such an approach would place an additional regulatory burden on us to effectively demonstrate compliance even where no evidence to the contrary has been put forward. We fully understand the need to ensure compliance with the regulatory rules in place, but sees no benefit in proactively supplying retail information of the type proposed to Ofcom on a regular basis. Ofcom is unlikely to fetter its discretion by agreeing that evidence in relation to retail prices and performance "proves" compliance with the obligation to price the upstream access product VULA on fair and reasonable terms at any six month juncture, and CPs could still raise disputes that we were non-compliant. Our general position is that it is always more appropriate for a formal request for the submission of retail information to be triggered by the identification of a specific concern, duly evidenced, about BT's retail pricing behaviour. In those circumstances, Ofcom should consider first whether it is more appropriate to use competition or regulatory powers and, if it considers that the complaint passes the relevant test, open the type of investigation that it considers most appropriate in the circumstances and make its request for retail information in the course of that investigation.

***Ofcom's powers:***

31. Ofcom's power to impose SMP conditions stems from the EU Common Regulatory Framework ("the CRF"), in particular the Access Directive.[10] The relevant CRF provisions were implemented in the UK by the Communications Act 2003 ("the Act"). The relevant provisions are set out below, followed by our an analysis of them which supports our contention that it would be premature to impose a reporting obligation on BT without knowing what the obligation is that the reporting requirement is there to police.

***The Access Directive:***

32. The Access Directive provides for NRAs' power to impose SMP conditions, including to ensure SMP operators do not engage in a margin squeeze, however, this power is limited to:

    - Cases where the analysis reveals inefficient competition on a market; and

[10] Directive 2002/19/EC of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (the Access Directive), OJEC L108/7, 24.4.2002.

- The imposition of "appropriate" obligations "based on the nature of the problem identified, proportionate and justified in the light of the objectives".

33. Recital (20) of the Access Directive provides that: (emphasis added)

*"Price control may be necessary **when market analysis in a particular market reveals inefficient competition.** The regulatory intervention may be relatively light, such as an obligation that prices for carrier selection are* reasonable as laid down in Directive 97/33/EC, *or much heavier such as an obligation that prices are cost oriented to provide full justification for those prices **where competition is not sufficiently strong** to prevent excessive pricing. In particular, operators with significant market power **should avoid a price squeeze** whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services **is not adequate to ensure sustainable competition**...*"

*34.* Article 8 of the Access Directive provides: (emphasis added)

*"2. Where an operator is designated as having significant market power as a result of a market analysis carried out in accordance with Article 16 of Directive 2002/21/EC (Framework Directive), national regulatory authorities shall impose the obligations set out in Articles 9 to 13 of this Directive as appropriate.*

*…*

*"4. Obligations imposed in accordance with this Article shall be **based on the nature of the problem identified, proportionate and justified in the light of the objectives** laid down in Article 8 of Directive 2002/21/EC (Framework Directive). Such obligations **shall only be imposed following consultation** in accordance with Articles 6 and 7 of that Directive."*

35. Article 13(1) of the Access Directive provides: (emphasis added)
*"A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations relating to cost recovery and price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access, in situations **where a market analysis indicates that a lack of effective competition** means that the operator concerned might sustain prices at an excessively high level, **or apply a price squeeze**, to the detriment of end-users...."*

***Commission Recommendation on Consistent non-discrimination obligations and costing methodologies:***

36. In September 2013, the European Commission adopted its Recommendation on "Consistent non- discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment"[11] ("the Recommendation"), which was still a draft when Ofcom published its first FAMR Consultation on 3 July 2013.

[11] Commission Recommendation of 11 September 2013 (OJEC L251/13 of 21.9.2013): http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:251:0013:0032:En:PDF

37. The Recommendation provides that if various conditions are met - including an EOI obligation, an "economic replicability" and a "technical replicability" tests - an NRA should not impose a wholesale price control obligation on wholesale NGA inputs.[12]

38. In its first FAMR Consultation[13], Ofcom considered that Options 1 and 2 (Option 2 being the one currently proposed) most closely aligned with the Recommendation.

39. Annex II of the Recommendation sets out the parameters of the *ex-ante* economic replicability test.

***Limitation on The Exercise of Ofcom's Power:***

40. As it acknowledges in the Consultation Document,[14] Ofcom's power is limited or restrained, specifically:
    - s.47(2) and 49(2) of the Act, provide that SMP conditions and Directions must be: (emphasis added)

      *"(a)* ***objectively justifiable*** *in relation to the networks, services, facilities, apparatus or directories to which it relates;*

      *(b)* ***not such as to discriminate unduly*** *against particular persons or against a particular description of persons;*

      *(c)* ***proportionate*** *to what the condition or modification is intended to achieve; and*

      *(d ) in relation to what it is intended to achieve,* ***transparent****"*
    - s.88 (1) of the Act, provides that SMP conditions under s.87(9) must only be imposed where: (emphasis added)

      *"(a) it appears to them from the market analysis carried out for the purpose of setting that condition that there is a* ***relevant risk of adverse effects arising from price distortion;*** *and*

      *(b) it also appears to them that the setting of the condition is appropriate for the purposes of— .*

      *(i) promoting* ***efficiency;***

      *(ii) promoting* ***sustainable competition;*** *and*

      *(iii) conferring the* ***greatest possible benefits on the end-users*** *of public electronic communications services*
    - when imposing SMP Directions, Ofcom needs to consider its general duties under Sections 3, 4 and 4A of the Act.

***Consistency of proposals with Ofcom's powers:***

[12] Paragraphs 48 and 49 of the Recommendation.
[13] Paragraphs 11.217-11.223, 11.457-468, in particular 11.458.
[14] At paragraphs 4.9-4.15 of the Consultation Document.

41. We consider that Ofcom's proposal in relation to the provision of additional information on VULA margins every six months, does not meet the above limitations on the exercise of Ofcom's power. In particular, we consider that Ofcom's proposal is premature, disproportionate and objectively unjustifiable.

42. In line with Article 8(4) of the Access Directive, implemented by Article 47(2) of the Act, SMP remedies:

    *"shall be based on the nature of the problem identified, proportionate and justified in the light of the objectives laid down in Article 8 of Directive 2002/21/EC (Framework Directive)".*

    Such obligations shall only be imposed following consultation in accordance with Articles 6 and 7 of that Directive."

43. Ofcom is, therefore, required to first identify the problem which the SMP remedy is intended to address, and only then impose an SMP remedy (from the available catalogue), proportionate to the problem identified.

44. As Ofcom has not clearly and sufficiently identified the issue it is attempting to resolve in the superfast broadband market, nor how its interpretation of the VULA condition will in practice be used to address that issue, we consider Ofcom's exercise of its power does not meet the proportionality requirement set out in the CRF and the Act.

38. In our view, Ofcom first needs to identify the concern it is attempting to address, that is, what behaviour will be considered not to be compliant with the requirement for VULA to be offered on fair and reasonable terms, and only then consider whether it is appropriate to impose an additional remedy proportionate to the concern identified and the behaviour that it is intended to prevent.

39. In light of this, Ofcom should not amend the SMP condition as part of the current review, and should wait until it has properly identified the issue which needs addressing.

**Section 4: Avoiding further market distortions by aligning Price and Cost Differentials**

This section provides BT's response to Question 8.1 of the December 2013 Ofcom consultation.

**Question 8.1**: Do you agree with our proposal to set the main rental charges such that the differential in charges between WLR+SMPF and MPF is equal to £10 by 2016/17, rather than moving more rapidly to reflect our now lower estimate of the LRIC differential of £0 to £4? Please provide reasoning and information to support your response to this question.

**Summary**

1. Ofcom's proposal is to set the main rental charges such that the differential in charges between WLR+SMPF and MPF (the "Price Differential") is equal to £10 by 2016/17, and not to reflect the new estimate of the LRIC differential between these products (the "LRIC Differential") of £0 to £4. In Question 8.1 Ofcom asks stakeholders if they agree with this approach and to provide reasoning and information in support of any response.

2. There are no impediments to Ofcom moving to the cost-based differential in 2016/17, if not before, and thus bringing to an end this market distortion. BT therefore considers that Ofcom ought to reflect its best estimate of the LRIC differential by the end of the controls under consultation (and that this is circa £2). Our central reason is that the supposition advanced by Ofcom that such a smaller Price Differential may undermine future investment to any material degree is unsupported by any evidence and is simply not credible, as the analysis we provide below demonstrates. In contrast, perpetuating a non-cost based Price Differential is inconsistent with productive efficiency, distorts competition and impedes 'competition on the merits' which the market now requires in order to operate effectively.

3. We have provided a detailed answer to this question in view of the significance of Ofcom's proposal for the efficient operation of the market and its distortive impact on competition. We also asked Plum Consulting to review the proposal and their Report is attached as an Annex to this Response.

4. The analysis set out below shows:

- that regulatory stability cannot be equated with the rigid application of prices or price trends established in previous market reviews and charge controls, particularly in the face of significant and relevant new information;
- Ofcom's refusal to take into account such significant relevant new information (ie the new estimate of the cost differential) produces an outcome that is illogical and inefficient even on Ofcom's own terms. The effect of Ofcom's proposals is:
    - to reverse its own moves towards greater cost causality, a central feature of its framework for assessing cost recovery under charge controls;
    - to overlook altogether the fact that Ofcom itself has changed the specification of the products involved with inevitable impacts on the differential even without its own

moves towards greater cost causality - comparing LRIC Differentials on a consistent basis results in a much less "significant" fall in the estimate than alleged by Ofcom; and

  - to lead Ofcom to create significant economic inefficiencies, and to hamper effective competition contrary to its duties.

- Ofcom's assertion that this is necessary in order to avoid "undermining investment" is completely unsubstantiated. In any event, the scale of the proposed intervention by Ofcom dwarfs any possible effects on recent investments and is therefore disproportionate.
- Finally, taken in the round, the Price Differential is not needed to subsidise Sky and TalkTalk which are both established and profitable suppliers more than able to pay cost-based charges for their inputs.

5. We have attached Plum Consulting's review of the public policy case for maintaining an artificial differential as an Annex to this response. Plum finds that:
   - The impact of the cross subsidy of MPF purchasers by WLR and SMPF purchasers is calculated at around £600m since 2005. Retaining the differential as proposed by Ofcom would increase this by an estimated further 59%, and bring the extent of the cumulative total market distortion to around £1 billion.
   - The objectives of the 2005 Telecoms Strategic Review ("TSR") have clearly been achieved, and no further market distortion is needed for established, scale operators. Plum believes Ofcom should consider an immediate reduction to bring the price differential into line with costs at the start of the next charge control, i.e. in 2014/15.
   - The objective of the TSR to promote copper-based access competition has since been overtaken by a revised priority to encourage investment and innovation in fibre-based access services, so the original 2005 justification for the subsidy should have less weight.
   - Plum suggest that one option could be to phase out the differential over three years by applying it only to MPF lines purchased under *past* regulation, and not to begin to subsidise those installed after 2013/14. After this three-year period, there should be no more assistance for MPF-based suppliers (i.e. TalkTalk and Sky), and competition should be entirely undistorted.

**4.1 Regulatory stability**

6. BT accepts that Ofcom should seek to provide a stable and predictable regulatory environment. However, we do not consider that in this case such an objective justifies the rate of change proposed by Ofcom, whereby a Price Differential of £10 is maintained by the end of the control period.

7. The rate of reduction of the Price Differential is manifestly too slow. In the last two years of the control period, the Price Differential is reducing by circa £1.50 only a year. Given a LRIC Differential of about £2, at the proposed rate of decline it would not be until after the control *after next* (ie that in place between 2021/2 to 2024/5) that a cost-based Price Differential would

be established.[15] There is no justification for a distortion remaining in place until the early-mid 2020s, which would be nearly 20 years since the Price Differential was introduced in 2005.

8. Each and every regulatory decision ought to be considered fully on its merits, with regard to the underlying (stable) economic principles. This may mean that Ofcom considers it necessary to depart from previously established positions with which it might otherwise be expected to continue. Indeed, Ofcom often seeks to make "one-off" adjustments like (i) the exclusion from WLR of the cost of providing printed telephone directories and (ii) the removal of evoTAM costs entirely from SMPF in the current consultation. Neither of these adjustments could reasonably have been anticipated by Openreach (or indeed other stakeholders) based on the position established by Ofcom at the conclusion of the previous relevant consultation. However, in contrast to its proposed approach to the Price Differential, Ofcom does not appear to consider expectations relevant in the context of these adjustments. Indeed, Ofcom's approach to regulatory stability and predictability appears quite unbalanced and inconsistent.

9. Further, were regulation always to follow the "expectation shareholders may have reasonably had based on past regulatory decisions",[16] then the information and evidence gathered in new consultations would be redundant whenever this deviated from such prior expectations. Clearly, this would be unsatisfactory in the extreme. New information must be a relevant consideration as to the appropriateness of continuing past regulatory decisions, especially when the new information indicates a significant change in a presumption behind the original decision.

10. Indeed we note that, in another context, TalkTalk also rejects "absolute regulatory stability" and a rigid pre-committed regulatory approach (that is, regulating exactly on the basis set out at a previous time) in favour of decisions being taken in a consistent and transparent manner, and based on the available evidence (which implicitly is that which is up to date).[17]

11. BT does not dispute that Ofcom's Statements have an important role to play in providing a basis for stakeholders to understand how Ofcom will act in periods beyond that actually under review (in this case, the period under review in the previous Statement cited by Ofcom was that to 2013/14). Ofcom's Statements can only, however, provide an indication of its likely behaviour based on what it knew at that time. It is clearly legitimate to ask whether the original position established should be maintained in the light of market developments and the new and better information which has subsequently become available. BT considers there is no unpredictably about such an approach.

12. The Price Differential shifts many tens of millions of pounds between different competitors in any year, with TalkTalk and Sky being the overwhelming beneficiaries, and distorts competition in a number of downstream markets. The amounts involved are such that a few sentences

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[15] £10 minus £2 = £8 which divided by £1.50 = 5-6 years after 2016/17, ie 2022/23.
[16] The consultation, paragraph 8.55
[17] *"Rather, we believe that there should be regulatory predictability, in that all parties (both third parties and CPs) can reasonably anticipate Ofcom's decisions on the basis of publicly available information, and that Ofcom takes evidence-based decisions in a consistent and transparent manner. In our view this is different from absolute regulatory certainty, which would lead to an inflexible approach and poor decisions being made, as Ofcom would pre-commit to certain regulatory approaches."* TalkTalk reply to BT's FAMR response, 11 December 2013, paragraph 2.26.

hypothesising that incorporating the new information might create regulatory instability and uncertainty, and thereby might harm investment (presumably mainly by MPF-based providers who are the beneficiaries), are wholly inadequate.

13. Regulatory stability and predictability cannot therefore simply be equated with not changing indicative prices (or price differentials) published earlier. Stability is about consistency in regulatory approach and thus the collection of facts and data; the analysis of that data and then the use of the analysis to make objective decisions – the very reasons that Ofcom describes itself as an *evidence-based regulator*. All the facts justify a revision to the actual differential, in particular:

    - a cost-based differential promotes productive efficiency and competition on the merits;
    - MPF-based suppliers are established at scale, as Ofcom recognises, and in good commercial health which would not be significantly undermined by slightly higher relative prices for MPF services ; and
    - hypothesised losses on recent investments from reducing the differential are likely to be very small relative to the intervention proposed (as we show below).

**4.2 Maintaining a price differential is illogical and inefficient**

14. In the current case, disregarding new evidence as to the correct level of the LRIC differential leads Ofcom to create significant economic inefficiencies, to fall foul of its own framework for cost recovery and to hamper effective competition contrary to its statutory duties.

4.2.1 Cost recovery and causality

15. In this consultation Ofcom makes a number of changes in estimating the exact costs caused in the provision of different services. Having carried out such analysis, Ofcom the rejects the very implications of the whole exercise, with the implications we explain below.

16. From Table 8.2 of the consultation one can derive that (on a CCA FAC basis, in 2016/17 nominal prices):

    - the DSLAM cost reallocation decreases the LRIC Differential by £0.66p;
    - the TAMs and evoTAMs adjustment decrease the LRIC Differential by £4.21; and
    - faults and service level cost changes decrease the LRIC Differential by £1.49.

    These three adjustments come to a total decrease in the LRIC Differential of £6.36.

17. The CCA FAC cost based differential between MPF and WLR plus SMPF is estimated in the same Table at £3.72.[18] Given that the proposed price differential is £10, this means that an extra £6.28 [£10 less £3.72] has to be added to (or subtracted from) costs to artificially inflate the price differential to £10.

[18] At "Other corrections", differential is £94.06 *less* £90.34 equals £3.72.

18. It can therefore be seen that what has been derived as the decrease in the cost differential (£6.36) from the three adjustments justified in the consultation and what needs to be "added back" for the proposed Price Differential (£6.28) are very similar amounts. The proposed Price Differential effectively "writes out" the effect of the very changes which the consultation is concerned to address in Sections 4, 5 and (for DSLAM costs) part of Section 7. What was discovered by Ofcom in these Sections of the consultation is negated by the proposed transition path in the very same consultation.

19. Thus, although Ofcom purports to make these three adjustments in order to arrive at a more cost causal allocation and recovery of costs under the charge controls, this is completely undermined by its subsequent imposition of the Price Differential. The *effect* of the proposal is (in part) to re-inflate the price of SMPF, which Ofcom is elsewhere proposing to decrease in order to ensure that SMPF purchasers were not contributing to the cost of EvoTAMs which SMPF does not cause. That is, the effect of the proposal is in some ways as if SMPF purchasers continued to contribute to the cost of EvoTAMs. Furthermore, the increase in the assessed costs for faults and service levels have also been implicitly transferred to SMPF-based suppliers, thus undoing the very outcome of the exercise. As a result, the price of SMPF (reflecting the 85% margin) is being required to cover costs for which SMPF-based suppliers have no responsibility.

20. Thus, the effect of Ofcom's proposal is to undermine cost causality, one of the key principles in Ofcom's own framework for assessing cost recovery, and one to which it devotes significant attention in other parts of the consultation. This is simply illogical and plainly inconsistent regulation.

4.2.2 Productive efficiency and effective competition

21. The situation regarding the optimal price differential, rather than the pace at which this is achieved, is we believe now clear as it has been set out by Ofcom a number of times since 2009 and was confirmed by the Competition Commission in its final determination of the 2012 WLR and LLU Charge Control Statement (the "Final Determination")[19]. In its Final Determination, when considering the question of the Price Differential in the context of the TAM price adjustment, the Competition Commission noted that:

    *"Productive efficiency reductions from the Price Adjustment. Ofcom said that from this perspective, the price differential between MPF and WLR+SMPF should be equal to the LRIC differential between them. This implies that the most productively efficient course is to remove the Price Adjustment. We think all parties would agree with this view."*[20]

22. Ofcom has explained the underlying logic of this position, stating:

    *"We consider that setting the charge difference between MPF and WLR/WLR+SMPF equal to the difference in LRIC will promote productive efficiency. This is because the MPF and WLR/WLR+SMPF wholesale products are alternative inputs for the same retail services -*

[19] Competition Commission, Case Case1192/3/3/12 and 1193/3/3/12, Determinations, 2013
[20] CC Final Determination, paragraph 7.128(b).

*broadband and voice services sold to end consumers. Setting the charge differential to be equal to the LRIC differential should induce an efficient choice of wholesale inputs, and so help to minimise overall resource costs."*[21]

and:

*"…charge differentials based on the absolute LRIC differentials <u>will tend to promote efficient future investment choices</u>. This would mean that charge differentials based on LRIC would provide a level playing field between competitors using different wholesale inputs, or 'competition on the merits' as EE puts it."*[22]

23. Ofcom's current proposal gives rise to economic and competitive distortions because one set of inputs is being required to continue to contribute proportionately more to overall cost recovery than another, disadvantaging suppliers which rely on those inputs.[23] Ofcom acknowledges these efficiency distortions and has been signalling its intention to bring prices into line with the LRIC Differential since 2009.[24]

24. Nor is the competitive distortion restricted to the downstream retail market for voice and broadband services:

    - First, a subsidised price for MPF will distort competition in the provision of fibre services, which is provided either via MPF or WLR. If MPF is subsidised, then this gives a competitive advantage to MPF providers in the provision of fibre, distorting competition as a result. Whilst recognising the increasing use of MPF for fibre, Ofcom ignores completely the competitive implications of its own point – whilst the use of MPF for fibre is "becoming more important", the importance of fibre competition is not considered further.[25]

    - Second, the Price Differential also causes significant distortion in the supply of bitstream services and managed network services at the wholesale level, where WLR and SMPF-based suppliers have to factor in higher input costs than those using MPF. Wholesale customers commonly purchase calls, lines and broadband services together, and competition is fierce for a small number of high value bespoke managed deals. In such circumstances, the cost advantage afforded to MPF players in terms of lower input prices is likely to result in a detrimental impact in the downstream (and competitive) bitstream market. This again points to a fundamental need to remove the non-cost based difference between inputs which are used to meet the same downstream requirement.

[21] The consultation, paragraph 8.33
[22] The consultation, paragraph 8.47
[23] As can be seen from Table 8.2 of the consultation, this is the result of the proposed transitional path to £10. The cost of SMPF is calculated as £3.77 but the price is £7.00 - a mark-up above cost of £3.33, or 85%, which is being imposed on all WLR providers who offer broadband. In contrast, a competitor using MPF benefits from a "negative mark-up" on estimated costs (of £3).
[24] A4.106 and A4.107, A new pricing framework for Openreach, Ofcom statement, 22 May 2009.
[25] Ofcom itself notes in 7.63 of the consultation that, "it is becoming more prevalent for MPF to be used to provide voice services, with the broadband being provided via FTTC. This may make the differential between WLR and MPF charges more important than it has been in the past."

4.2.3 Productive efficiency and investment

25. There is a further point regarding the setting of charges which do not provide for productive efficiency – they can cause inefficient investment. Thus, we note Ofcom's recognition made in 2012 that (emphasis added):

    *"TalkTalk's approach would lead to a price differential between MPF and WLR/WLR+SMPF that would be considerably greater than it would otherwise be. It would be significantly above the actual LRIC that Openreach would be incurring in providing WLR compared to MPF, and above what the LRIC would be when based on a correctly applied MEA methodology. This could lead to inefficient investment and switching to MPF."*[26]

26. Ofcom further recognises in the current consultation that a price differential between potentially substitute services that does not reflect their cost differential has the potential to drive "inefficient behaviour".[27] Clearly, then, the proposed £10 Price Differential carries this risk in, the form of the unbundling of ever smaller exchanges for which the upfront capital cost is only recovered because of the tilting of relative prices towards the use of MPF rather than WLR.

4.2.4 Allocative efficiency

27. For completeness, we also note that the cost-based differential is likely to be consistent with allocative efficiency, which is generally achieved when prices reflect marginal costs (where marginal costs may be defined as long run incremental costs). As Ofcom notes, the suggestion that the fixed and common costs which need to be added to marginal costs should be allocated on the basis of demand elasticity can be rejected in this case as Ofcom recognises a lack of evidence regarding the required relative price elasticity of broadband over voice.[28]

28. Further, it is also Ofcom's view that they consider that productive efficiency is likely to be a much more important consideration than allocative efficiency in the present context.[29]

29. For what we might term 'static efficiency' the clear implication is therefore that the price differential should reflect the cost differential. In BT's view, Ofcom has not adequately explained why regulated prices should be the cause of static inefficiency more than ten years after the distortion was first introduced, and we address this issue below.

**4.3 Moving to the LRIC Differential by 2016/17 will not discourage efficient investment**

30. In paragraph 8.63 of the consultation, Ofcom explains that, "some aspects of dynamic efficiency point to a more gradual change" (than entailed by moving to the optimal differential by

[26] Ofcom Statement, 7 March 2012, paragraph 7.110
[27] The consultation, footnote 22
[28] The consultation, paragraph 8.39, *"We do not consider that the responses by Sky, TalkTalk or Frontier Economics provide any evidence that the elasticity of voice is lower than for voice and broadband. For example, we do not consider that it follows from voice penetration being higher than fixed broadband penetration that voice only consumers have a lower elasticity."*
[29] The consultation, paragraph 8.41.

2016/17). In particular, Ofcom explains that the LRIC differential is now significantly lower than previously estimated; and that moving from the current price to this latest estimate in the three years of the control could discourage investment in the future by undermining the profitability of recent investments.

31. This supposition is evaluated below, where we consider both more recent investments (to which Ofcom has specific concern[30]) and MPF-based operators generally (ie the totality of their businesses). We base the various impacts using the charges shown by Ofcom in Table 8.4 of the Consultation where, for example, MPF is £3.33 cheaper after the differential is imposed; and WLR+SMPF is £2.95 more expensive.[31]

32. We note first that in referencing the LRIC differential as estimated by Ofcom in March 2012, and comparing this with the current estimate, Ofcom is not comparing like with like. WLR no longer includes provision of a printed Phone Directory and this change in the specification of the product is effectively responsible for a reduction in the cost differential of £2.23. Second, the SMPF product no longer includes the cost of the testing functionality provided by evoTAMs, change which reduces the cost differential by £0.86.[32] (In both cases, these costs have to be met by WLR-based suppliers in addition to the proposed WLR and SMP charges under the price control.) Thus, over £3 per line of the reduction in the cost differential simply follows from Ofcom's changes to the definition of the products (and their costs) themselves.

33. Ofcom makes no recognition that some of the reduction in the LRIC Differential is caused by this product re-specification, something which should clearly be considered when it remarks on the extent of the change in the LRIC Differential. It is plainly inconsistent to make such changes to the product definitions, but then to disregard this for the purposes of comparing current and historic estimates of the LRIC Differentials. Comparing LRIC Differentials on a consistent basis (i.e. in line with Ofcom's new product specifications) results in a much less "significant" fall in the estimate than alleged by Ofcom.

4.3.1 Profitability of investment in exchanges since March 2012

34. Ofcom states that:

> *"we are concerned that MPF operators will have continued to make investments in their networks and in unbundling new exchanges on the basis of the March 2012 Statement* [where the differential was estimated to be £10 to £14 in 2013/14]. *If our actions were to undermine the profitability of these investments, it could undermine regulatory certainty."*[33]

35. However, Ofcom provides no quantification of MPF-based investments in unbundling new exchanges, "made on the basis of the March 2012 Statement", or of the extent to which a cost-based differential gradually introduced by 2016/17 would significantly undermine the profitability of these investments. The analysis of this concern we provide below suggests that

[30] The consultation, paragraph 8.63.2
[31] "LRIC differential at £10" compared to "Other corrections".
[32] Both Directory and evoTAM cost impacts taken from the Ofcom model.
[33] The consultation, paragraph 8.63.2

the amounts involved cannot be large relative to the distortions involved, and that giving primacy to this concern is disproportionate.

36. The number of exchanges unbundled by the largest two MPF-based suppliers, namely Sky and TalkTalk[34], during the period in question can be estimated from public documents. From these we estimate that, for each supplier, the approximate number is circa 500 exchanges over the period between April 2012 and up to March 2014.[35] The capital cost involved is likely to be on average around £60,000 per exchange per operator, implying that the total investment is in the order of £60m.[36] These investments, we accept, effectively represent sunk costs[37] that would not be recoverable on exit.

37. Ofcom does not contend, however, that exit from all these exchanges would follow from moving to a cost-based differential in 2016/17 (or that they would be loss-making). Ofcom's suggestion is a far milder one – that the profitability of these investments *"might be undermined"*. Ofcom, however, gives no suggestion as to how this has been, or might be, assessed and nor is any range provided for the size of the possible impacts involved. <u>There is simply no analysis in the consultation providing substantiation on this central point, which Ofcom considers outweighs the productive and allocative inefficiencies that follow from its proposal</u>.

38. We assume Ofcom's concern is that profitability is undermined to such an extent that investment mistakes were made i.e. some unprofitable investments were made that should not have been. This seems to be the thrust of Ofcom's reference to sunk costs in the consultation as such costs cannot be recovered on market exit e.g. in the event of a retrenchment in the extent of unbundling.[38]

39. In BT's view it is conceivable that some of the £60m investment could, as a result of the lower Price Differential, become unprofitable when it would have been profitable under a £10 Price Differential.[39] That is, a *proportion* of the £60m one-off investment might be "undermined" due to the imposition of a cost-based differential in 2016/17. However, this proportion seems unlikely to be very large, for a number of reasons.

[34] TalkTalk and Sky together account for approximately 95% of all MPF lines sold by Openreach (estimate derived from public sources).
[35] Estimates derived by BT from Sky and TalkTalk Annual Reports and Investor Presentations since March 2012.
[36] BT estimate of the cost of DSLAMs, MPF migration costs, Line Cards, backhaul connection charges and co-location space provisioning per operator per exchange, based on a 25% market share.
[37] The consultation, paragraph 8.63.3
[38] Ofcom's concern cannot simply be that what was expected to be profitable is simply marginally less profitable but profitable nonetheless. Such a change would obviously follow from the removal of a distortion in a supplier's favour and, if this were Ofcom's concern, it would imply that an adverse effect (no matter how small) on a party is reason enough to maintain a distortion indefinitely. Regulation on such a basis – that a party must never be made worse off - could not possibly lead to proportionate regulation when other factors need to be part of a balanced consideration.
[39] We assume Ofcom's concern is that profitability is undermined to such an extent that investment mistakes were made in the sense that investments went ahead that should not have done, ie some unprofitable investments were made, this being the point of mentioning sunk costs in paragraph 8.63.3. Ofcom's concern is not, we assume, simply that what was expected to be profitable is simply less profitable (but profitable nonetheless), as such a change cannot possibly be thought to have a deleterious effect on investment incentives.

- First, the average annual cost of providing a broadband line using MPF and the broadband network elements is circa £200 a year per user, implying a £3[40] price increase in the annual rental charge for MPF would add only 1% to 2% to annual cost. The average network cost in providing a broadband line using WLR+SMPF and BT's IPStream broadband backhaul service is circa £275 per year per user, so a £3 price increase to MPF implied by the cost-based differential would not close the cost advantage to MPF-based suppliers by anything other than a very small amount.[41,42] (To give some perspective, TalkTalk advertises that customers can save £190 a year by switching from BT.[43])

- Second, Ofcom is seeking to keep "stable" what it can control – the differential between regulated inputs, but suppliers' expectations of profitability will not be exactly realised for many reasons besides changes in Ofcom's understanding of costs. For the reasons given in the next paragraph, we think that the business case for unbundling is likely to have improved since some of the investments were made over the period in question and thus, e*ven if* the lower differential reduces profitability to some degree, other factors have moved to improve it. CPs will therefore not be "net losers" compared to where they expected to be when they made their investments, and they are unlikely to have lost money in unbundling the more recent exchanges.

40. As mentioned above, profitability is likely to have improved against reasonable expectations[44] for a number of reasons, including that (i) the broadband market has continued to grow despite the recession, to reach 22.5m lines as of September 2013 [45]; (ii) backhaul prices from Openreach will decrease by 30% between 2013/14 and 2016/17 as result of the AISBO price control which started in April 2013;[46] and (iii) ARPUs for MPF-based providers have been increasing.[47]

41. The considerations highlighted above do not suggest that much of the circa £60m, if any, would be made unprofitable by a cost-based Price Differential in 2061/17. While BT does not have the necessary information to assess what precise proportion of exchanges would become unprofitable and by how much, the illustration below shows how unlikely this is to be material.

42. Suppose that one in five of the unbundled exchanges earns no revenue as a result of the lower cost-based price differential (that is, they are unbundled, and customers are migrated to MPF but then all of them are lost to WLR-based suppliers) but the other 80% of exchanges are

[40] We use £3 here on the basis that Table 8.4 of the consultation shows MPF would be £3.33 higher under cost-based prices.
[41] £200 being the MPF rental of circa £85 plus £100 for broadband network costs for these newer / smaller exchanges estimated from a component-based BT model using publically available information eg Openreach EAD charges. £275 being WLR and SMPF rental of £105 plus IPStream user charge of circa £15 per month (£180 a year). We assume no difference in voice costs and these are therefore excluded from the comparison.
[42] Even if the offsetting reduction in WLR charges was factored in, there is no change to the basic position.
[43] TalkTalk Marketing literature, January 2014.
[44] Of course, expectations cannot ever be known for certain, and this is one problem with regulating on this basis in that it must start from an uncertain position.
[45] Enders Analysis, Market trends and outlook, Q3 2013.
[46] The price control on Ethernet services announced by Ofcom on 28th March 2013 is for 11.5% pa reductions in real terms, for three years. The control runs from 1 April 2013 to 31 March 2017.
[47] TalkTalk and Sky Results, eg TalkTalk Interim Results, 12 November 2013

unaffected. This is equivalent to assuming a 20% loss of anticipated customers spread over all these exchanges, which will all see some decline in their profitability.

43. On this basis, we can therefore arrive at a very approximate estimate of the potential adverse impact on CPs who, under Ofcom's supposition, invested in new exchanges, when they would not otherwise have done so had they known the cost differential was much smaller. This is in the order to £60m *times* 20% = £12m. (This £12m may alternatively be viewed as the decrease in net earnings on these 1,000 exchanges, consistent with a 20 percentage point reduction in market share.)

44. In contrast, the £3.33 direct subsidy on below-cost MPF lines to Sky and TalkTalk is worth about £30m in one year alone (and about £80m in the 3 years to 2016/7). BT believes this underlines the extent to which the concern about "undermined profitability" and its remedy (keeping the distortion based on a £10 Price Differential) are disproportionate, even putting aside all the efficiency reasons in favour of moving to a cost-based Price Differential.

45. Such a calculation also shows that even if all the post-March 2012 investment was <u>entirely</u> mistaken – that there were no MPF customers on any of these newly unbundled exchanges – the subsidy paid to Sky and TalkTalk in three years of the control (and not even considering any subsidy paid from 2017/18 onwards) would still be *greater* than their investment losses.

46. BT appreciates that this estimate is illustrative and broad-brush. However, in contrast, Ofcom has provided no substantiation or quantification at all, their only basis being that the lower cost-based Price Differential *might* impact on profitability and that it if did, then this *might* impact on regulatory certainty to such an extent that future investments are not made. To have such an effect, ie to impact materially on willingness to invest in the future, the impact on profitability must be significant.

47. This is doubly so if the effect is to be felt more widely beyond the directly affected CPs as suggested by Ofcom.[48] The suggestion that, in reflecting costs in its charges and without this materially affecting the two key parties, Ofcom would push UK investors to decide "in general" that the UK market is so beset with regulatory instability that it is too risky to make efficient investments is one which simply lacks any credibility.

48. Ofcom simply cannot rely on its argument that moving to a cost-based Price Differential by 2016/17 would discourage investment in the future without providing some substantiation of this e.g. that CPs invested on the basis of the £10-£14 differential, including how much was invested and what commercial losses might follow as a result of the updated view of the differential.

49. Even to the extent that this concern could be shown to be material, Ofcom would still have to take the other side of this coin into account i.e. if there is a *material* concern about the impact on the profitability of recent past investment, then there must also be a corresponding *material* concern about perpetuating the distortion in future. To the extent that our assumed 20% loss of

[48] The consultation, paragraph 8.63.2

investment is deemed to be too low, and the effect much larger, then this must imply that the non-cost based price differential has caused significant inefficient investment, and hence resource misallocation (in that exchanges have been unbundled only on the basis of distorted wholesale prices and are otherwise unprofitable). If it is the case that the 20% ought to be higher, then it must also follow that maintaining the differential for what appears to be at least six more years would lead to *more* inefficient investment in further unbundling of ever smaller exchanges. Ofcom has said it has been concerned about this risk since 2009, it plainly cannot ignore the risk if it has been shown to have materialised.

4.3.2 Profitability of investment *before* March 2012

50. Besides the impact on newly-unbundled (and generally smaller) exchanges, it might be argued that the introduction of a cost-based Price Differential by 2016/17 might undermine MPF-based providers across the whole base of their investments (rather than on their recent, marginal investments which we estimate to have cost in the region of £60m).

51. However, we do not understand this to be the case as Ofcom states that:

*"We consider that the main users of MPF are now established, scale operators, following a number of years during which the differential between WLR/WLR+SMPF and MPF charges has been greater than the LRIC differential. Both Sky and TalkTalk [who have been active since 2005 or 2006] have continued to unbundle ever smaller exchanges, where the business case for doing so is likely to be increasingly marginal. If the business case of using MPF works for these small exchanges, we consider that it is likely to remain profitable for the large majority of the population covered by the MPF footprint, which involves larger exchanges and hence greater benefits from economies of scale."*[49]

52. BT agrees with this assessment. Clearly, losing an artificial advantage will have an impact on those suppliers who were advantaged, but the two main MPF-based providers are well able to absorb a marginal change in their costs.

53. Regarding TalkTalk, following the company's update in November 2013, Enders Analysis noted (emphasis added):[50]

*"The company expressed increased confidence in its future progression by increasing its revenue growth guidance from 2% to 3% for 2013/14 (implying 4% in H2 2013/14) and from 2% to 4% in the medium term."*

*"The company also firmed up a date for hitting its medium term EBITDA margin guidance, guiding to 25% by the 2016/17 financial year, but with nearer term margins still suppressed by extra SACs*." [SACs are Subscriber Acquisition Costs.]

54. Enders also noted that:

[49] The consultation, paragraph 8.46
[50] TalkTalk Group Q2 2013/14 results: Sport-less performance, Enders Analysys, 18 November 2013

*"Pay TV net adds remained strong at 167k, notably higher than BT's 70k in the same period and accelerating slightly from 160k last quarter"*

adding that

"*This is very healthy progress".*

55. This is consistent with TalkTalk's comment that revenue from TV had been higher than its expectations.[51] TalkTalk also adds that it plans to unbundle a further 300 exchanges in FY2014, with, *"potential for more over time as costs per exchange fall and ARPU grows".*[52]

56. This is not to deny that higher MPF charges and potentially keener competition from WLR-based suppliers might not impact TalkTalk's financial performance – this is the very effect of a distortion - the issue is how material this impact is likely to be. In particular, Ofcom's concern with "undermining profitability" might carry some weight were there to be any analysis that supported a view that the lower differential would reduce TalkTalk's IRR (Internal Rate of Return) on its capital investment to a level at or below its cost of capital. Based on TalkTalk's published results, this possibility seems very unlikely.

57. For example, TalkTalk's 2013 Annual Report shows "Underlying EBITDA" of £352m and Operating Profit consistent with this of £246m.[53] This has been earned on "Non current assets" of £1,046m[54], giving an effective pre-tax rate of return on long term assets of <u>23.5%</u> (£246m/£1046m). Excluding "Goodwill" of £479m, from Non current assets, the rate of return becomes (£246m/£567m) = <u>43.3%.</u>

58. An increase of £3 per MPF line would increase TalkTalk's costs by about £9m.[55] The impact on the rate of return is therefore to reduce it by under one percentage point to 22.7% (excluding Goodwill, to 41.8%). There could be a further effect if TalkTalk chooses to keep its price differential against WLR-based suppliers unchanged and the latter pass on the reduction in their wholesale charges – and thus to position itself in the retail market exactly as it has whilst being in receipt of the subsidy. Although this would involve TalkTalk lowering its prices, despite the increase in input charges, their rate of return would still be over 20%[56] (and 40%, excluding Goodwill).

59. To put the amounts into perspective, TalkTalk has issued guidance that it is targeting an EBITDA margin of 25% in FY2017,[57] which implies a further 4% increase in earnings[58] . This equates to

[51] TalkTalk Interim Results, 12th November 2013.
[52] Preliminary Results Presentation, May 2013, Slide 20.
[53] Page 32. Operating profit quoted on this page includes £62m "Investment in TV" which we have added back in to give an Underlying Operating Profit consistent with the Underlying EBITDA quoted by TalkTalk.
[54] TalkTalk's 2013 Annual Report Page 74.
[55] Based on TalkTalk purchasing 3 million more MPF lines than WLR/SMPF (TalkTalk gains from lower costs for each WLR/SMPF line it takes, so only the net number of lines has a financial consequence.) £246m less £9m = £237m, which is 22.7% of Non-current assets.
[56] The price reduction for WLR+SMPF is £97.01 minus £94.06 [from Table 8.4] = £2.95 per lines, which on 4million lines is £12m. £237m less £12m = £22.5m, which is 21.5% of Non-current assets.
[57] Interim Results, 12th November 2013.
[58] Underlying EBITDA in FY13 was 21%.

about an increase in cash generation from FY2013 to FY2017 of £65m-£70m.[59] TalkTalk could therefore cover the maximum possible effect of a cost-based differential (paying more for MPF but having lower retail prices to maintain its competitive positioning in the manner described in the previous paragraph) with less than one third of the increase in cash generation by the end of the control period in question.

60. We note further that TalkTalk has been making Net (post-tax) profits of circa 10.6% of Non-current assets over the last five years. [60] The 2013 results – nor the projected increase up to FY2017 - do not represent a return after many years of heavy net investment (or unrecovered "costs of entry"). There is therefore no case that high returns are needed over the period 2014/15 onwards to recover start-up/entry costs.

61. On Sky, Analysys Mason have recently commented that:

*"Since launching fixed broadband and voice services in 2006, it has been very successful at upgrading its pay-TV base onto triple-play tariffs, and had 5.0 million users by 3Q 2013*." [61]

*"Sky has been the big winner in terms of broadband market share in the last 2 years. From 17.1% at 3Q 2011, its share grew organically to 19.8% in 1Q 2013, reaching 22.3% in 3Q 2013, boosted by the acquisition of O2's fixed business."*[62]

62. Consistent with this description, Sky's Chief Executive, commented recently that (emphasis added):

*"We were particularly pleased with the continued strong performance in home communications. Quarterly growth in broadband was up on last year taking us past the 5-million customer milestone. In all, 36% of customers now choose to take all three of TV, broadband and telephony from Sky, over half a million more than last year."*[63]

63. Sky reported EBITDA for the three months to September 2014 at £392m. Sky purchases around 5 million MPF lines, therefore its costs per quarter would be circa £4m higher under cost-based differential than under the proposed £10 differential.[64] That is, a removal of the subsidy would cost Sky about 1% of its EBITDA. To give some further perspective, Sky's EBITDA has increased by about 55% over the last five years.[65]

**4.4 Conclusion**

[59] Underlying EBITDA FY 2013 was £352m on Revenues of £1,670; £352m/£1,670m = 21%. An increase to 25% implies 4% extra on revenues of £1,670m= £66.8m.
[60] Derived from page 74, TalkTalk's 2013 Annual Report.
[61] Analysys Mason UK telecoms Market Report 2014, January 2014, page 9.
[62] op cit. Page 21.
[63] BRITISH SKY BROADCASTING GROUP PLC, Unaudited results for the three months ended 30 September 2013 http://corporate.sky.com/documents/pdf/latest_results/q1_1314_press_release.pdf
[64] £3 *times* 5m / 4 = £3.75m
[65] Derived from Slide 15, Sky Presentation on 2014 First Half Results.

64. Ofcom and the Competition Commission have recognised the various efficiency benefits of removing the differential – in particular, it ensures productive efficiency and avoids the risk of inefficient investment. It is also consistent with "competition on the merits" and the avoidance of static welfare efficiency losses. On this latter point, Ofcom will see in the report from Plum Consulting that the current Ofcom proposal involves increasing the extent of the static inefficiency already incurred by the non-cost based price differential by a further 59% over that already incurred from 2005 to date. Given that the objectives of the TSR have clearly been achieved, and that competition is established, a prolongation of such deleterious effects requires exceptionally strong reasoning to the contrary.

65. There is no evidence that such reasoning exists. Sky and TalkTalk are the principle beneficiaries of the pricing distortion by which MPF-based suppliers are subsidised by WLR-based suppliers. We have shown that the contended "lost profitability" on recent investments to which Ofcom gives particular concern cannot be approaching the scale of the subsidy proposed. Both these suppliers have the ability to absorb the removal of the distortion in their favour and still make good returns - they do not need "propping up" by Ofcom. Their investments would not be "undermined" (although there is likely to be some small adverse impact on them, a fact that is inevitable given that a distortion in their favour is being eliminated).

66. There is simply no objective basis for a concern that undistorted wholesale prices could possibly cause either company a loss or affect either company's willingness to invest in the UK where it would be efficient for them to do so. Nor is there any evidence that Ofcom would "undermine its own credibility as a predictable and consistent regulator" by the introduction of cost-based charging in 2016/17, given that it already began signalling this as being appropriate nearly 5 years ago.

67. Ofcom should recognise that a three year transition to cost based charging is generous to these operators and therefore give consideration to Plum's suggestions that the transition period is accelerated beyond this timescale, either by making a one-off adjustment in 2014/15 or at least immediately ceasing any subsidy on new MPF lines.

## Section 5 - Base year data for charge control cost modelling

This section sets out our response to Question 7.5 in the 19 December consultation:

***Question 7.5**: Do you agree with our proposal to update the cost model base year information for the most recent 2013 RFS cost information (adjusted as proposed in this Consultation) while retaining the 2012 RFS allocation methodologies (as adjusted as set out in the July 2013 Consultation and this Consultation)? Please provide reasoning for your answer.*

### Summary

1. We do not agree with Ofcom's proposals to update the cost model base year information using *adjusted* 2012/13 RFS cost information, where those adjustments simply reverse out all the changes to methodologies made in 2012/13.

2. Ofcom accepts that fully allocated cost ("FAC") information provides an economically efficient basis for setting charge controls and that it should use the latest available cost information when making regulatory decisions. The cost information published in the 2012/13 RFS is just such cost information, it being entirely consistent with the published Regulatory Accounting Principles ("the RAP") and benefiting from unqualified "fairly presents" audit report.

3. The RAP establishes the key importance of cost causality in setting cost allocation methodologies. Prices set on the basis of such allocations send clear economically efficient signals to purchasers and suppliers. BT has been transparent as to the reasons for the significant changes made to its allocations within the 2012/13 RFS and why the new allocation methodologies are superior to those previously used. BT's view is supported by external consultants, Deloitte, in their report "BT RFS Attribution Methodology Changes" ("the Deloitte Report"), which confirmed all but one of the changes as clear improvements.

4. Considerable detail – over and above what is normally published about the impact of methodology changes – has been shared with Ofcom and published on BT's corporate website and therefore available to all stakeholders. This includes the report published by BT in October 2013 presenting the 2012/13 RFS using the 2011/12 methodologies ("the October Report")[66] and the Deloitte Report. Ofcom has had ample opportunity to consider the merits of each change, but – to date – has raised no specific concerns with any of the individual methodology changes to support its proposal not to apply include those changes in the charge controls.

5. Absent a clear and specific reason for rejecting each change, on a case by case basis, Ofcom should include that change, it being the most appropriate and up to date information on the costs of providing the set of services relevant to these charge controls. Ofcom's more general concerns with consistency with other controls, the interdependence of the methodology

[66] "Report requested by Ofcom describing certain changes Ofcom describing certain changes to the Accounting Documents for the year ended 31 March 2013 and illustrating the resulting differences to the Current Cost Financial Statements had those changes not applied", available on line at http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/ReportrequestedbyOfcomfortheyearended31March2013.pdf

changes, the overall balance of the changes and timing are, in themselves, an insufficient basis to reject the totality of the changes and, in any event, Ofcom has failed to consider options to address those concerns.

6. To depart from the published data without clear reasons and objective justifications will result in controls that are not economically efficient, leave costs to be unjustifiably recovered from unregulated services, or the wrong regulated services and therefore run significant risks of under-recovery of efficiently incurred costs moving forward. Ofcom should therefore use the published FAC data within the 2012/13 RFS as the base year within the model with any adjustments limited to areas where clear economic efficiency issues have been identified.

7. The detail of our response to this question sets out:

   a) Economic efficiency reasons for using the latest available fully allocated cost information in base year costs in the model;

   b) The requirements BT faces in producing RFS data;

   c) The basis on which BT can make changes to cost allocations within the RFS, including as discussed in the FTI Report;

   d) The information provided to Ofcom to explain the allocation methodology changes within the 2012/13 RFS;

   e) An assessment of Ofcom's rationale for reversing out all the 2012/13 methodology changes in setting base year costs; and

   f) A proposed way forward, including – at a minimum – assessing only the changes to BT TSO charges.

8. For all these above reasons Ofcom's current approach falls far short of what would be expected by an evidence driven regulator and fails to ensure that Ofcom complies with its statutory duties.

**5.1 Economic efficiency and use of the latest available fully allocated cost information**

9. It is common ground between BT, Ofcom and CPs that Ofcom should ideally use the latest available FAC information in its cost forecasting model. Ofcom has clearly stated in numerous charge control consultations that the use of FAC data is the most appropriate means of meeting economic efficiency objectives for a multi-product firm like BT where common costs will be significant and will need to be recovered. We note that Ofcom has rejected alternative means of recovering common costs such as Ramsey pricing and been clear in stating that overall economic efficiency considerations support the use of FAC data where costs are allocated on an activity based charging method driven by identification of the underlying cause of those cost.

10. It is also common ground that the latest audited RFS would normally be accepted as the best source of up to date FAC data for use in a charge control cost model.[67] We accept that the use of RFS data is subject to it: (i) being appropriately robust; and (ii) alterations or adjustments

[67] See for example, Ofcom's Stuart McIntosh's letter to BT's Mark Shurmer of 6 December 2013

necessary for Ofcom to discharge its duties in the context of this charge control consultation.[68] BT's published RFS, including cost allocation methodology changes, are therefore scrutinised in detail by Ofcom before being uses as the base year for in a charge control. The 2012/13 RFS should be no different.

11. Indeed, while an analysis of the individual cost allocation methodology changes is conspicuously absent in the consultation, Ofcom does scrutinise in some detail the appropriateness of including certain select costs within the base year data for the charge control, e.g. the provision for deafness claims and the Career Transition Costs. Ofcom even goes so far as to invite stakeholders to submit suggestions of "*any other specific BT RFS cost items which merit further investigation by Ofcom*" to establish whether they constitute forward-looking and efficiently incurred costs indicating a clear intention to continue to review potential changes.

**5.2 BT's production of the RFS**

12. BT is required under a series of SMP obligations and related directions to produce annual financial statements showing the revenues and costs of providing certain services in regulated markets. This includes a requirement to produce costs at the required level of detail for each service reported, on a current cost, fully allocated basis. Among other things, we must therefore: (a) value our assets on a replacement cost basis; and (b) establish methodologies for allocating all costs incurred by BT across all services that we provide.

13. Being a multi-product firm, the majority of the costs BT incurs – for labour, equipment, platforms, etc. – are shared across numerous services and markets. The choice of allocation methodologies is therefore critical in allocating the value of cost reported against any individual service and, in price controlled regulated markets, the prices that are ultimately set. To provide transparency and assurance that the process of setting these methodologies is carried out fairly, clear criteria are followed:

    a) all allocations are set consistently with the RAP;

    b) all allocation methodologies are detailed within Detailed Attribution Methodology ("DAM") which is published; and

    c) each annual set of numbers is audited with an opinion provided as to whether the RFS "fairly presents" data in accordance with the RAP, the DAM and other documents collectively known as the Primary Accounting Documents ("the PAD").

**5.3 The basis on which changes can be made to the methodologies in the RFS**

14. In the context of Ofcom's separate consultation on regulatory reporting[69], we commissioned FTI Consulting to produce a report on Ofcom's assessment of the issues and proposals moving forward ("the FTI Report"). The FTI Report, which accompanies this submission, details in section 3 the process by which BT makes changes to its allocations and in section 4 the role of the auditor in reviewing the RFS, including BT's methodology changes.

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[68] For example, to exclude certain costs not deemed forward-looking or to adjust asset values (RAV and inflation of assets in technology neutral models).

[69] Regulatory Financial Reporting: A Review, published 20 December 2013

15. Section 3 of the FTI report specifically provides details of the RAP and explains that the key principle relates to cost causality which is defined within the PADs as:

    *"Revenues, costs, assets and liabilities should be allocated to network components and services 'in accordance with the activities' which cause them to be earned, acquired or incurred..."* (PAD, pages 13-14).

16. Given Ofcom's focus in the context of setting a charge control is, quite correctly, on FAC, cost causality is key. While consistency of cost allocation is also listed as a principle, it sits below cost causality and objectivity in terms of priority. This means that BT has the flexibility to, and in certain circumstances should, change cost allocations over time where those changes result in cost being more accurately allocated in accordance with the cause of those costs. Allocation methodologies are not and should not be fixed over time.

17. There may be a number of drivers of change in allocation methodologies, including, but not limited to:

    a) Data changes: improvements in processes and systems generate improved, more accurate or higher level of detailed data, which can be used to better allocate costs across services;

    b) Organisational changes: management and organisational changes alter the way in which costs may be shared across services and the information available in understanding key cost drivers;

    c) Technological changes: BT is constantly evolving its network platforms and associated support systems. The replacement of old platforms with new ones will change the way in which services share costs and the relationship between provision of services and the overall levels of costs incurred; and

    d) Market changes: for instance, life cycle effects may mean that the pace at which one product may substitute for another will change from year to year altering the relationship between costs incurred and underlying drivers.

18. Cost causality is therefore of key importance and we would not expect Ofcom to disregard audited changes in methodologies that go straight to the key issue of better allocating the cost caused by the provision of services which are the subject of this charge control review.

19. The requirement to ensure that we are producing FAC information that remains consistent with the RAP over time, reflecting factual changes that occur or improved information as it becomes available, means that we review methodologies and identify those areas where adjustments are required. Our internal governance process requires that methodology changes are submitted first to our Accounting Separation Improvement Group (ASIG), and secondly, where the proposal is significant, also to our Methodology Review Group (MRG). One or both of these two bodies consider any proposed change against the RAP. A methodology change is only approved for use in the RFS where one or both of the ASIG and MRG consider that change would be clearly superior to the existing methodology in terms of cost causality and objectivity.

20. The auditor will then review all material changes. As explained in Section 4 of the FTI report, the "fairly presents" audit opinion references those criteria and documents which together make up

the PAD. The auditor must therefore test whether each allocation methodology change is consistent, to a fairly presents standard, with the principles set out in those documents. If they are not, then the auditor would need to qualify their opinion.

21. PwC reviewed every paper approved by the ASIG and the MRG in 2012-13. These papers were reviewed individually and then the cumulative impact of all papers was assessed. This ensured that the impact on regulated markets was assessed, even if the changes individually had a less than 5% impact on a given regulated market. For 2012/13, PwC gave an unqualified audit opinion which, to be clear, means that the published RFS data is considered by them consistent with the PAD, including the RAP. It is worth noting that PwC have clear duties not only to BT but also to Ofcom and other stakeholders.

**5.4 Information provided to Ofcom in support of the methodology changes**

22. On top of internal assessments and the PwC review of the methodology changes as part of the audit, BT commissioned an independent expert report from Deloitte. Deloitte reviewed the 16 most significant methodology changes, representing 95% of the impact of changes in allocation methodologies for regulated markets. Deloitte considered that only one change was not, in its view, a clear improvement. A copy of this report was shared with Ofcom on 16 October 2013 and was published on our corporate website on 16 December 2013. The Deloitte Report is also accompanies this response.
23. We also explained the methodology changes to Ofcom's competition finance team as part of both our ongoing engagement in producing the RFS each year (where changes will always be flagged and discussed) and in meetings subsequent to RFS publication.[70]

**5.5 Ofcom's rationale for reversing out the 2012/13 methodology changes in setting base year costs**

24. Despite explaining the reason for each of the methodology changes to Ofcom, Ofcom has not provided any views on the robustness and appropriateness of individual changes made. Ofcom has not, for instance, challenged any of the individual changes on the basis of inconsistency with the RAP, other accounting concerns, economic efficiency considerations or resulting inconsistency with Ofcom's duties.
25. Ofcom has remained silent on whether the costs of providing the relevant WLR and LLU services within the published 2012/13 RFS data are an inappropriate basis on which to set those charge controls. Our position is that given that the data is considered to be consistent with the RAP, including the primacy given to cost causality, and based on revised methodologies that are considered superior to the previous methodologies, then they must provide the most appropriate basis for setting economically efficient prices – that is, prices that will reflect how costs are efficiently incurred within BT and send appropriate signals to purchasers and other suppliers.

[70] These discussion are set out in the correspondence between BT and Ofcom and which BT published on its corporate website in December 2013 at: http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/CorrespondencewithOfcomaboutBTs2012-13RFSinthecontextoftheFixedAccessMarketReview.pdf

26. Ofcom's reasons for rejecting the use of the published data is not that it is based on methodologies that are considered inconsistent with the RAP or are not superior to previous methodologies. Instead, Ofcom raises a more general concern around consistency of treatment over time and the potential for this to allow BT to set prices across different markets and different charge controls which would then allow it to over-recover certain common costs.

27. Specifically, Ofcom notes that Figure 7.1 in the 19 December consultation document shows that in aggregate the methodology changes move costs from LLCC services into WLR/LLU services. As the LLCC uses 2011/12 RFS data in the base year, Ofcom is concerned that BT may recover the same costs twice across two overlapping charge controls.

28. As a headline point, we would note that regulatory practice has tended to treat each charge control on its own merits. Consistency of approach between separate decisions is clearly considered relevant, but not something that outweighs new evidence or analysis when that may support a change of approach in that specific decision. Overlapping charge controls may therefore include different efficiency and volume assumptions or different levels of WACC or even exclude costs that had previously been allowed. It is notable that in this consultation, Ofcom – at question 7.8 – invites general comment on whether any RFS cost items merit further investigation by Ofcom, suggesting that it would be open to changing previous treatments of costs beyond those covered by the methodology changes.[71]

29. Furthermore, we would echo some points made in correspondence with Ofcom on the potential for over-recovery across charge controls:

    a) First, the actual impact is far from clear and has not been quantified. The effects of the methodology changes shown in figure 7.1 show the single year impact of the change against the counterfactual of retaining the previous methodologies. However, while the methodology changes would generate a higher final year projected cost in the LLU and WLR compared to the counterfactual of using the previous methodologies, it will also be the case that prices at the start of this control will reflect decisions made in the previous charge control. These controls would have been set by reference to models which incorporated previous methodologies. The glide from where prices start to where costs are forecast to end the period will therefore reduce the impact of any "double recovery" in the initial years of the control.

    b) Second, once a clearer view on impacts is understood, any concerns could quite easily be mitigated in the design of glide paths across this control or the next leased line charge controls which could be re-set before the WLR/LLU control has ended.

    c) Third, Ofcom's proposal to reverse out the changes without reference to the underlying appropriateness of the changes themselves raises the prospect that changes to

[71] For example, in the Verizon UK Limited and another v Office of Communications appeal, Case 1210/3/3/13, the Competition Commission in its Determination notified on 12 December 2013, noted that "2.52 Ofcom argued that its decision to reallocate costs to Ethernet, but not to allocate costs away from TI to other non-leased lines services, was consistent with its general approach.[…] It argued that because TI and Ethernet were within the scope of the same market review, the reallocation resulted in the same total costs being recovered from leased lines as a whole, and therefore it did not generate any inconsistency with other charge controls.[…] By contrast, it argued that reallocation away from the leased lines market would risk under-recovery of costs, and – if done on a consistent and symmetric basis – would involve an enormous amount of work (to predict the evolution of BT's RFS[…]).

methodologies would only be acceptable at a point in time when they work against BT. In other words, Ofcom may well set the next LLCC on the basis of the new allocations and may accept that the changes are superior. But it would do so without reference to the fact that it disallowed recovery of costs in the ongoing WLR/LLU controls. Until the next round of WLR/LLU controls these costs would not be recovered, this particularly telling in respect of the BT Technology, Service and Operations ("BT TSO") cost where Ofcom would not have the equivalent of the 2011-12 account methodology to fall back on, it not being possible to produce future accounts on an old (2011-12) basis.

30. Ofcom raises two other concerns to justify its dismissal of the methodology changes in totality, rather than assessing the appropriateness of the changes on a case by case basis.
31. The first relates to a concern about the "interdependence" of the methodology changes. To the extent that this may be a concern, it is one that only arises as a result of Ofcom's refusal to consider each of the methodology changes on its merits. A full review would clarify the extent to which the changes were linked and whether it may be appropriate to accept some of the changes but not others in setting base year data. However, if Ofcom felt it could only assess some of the changes, then the extent to which interdependence mattered could then be identified. We demonstrate below, as an example, that the changes to BT TSO costs do not raise such issues.
32. The second concern relates to the perceived "balance" of the process for implementing changes. This concern is raised with no context or examples of where Ofcom believes our approach has lacked balance. It also ignores the fact that many costs within the RFS either reflect regulatory decisions or are already adjusted by Ofcom in setting controls. CPs consistently argue for adjustments to be made for a variety of reasons and Ofcom considers such suggestions on their merits. Ofcom should adopt a consistent approach here.
33. Finally, we note that Ofcom make reference to concerns with timing in dismissing our call to consider each change on its merits. It is frustrating to have such a debate at a point in time where Ofcom has had relevant information from BT for many months but has so far failed to carry out a detailed assessment.

**5.6 Proposed next steps**

34. We would suggest that as a starting point Ofcom should consider the methodology changes relating to allocation of costs incurred by ("BT TSO"). This is because:
    a) the changes were triggered by a clear organisational change and issues of "balance" cannot be relevant;
    b) the changes raise no concerns with interdependence with other changes; and
    c) the changes do not raise any concerns about double recovery of costs from LLCC services to WLR/LLU services.
35. In the context of the BT TSO changes we address each of these points in turn below.

***(a) Organisational change and balance***

36. Following the creation of BT TSO out of BT Operate ("BTO") and BT Innovate and Design ("BTID"), our review of costs and attribution methods during the course of the preparation of the 2012/13 RFS found that for similar fixed costs in BTO and BTID, there were different methodologies applied to similar costs. Our review therefore had to identify new drivers of costs for areas where previous drivers had been removed.

37. The details of these methodologies were explained in both the October Report and the Deloitte Report. The new methodologies were considered by PwC to be consistent with the RAP.

38. In terms of balance, the "changes" in allocation methodologies relating to BT TSO were triggered by the formation of that organisation at the start of 2013. At this point, BTO and BTID were combined to form BT TSO. As a result, we did a full review of BT TSO operating costs, to do otherwise would clearly not have been balanced response to this organisational change.

39. Ultimately, having reviewed all costs, the methodology changes only affected a sub-set of the total cost. For most of the operating cost, the treatment has remained broadly unchanged as we were able to identify direct cost causal activities. This is because BT TSO has captured cost by activity, and activity driver that is the same in the old and the new organisation. An example is the specific development activity undertaken by BT TSO for each revenue-generating Line of Business.

***(b) Interdependence***

40. At Ofcom's request, to give Ofcom and stakeholders visibility of the impact of the changes, we produced and published the October Report showing what the 2012/13 RFS would have looked like had they been prepared using 2011/12 methodologies and showing the market differences. We believe that this report, including the analysis of the methodology impact by market, is sufficient to enable Ofcom to evaluate each methodology on its merits. In addition, we have already offered to run our regulatory costing system to provide a different cut of the data for Ofcom. Ofcom has not taken up this offer.

    As an example, BT attaches a further report, in the form of the spreadsheet, prepared on the basis of 2012/13 RFS data but using the 2011/12 methodologies except for the three related to TSO ("the TSO Report"). The TSO Report enables Ofcom to review the impact of the three BT TSO methodologies alone. The schedule "Impact of each material methodology change on costs allocated to each market" in this report shows that the impact of these three changes is broadly the same as those shown on page 18 of the October Report.

***(c) Double recovery***

41. Looking at the TSO methodology changes in isolation, the impact upon the recently closed leased line charge control is approximately only £1million. This report shows the impact of these three methodologies on the current LLCC to address Ofcom's concerns on "potential interdependence".

The TSO Report clearly shows that: (i) costs are not reallocated between the product markets; (ii) that the TSO methodology changes actually increase the costs allocated to the business connectivity markets; and (iii) Ofcom's concerns of over recovery as a result of current and proposed charge controls disappear.

| Charge Control | Regulated Market | Impact |
|---|---|---|
| LLCC | TISBO up to and including 8Mbit/s | (£6m) |
| | TISBO above 8Mbit/s up to and including 45Mbit/s | £0m |
| | TISBO above 45Mbit/s up to and including 155Mbit/s | (£1m) |
| | AISBO up to and including 1Gbit/s | £8m |
| | Total Business Connectivity/Leased Lines | £1m |

42. To allow Ofcom to consider these specific TSO changes, the TSO Report was prepared consistently with the October Report. BT has offered to provide similar reports to Ofcom in respect of other methodology changes. So, for the BT TSO changes, the impact upon the LLCC is not relevant and therefore Ofcom's main concern of over-recovery is not justified.

43. For all the above reasons Ofcom should now consider carefully each of BT's methodology changes and include in the base year.