OFCOM'S FIXED ACCESS MARKET REVIEWS

SKY'S RESPONSE TO THE CHARGE CONTROL ELEMENTS OF OFCOM'S DECEMBER 2013 AND JANUARY 2014 CONSULTATIONS

1. Overview

1.1 This submission constitutes the response of British Sky Broadcasting Limited ("Sky") to the LLU and WLR charge control elements of Ofcom's consultation on the Fixed Access Market Review dated 19 December 2013 (the "Consultation") and further consultation dated 16 January 2014 (the "January 2014 Consultation").[1]

1.2 Charge controls should be demanding such that, where BT reduces its costs below those forecast by Ofcom and earns additional profits, it is a result of its hard work, enterprise and innovation. Consumers can benefit from these additional efficiencies by paying lower prices in the future. However, BT should not be certain before the controls even start that it will be able to earn supernormal profits and have incorporated those extra returns into its business plans (which it appears to have done with respect to the next LLU and WLR charge controls). If excess returns were certain, then it is clear that consumers would be paying too much. Sky considers that Ofcom should consider very carefully whether it has been sufficiently rigorous in its scrutiny of forecasts of BT's costs over the next charge control period, to ensure that it is difficult for BT to beat those forecasts. We address these issues in **Section 2 (Ofcom must ensure that charge controls are sufficiently rigorous)**.

1.3 BT has an incentive to alter its financial statements just prior to the start of the next charge controls, in particular to increase the costs attributed to regulated services, and appears to have acted upon that incentive in compiling its Regulatory Financial Statements ("RFS") for 2013. Ofcom is correct to reject the new cost allocations made by BT as they are clearly inappropriate, but Sky remains concerned that LLU and WLR prices will be too high because the base year costs will still include unjustified 2013 costs and cost allocations from 2012. Ofcom should scrutinise these properly. Sky's views on this issue are set out in **Section 3 (BT's Regulatory Financial Statements / Base Year Costs)**.

1.4 WLR and LLU prices are too high because, contrary to standard accounting practice and BT's accounting policy, depreciation costs do not reflect the considerable residual value of copper cables and because the duct network appears overvalued. Sky recommends that Ofcom adopts a depreciable value approach to calculating depreciation costs for copper cables and to extend the asset life of ducts. We discuss this further in **Section 4 (Copper cable and duct costs)**.

1 '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 one the VULA margin, and approach to pricing for TRCs and SFIs' dated 16 January 2014. All paragraph references in this response are to the December Consultation unless otherwise stated.

1.5 It is clear that fault rates have increased substantially since 2009 and that the main cause is lower levels of copper cable replacement by BT coupled with reduced preventative maintenance. It is evident that (i) increased rainfall, broadband penetration and broadband usage have little effect on fault rates, and (ii) it is still unproven whether BT's roll-out and activation of its fibre-to-the-cabinet ("FTTC") service has not caused additional faults. Ofcom should make a downward adjustment to faults rates and costs in order to account for inefficiently high levels of faults and ensure that there are no fault costs included as a result of fibre (which Ofcom requires to be excluded). Further analysis can be found in **Section 5 (Fault rates)**.

1.6 Sky continues to contend that Ofcom's proposal to base price differentials between the core rental service on estimates of their respective incremental cost differences is likely to result in inefficiencies and therefore it is appropriate and justified to 'aim up' when estimating cost differences. In any event, Sky could not have reasonably expected these cost differences to reduce to current estimates and made important business decisions predicated on a wider margin. As such, if Ofcom implements its proposal, then it is reasonable and correct to extend the period by which price differences reflect incremental cost differences to 2020 at the earliest. Sky considers this issue further in **Section 6 (Price differentials)**.

1.7 Sky welcomes Ofcom's proposal to implement charge controls on Time Related Charges ("TRCs") and Special Fault Investigations ("SFIs"). This is long overdue as these services are largely uncompetitive and priced well above cost. In addition to imposing the charge controls, we consider that there are some additional steps that Ofcom can take to improve the scope for further competition in the provision of these services. We outline our views further in **Section 7 (Charge controls for TRCs/SFIs)**.

1.8 In **Section 8 (Other Points)** we cover additional issues relating to aspects of the LLU and WLR charge controls process, forecast migration costs for MPF, and interim pricing arrangements.

2. Ofcom must ensure that charge controls are sufficiently rigorous

2.1 Sky has no principled objection to BT earning returns in excess of its regulated cost of capital. On the contrary, Sky appreciates the significant benefits that can result from incentivising cost minimisation through a CPI-X charge control mechanism such that, if costs are reduced below the forecast level, these efficiencies result in lower prices under subsequent charge controls (subject to quality of service remaining constant throughout).

2.2 However, charge controls should be demanding; they should require hard work, enterprise and innovation for BT to beat them. In particular, there should not be a clear expectation on BT's part <u>at the start of a charge control</u> that it can beat Ofcom's cost forecasts.

2.3 The Frontier Economics Report, prepared on behalf of Vodafone, suggests, however, that BT has been able to earn substantial excess profits on the supply of regulated products in each charge control period, with estimates of nearly £5bn in excess returns being made over the eight years to 2013.[2] In fact, the level of excess returns on regulated products appears to be increasing with over two thirds of the additional profits coming in the past four years.

2.4 Sky considers that there is evidence available that suggests that the current proposed charge controls for LLU and WLR are not sufficiently demanding, and will therefore perpetuate BT's ability to earn supernormal profits from the supply of regulated products.

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2 Frontier Economics found that additional returns had been earned in <u>all</u> years analysed (2006 – 13). See Figure 3, *Assessment of BT's regulated profitability - A report prepared for Vodafone,* January 2014.

BT already appears confident that its costs of supplying these products will be below those forecast by Ofcom over the next charge control period, and therefore already expects to earn supernormal profits on regulated products over the next charge control period. For example, in its results presentations and analyst briefings, BT continues to forecast significant cost efficiencies across its businesses[3] and indicates that these costs efficiencies will result in increased free cash flow i.e., that the cost savings will feed through into higher profits rather than being regulated away through lower prices. Analysts anticipate the main sources of cost efficiencies at BT will be Openreach and Global Services[4].

2.5 It is likely, therefore, that BT has already factored into its business plans returns from Openreach which exceed its cost of capital, which implies that it is confident of achieving lower costs than forecast by Ofcom within the next charge control period. As a result, prices would be higher than necessary and the key objective of the charge control condition – to prevent excessive pricing – would be undermined.

2.6 For these reasons, Sky considers that Ofcom should consider very carefully whether it has been sufficiently rigorous in its scrutiny of forecasts of BT's costs over the next charge control period, to ensure that it is difficult for BT to beat those forecasts.

3. BT Regulatory Financial Statements ("RFS") 2013 / Base Year Costs

3.1 The charge control setting process relies to a very significant extent on the costs attributed to the provision of regulated products in BT's RFS for the period prior to the next charge control.[5] This, together with the hard deadline for setting a new charge control, provides BT with a strong incentive to make significant changes to its RFS as close to that deadline as possible, which have the effect of increasing the costs attributed to regulated products and/or to those products upon which its retail division's competitors are relatively more dependent (such as MPF).

3.2 A key reason for making such changes in the period prior to a new charge control is that it may be difficult for Ofcom properly to examine, consider and adjudicate on such changes in the period in which it is undertaking a market review and charge control setting process.

3.3 Sky considers that BT may have acted upon these incentives in the preparation of its latest set of RFS (2013) where it has made a series of cost allocation changes that have the effect of significantly increasing the costs of regulated services and, in particular, LLU and WLR just prior to the start of the next charge controls.

3.4 We note that this is not the first time that BT has introduced significant methodological changes to the preparation of its RFS such that the relevant costs for services whose prices were just about to be set by Ofcom were increased significantly. In 2009/10, BT introduced a duct revaluation which, had it been accepted, would have resulted in higher forecast costs in the pending WLR and LLU charge controls from 2011. On that occasion

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3 Q4/full year 2012/13 results and business update – Part 1 at slides 10,15 and 37 which indicate significant cost reductions including a £4.7bn reduction in OPEX and CAPEX over last 4 years - http://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q413_slides_update_part1.pdf

4 See paragraph 6.1 (iv) of Sky's response to the Fixed Access Market Reviews: Approach to setting LLU and WLR Charge Controls Consultation dated 11 July 2013 (the "July Charge Controls Consultation").

5 Reliance on estimates of BT's costs in the period immediately prior to the next charge control period also provides an incentive to increase <u>actual</u> costs in that period, thereby (a) resulting in higher regulated charges, and (b) providing easy opportunities for cost reductions once the charge control has been set. See also paragraph 7.82, paragraph 1.14 and 6.5 of the July Charge Controls Consultation and paragraph 3.5 of Regulatory Financial Reporting: A Review consultation dated 20 December 2013 (the "RFS Consultation") which confirms the significance of BT's RFS to Ofcom's charge control analysis.

Ofcom chose a different method to value BT's ducts in the charge controls, which resulted in lower prices than would otherwise have been the case had Ofcom relied upon BT's RFS.

3.5 This time, Ofcom is proposing to include 2013 costs (with some notable exceptions)[6] but to reject BT's proposed new cost allocations in its 2013 RFS and adopt the allocations in the 2012 RFS instead. We agree that Ofcom is correct to reject the new allocations but remain concerned that costs are still overstated or inappropriately allocated. Ofcom's approach effectively supports BT's stated overall level of 2013 costs and its 2012 allocations despite BT's incentives to overstate them and to allocate relatively more costs to certain products.

3.6 While Sky does not address here each of the changes that BT introduced in its 2013 RFS, it is worth focusing on certain changes which, in our view, demonstrate BT's ability to act upon its incentives outlined above and why Ofcom is correct to reject them. We also consider, in some cases, they are indicative of wider inappropriate practices by BT in preparing its regulatory accounts generally – not just in 2013 – which further supports our concerns that Ofcom's proposed rejection of the new cost allocations is insufficient.

3.7 In this regard, we welcome Ofcom's RFS Consultation but urge Ofcom to revisit key 2012 allocations and overall 2013 costs to ensure that they form an appropriate basis for setting the base year costs for the next charge controls. A key concern for Sky is that, had BT not sought to make cost allocation changes in 2013 and subsequently been required to provide additional information regarding those changes, then it simply would not have been possible for stakeholders (or, perhaps, Ofcom) to ascertain that certain inappropriate costs had been included in the first place. As such, we recommend that Ofcom looks again at the 2012 RFS allocations and the overall level of 2013 costs (both of which Ofcom intends to use when setting prices) to ensure that they are fit for purpose.

3.8 The following sections briefly consider the following costs further: (i) deafness claims, (ii) BT's Career Transition Centre ("CTC"); (iii) Openreach computing, (iv) Openreach overheads, (v) vacant exchange space and (vi) Technology, Service & Operations ("TSO").

(i) Deafness claims

3.9 In the 2013 RFS, BT changed the allocation of costs relating to hearing loss compensation claims from BT engineers as a result of their use of voice line testing equipment between the 1970s and 1990s. BT has sought to recover more of these costs from LLU and WLR services and relatively less from TISBO and AISBO services. There are at least five reasons why these costs should not be recovered through regulated charges at all and, even if it were appropriate to include these costs (which it is not), why the allocation change is wrong:

- Ofcom had previously required BT to exclude them from its RFS;
- they are not forward looking costs (as is typically required for charge controls);[7]
- they are not efficient and, more importantly, allowing BT to recover them through regulated charges would reduce its incentives to maintain prudent health and safety practices;

6 Paragraph 7.98 .

7 In fact, the asset lives of the relevant copper lines upon which the testing equipment would have been used would also have long expired.

- the costs relate to the testing of voice lines, not AISBO and TISBO services from where BT had previously recovered them and the testing equipment pre-dates the launch of LLU; and

- these costs were included in the assessment of base year costs for the AISBO and TISBO charge controls ("the Leased Lines Charge Controls") and, as such, any costs reallocated to LLU and WLR in 2013 would effectively have been recovered twice if Ofcom had not rejected the allocation change.

3.10 Each of these reasons is sufficient by itself to warrant the rejection of these costs but, taken together, demonstrate serious flaws in the regulatory accounting regime in that BT considered that it could include them and do so without penalty.

(ii) Career Transition Centre

3.11 BT has changed the allocation of costs for its CTC where certain BT employees whose roles have been discontinued are held prior to being redeployed to other roles within BT. The original allocation weighted the distribution of costs of the CTC to the BT lines of business from where the relevant employee roles had been discontinued. BT's change in method in 2013 has been to weigh the CTC cost allocation according to full time employees ("FTEs") and return on assets. The effect of this additional weighting appears to allocate more costs to regulated access services like WLR and LLU than would otherwise be the case.

3.12 BT argues that this new method is correct because staff in the CTC represent a group resource and should therefore be treated as an overhead. However, there are at least five reasons why this approach is wrong:

- the new allocation is not causal because it is the original lines of business from where the CTC staff came that created the cost by discontinuing their roles (it is normal business practice to treat any costs related to the retraining of redundant staff as redundancy costs which would be borne by the business unit that sheds the roles);

- there does not appear to be any causal linkage between 'return on assets' and CTC costs;

- CTC costs generally (irrespective of the allocation) are not efficient costs and are a function of BT's inefficient labour practices (e.g. its no redundancy policy);

- the timing of the change in allocation appears to favour BT Retail and BT Global Services where most roles have been reduced during BT's cost transformation programme so far and disadvantage Openreach (and its customers) by increasing cost allocations to regulated services; and

- Ofcom only allowed CTC costs to be recovered from regulated prices before on the basis that the costs recovered were relatively trivial at the time (prior to this latest reallocation)[8].

3.13 For these reasons, Ofcom should reject the inclusion of these costs in the regulated cost base entirely and not simply revert to the old allocation.

[8] Paragraph 7.105.

(iii) Openreach computing

3.14 BT has changed the allocation of Openreach computing costs from being based on CAPEX in the current year to being based on depreciation in that year. This approach is wrong because, even if both allocation methods were equally causal (which is not demonstrated by BT), moving from one method to the other mid-asset life could result in some products making disproportionate and inappropriately larger contributions to overall computing costs than would be the case had one method been adopted throughout.

(iv) Openreach overheads

3.15 To date, Openreach overhead costs have been allocated on the basis of pay. In the 2013 RFS, BT has allocated these costs on the basis of pay and return on assets. The effect of this change has been to allocate more costs to asset-heavy products like WLR and LLU. BT does not appear to have explained adequately why the new method is more appropriate than the previous one. What is clear, however, is that BT would gain through higher charge controls for WLR and LLU if this change were included within Ofcom's base year cost estimates.

3.16 In the absence of any evidence explaining why this new cost allocation method is superior, it is appropriate to reject this change.

(v) Vacant exchange space

3.17 This change involves BT electing to allocate vacant exchange space costs only to the Main Distribution Frame ("MDF") and cable chambers which are used mostly by LLU and WLR - as opposed to all the other services housed in the exchange. BT has introduced another change in cost allocation that has the effect of increasing the costs of WLR and LLU just prior to the setting of the relevant charge controls and reducing the costs of services that either have no charge control at all or have already had their charge control set.

3.18 Yet again, however, BT's approach is flawed as it implies that, were there not MDFs and cable chambers, then BT would be able to reduce its exchange space costs. But BT has provided no evidence to support this implicit assumption and, as such, this change appears to be less causal than the previous method.

(vi) Technology, Service & Operations ("TSO")

3.19 BT has merged two internal departments into one and claims that it is no longer possible to allocate the relevant costs to the rest of BT on the same basis as it had done before. Its new allocation method results in significantly higher costs for LLU and WLR in the 2013 RFS. BT has provided no explanation as to why the new method is superior to the previous one (e.g. more causal).

3.20 Moreover, despite high restructuring charges (£400m in 2013/14), BT has been quite clear that the result of the reorganisation will be to reduce substantially future costs. From 2014/15 onwards, BT expects £200m annual savings and, one part of the change, to put BT Operate's field force into Openreach, is cited as a key pillar of future efficiencies such as CAPEX savings.[9]

3.21 It would be incorrect to allow the restructuring charges to be included in the base year costs of the charge control (£151m of which appeared in BT's 2012/13 statutory

[9] See pages 2-4 of BT's Q4 2012/13 results presentation transcript, http://www.btplc.com/sharesandperformance/quarterlyresults/pdfdownloads/q413_transcript1.pdf which refer to slides 10 and 16 of the accompanying presentation (link provided in footnote 3).

accounts).[10] We also note that, for BT, the cash profit from the restructure by 2016/17 (the end of the next LLU and WLR charge controls) would be c£150m.[11]

4. Copper cable and duct costs

4(A) Ofcom should adopt a depreciable value approach to copper depreciation charges

4.1 In its regulatory accounts, BT depreciates the value of copper cable to zero over its asset life. Yet copper cables have significant scrap value at the end of their economic lives, and are normally sold by BT. Currently, 'business as usual' income that BT receives from copper cable scrap (i.e., income that arises from the routine scrapping and replacement of copper cables in order to maintain the network) appears as a negative cost (income) in its regulatory accounts. This approach is contrary to standard accounting convention[12] and BT's own accounting policy[13]. Ofcom, however, has implicitly accepted this approach in its proposals for the charge controls from 2014 – 17.

4.2 Copper cable costs form a significant portion of the WLR and MPF rental cost stacks. BT's approach means that depreciation charges on copper cables, which are included as a cost in setting regulated charges, are higher than they would be if a standard residual value approach were adopted. This results in higher wholesale charges for BT products such as WLR and MPF to the detriment of end-users.

4.3 Furthermore, BT is able to earn windfall gains from large-scale removal of copper cables, for example when products and services are migrated away from copper networks to other infrastructure, or discontinued entirely.[14] Significant levels of removal of copper are, therefore, treated as 'one-off' events, with BT keeping much of the copper scrap income for itself.

4.4 Frontier Economics discusses these issues in more detail in its report prepared for Sky and TalkTalk and puts forward two alternative depreciable value methods which would reflect the residual value of copper cables but which would avoid the risk of windfall gains or losses (i.e. over-recovery or under-recovery) that could arise from moving away from the 'negative cost' approach part-way through asset lives[15]. These are:

(i) Option A, which is consistent with and based on accounting standards, reduces the future depreciation of existing assets to take account of the residual scrap value of those assets; or

(ii) Option B, which is similar to Option A, except inasmuch that future costs are reduced to reflect historic over-payment by customers in the past, even where the current carrying value of assets is below the residual value of the corresponding copper cable.

4.5 Sky is strongly of the view that Ofcom should adopt one of these approaches, in order to avoid the clear problems associated with the current approach, and to bring the approach into line with standard accounting practice in relation to this issue.

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10 *Ibid*, page 3.

11 *Ibid*, page 4. See also Tony Chanmugam's comments on future cost savings, page 14 onwards - http://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q413_transcript1.pdf.

12 IAS 16 ("International Accounting Standard"") - "Property plant & equipment".

13 BT Current Cost Accounting Detailed Valuation Methodology 31 July 2013, section 1.10

14 This is what happened when BT scrapped its MUCJ network.

15 Frontier Economics Report – Regulated Costs for BT's Copper Cable – January 2014 submitted to Ofcom on 2 January 2014 (the "2014Frontier Report").

4.6 This issue is highly material. Frontier Economics estimates that the residual value of E-side copper, which BT has targeted for recovery in 2023, to be £1 billion with no guarantee that current consumers that are overpaying due to higher depreciation charges will receive the benefit of this future income. A move to a depreciable value approach could result in LLU and WLR prices being £4 p.a. lower in 2016/17 than proposed under the current approach.

4(B) Duct costs appear overstated

4.7 Where a network asset has little or no residual value, a long asset life and the network is in a steady state, CAPEX can be expected broadly to match depreciation charges. However, for a sustained period, over the last decade, duct CAPEX has been significantly below duct Operating Capital Maintenance ("OCM") depreciation[16].

4.8 Sky considers that there are two possible explanations for this. Either:

(i) the duct network is overvalued; or

(ii) duct asset lives of 40 years are too short.

4.9 We note that BT has argued that the duct network is undervalued but this appears unlikely given the sustained period of relatively lower CAPEX levels compared to OCM depreciation and in this regard we note, as recognised by Ofcom, that BT has reduced expenditure on preventative maintenance.[17] If the valuation were to increase, as BT asserts it should, then this mismatch would widen. We consider that this is prima facie evidence that, if anything, the duct network is overvalued.

4.10 One way of addressing the mismatch would be to reduce the depreciation rate so that it was in line with long term CAPEX (effectively a renewals accounting approach) while leaving the current Regulatory Asset Value ("RAV") as it is.

5. Fault rates

5.1 Sky considers that the current LLU and WLR fault rates are inefficiently high. This is to a large degree, a direct consequence of reduced capital expenditure by Openreach on replacing older parts of the copper network without any compensating increases in preventative maintenance. Therefore, contrary to Ofcom's conclusion in the Consultation, it is appropriate for Ofcom to consider whether to apply a one-off reduction to base year costs to reflect a more efficient fault rate. In Sky's view a one-off reduction is justified and should be applied.

5.2 In order to support its submission in relation to LLU and WLR fault rates, Sky (with TalkTalk) commissioned Frontier Economics to produce a further report on the issue ("the 2014 Frontier Report"). Where appropriate, we draw upon the findings contained within that report.

5(A) Current fault rates have risen significantly and are inefficiently high

5.3 Sky considers that, on any reasonable reading of the available data, the fault rates in BT's access network are at an inefficient level. However, Ofcom proposes to use the current rates (i.e., those from 2012) and the resultant costs as an input into the base year costs in the charge control.

16 See Figure 1.

17 Paragraph 5.86.

5.4 In a reversal of its position in the July 2013 Consultation[18], Ofcom now claims that it is uncertain that fault rates are significantly higher than historic trends and, as such, it is uncertain that fault rates are inefficiently high.[19]

5.5 While Ofcom states that it would be appropriate to consider whether to make a one-off reduction to fault costs in the base year should it be proven that they were elevated as a result of under-investment by BT, it has not been able to determine in this instance that under-investment has caused an increase in faults. Furthermore, Ofcom indicates that, even if it were able to determine this, it was unable to determine the level of any one-off reduction in fault costs to be applied to the base year in the charge control model.[20]

5.6 In Sky's view, Ofcom's conclusions are implausible and not supported by the available evidence. All stakeholders agree that fault rates have increased significantly – any disagreement centres on the cause (or causes). A failure to act on the available evidence, and to make a downward adjustment to faults costs in the base year, will result in consumers paying higher prices for lower quality lines and, as such, does not accord with Ofcom's duty to further the interests of consumers.

5.7 Ofcom has changed its position between the July and December consultations. After initially presenting evidence in the July 2013 Consultation that showed significant increases in faults rates from 2009 after several years of mostly sustained decline, Ofcom now argues that it is no longer clear that fault rates have increased significantly. In order to support this claim, it attempts to cast doubt on the robustness of its initial calculations. In particular, it argues that fault rates between 2007 and 2009 may not have declined by as much as it originally thought and, instead, it now places more weight upon a projection of faults provided to it in 2007 by Openreach which showed more modest forecast declines.[21]

5.8 As a result, Ofcom now says that fault rates since 2009 to 2012 could have risen by between 20% and 53% and not by over 50% as it had originally put forward.[22] Therefore, Ofcom argues that it is unable to arrive at a definitive figure for the increase in fault rates and that it is now no longer certain that there has been a significant increase in faults.

5.9 Ofcom's new analysis is, however, less robust then its previous approach. In claiming that its initial estimates of 2009 fault rates may be understated, Ofcom argues that the implied annual reduction in faults between 2007 and 2009 of 15% was too high because it exceeded the forecast level of fault rate reductions provided to it by Openreach in 2007 of 2% per annum and which it used for its own similar projections from 2009.[23]

5.10 Ofcom's findings are flawed for the following reasons:

(i) Ofcom is supplanting a fault rate estimate based on actual, contemporaneous, pro-rated faults data with a less reliable one based purely on a forecast made two years before;

18 Fixed Access Market Reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30: Consultation on the proposed markets, market power determinations and remedies dated 3 July 2013 (the "July 2013 Consultation")

19 Paragraph A10.37 of the July 2013 Consultation.

20 Paragraph 5.92.

21 Paragraphs 5.13 to 5.15.

22 Paragraph 5.15.

23 Paragraph 5.13 and Chart A9.1, Ofcom, A new pricing framework for Openreach – Annex 9, May 2009 (Ofcom, 2009 PFFO Statement).

(ii) BT has an incentive to understate the scope for future fault rate reductions because regulated prices could be higher as a result;

(iii) BT has consistently acted upon this incentive by arguing in its submissions to Ofcom that the scope for future efficiencies was low while simultaneously advising analysts in its financial results presentations that the scope was much higher;

(iv) rewarding BT through higher regulated prices as a result of inconsistencies between its reporting of fault rate data between 2008 and– 2009 compared to the rest of the dataset (1994 – 2007 and 2010 – 2012) would incentivise further poor record-keeping;

(v) a 15% p.a. reduction in fault rates is entirely plausible. In the year immediately preceding 2008, faults had reduced by c.10% and there were at least two periods (1994 – 1997 and 2000 – 2003) where the fault rate on average reduced by over 30% p.a. If anything, Ofcom's new 2% p.a. reduction is not supported by the available data;

(vi) even Ofcom's new lower bound of estimated increases in faults rates of 20% over three years represents a significant increase; and

(vii) BT's annual reports between 2008 and 2010 support the initial estimates that faults rates declined by on average c.15% per annum between 2007 and 2009 and not Ofcom's new estimate. The relevant BT annual reports showed the following fault rate reductions:

- 2008 by 10%;
- 2009 by over 20%; and
- 2010 by 11%.

5.11 Frontier Economics uses BT's annual report data to compensate for the inconsistencies in the time series fault rate data provided to Ofcom by Openreach in order to show a decrease in fault rates between 2007 and 2009 broadly similar to Ofcom's original projections. This is clearly a more robust approach than Ofcom's new method and provides compelling evidence that fault rates have increased significantly.

5(B) It is evident that the key driver of increased fault rates is reduced investment and maintenance by BT

5.12 Having established that faults rates have increased substantially since 2009, we consider the likely causes of the increase. This is important because, as Ofcom states, were it to be proven that some or all of the increase was attributable to under-investment in preventative maintenance by BT, then it would be appropriate to consider whether base year costs should be reduced to reflect a more efficient fault rate. If, on the other hand, fault increases were mainly caused by exogenous factors such as rain or higher levels of broadband penetration – as put forward by BT- then it may not be appropriate to make any adjustments to base year costs.

5.13 Sky does not consider that the causes of increased fault rates suggested by BT – increased rainfall and broadband penetration – will contribute to fault rates to a significant degree. In its response to the July Charge Controls Consultation Sky referred to an earlier accompanying Frontier Economics' report that showed that both rainfall and broadband penetration were unlikely to have made a significant contribution to the increase in fault rates since 2009.

5.14 Ofcom also argues that the 'weather effect' is too hard to predict and, therefore, will not make any adjustment in the charge control model to account for the effects of increased rainfall.[24] We note however that, to the extent that rainfall does have some limited effect, it would be wrong for Ofcom to embed into the base year any incremental fault costs that have been caused by the exceptionally high rainfall that occurred in 2012. To the extent

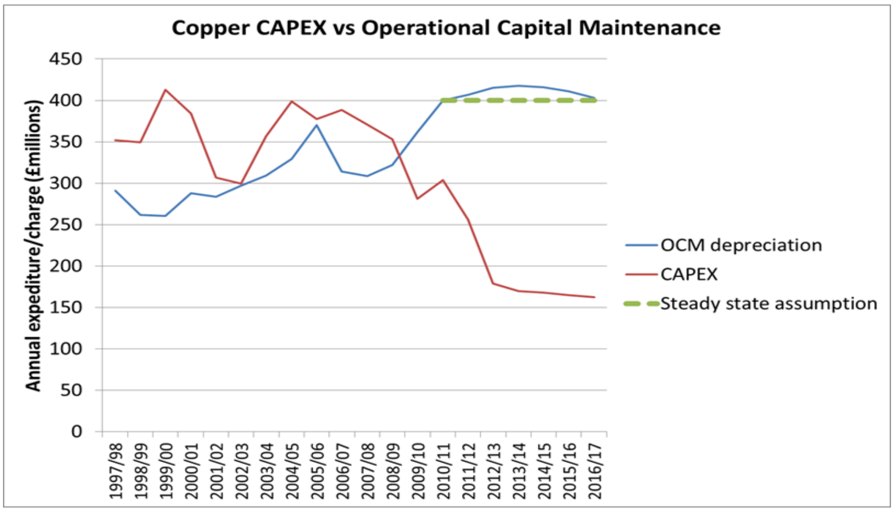
[24] Paragraph 5.114.

that it is material, Ofcom should adjust for this by adopting an average over a longer period.

5.15 In Sky's view, most of the increase in faults is attributable to factors within BT's control. Specifically, since 2009 BT has substantially reduced its CAPEX on replacement copper thus extending the working life of older cables. Crucially, however, BT has not increased its investment in preventative maintenance programmes in order to improve the reliability of those network elements that are no longer being replaced.

5.16 This sharp reduction in copper replacement CAPEX[25] is clear from **Figure 1** below.

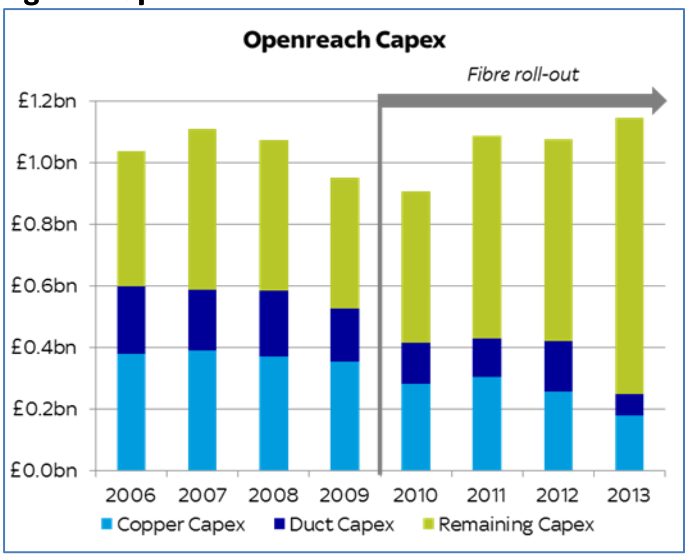
Figure 1: Comparison of depreciation and CAPEX



Sources: RAV model, Frontier Economics

5.17 Openreach has not reduced its CAPEX generally over the same period – total capex has remained broadly stable – but it has diverted more of its CAPEX budget into the roll out of fibre-to-the-cabinet (FTTC), a technology that is only materially used by BT Retail.

Figure 2: Openreach CAPEX



Sources: BT reported KPIs, Ofcom RAV model, Frontier Economics

25 There have also been significant falls in duct CAPEX.

5.18 Therefore, the main beneficiary of this rebalancing of capital expenditure is BT's retail division while the resulting higher fault rates are experienced (and paid for) by all CPs and their customers.

5.19 Sky does not consider that reducing copper CAPEX in itself is an unreasonable course in practice and can be justified given that, with the roll out of FTTC, the useful life of e-side copper may now be shorter and to deploy new copper assets could result in them being stranded. However, in such circumstances it is incumbent on BT to ensure that effective preventative maintenance is carried out on older cabling in order to avoid unnecessary increases in fault rates.

5.20 There is no evidence of an increase in preventative maintenance to compensate for the reduced replacement of older copper cabling.[26] Again, this may be reasonable if the preventative maintenance programmes delivered up to 2009 had some permanency in keeping fault rates low but this is not the case. As shown above, faults have increased significantly since copper CAPEX has been reduced.

5.21 BT has asserted, however, that the preventative maintenance programmes conducted between 2000 and 2009 and which were so successful in driving down fault rates should not be repeated as they would not deliver any further significant reductions in faults[27]. Ofcom appears to have accepted this argument. It is plainly without merit:

(i) as the life of the copper network is now being prolonged more preventative maintenance will be required, not less;

(ii) the benefits of preventative maintenance – such as weatherproofing, field force training and improving frame quality – are not permanent and will diminish over time and, as such, will need to be renewed (some of the maintenance programmes that delivered improved fault rates were conducted over 10 years ago);

(iii) even if it was accepted that certain preventative maintenance programmes were not repeatable in the short run to the same degree, there will be new programmes and changing network conditions that will provide a continual source of future efficiencies. As with many sources of future efficiencies, they are not all known several years in advance and, in keeping with Ofcom's approach to efficiency generally, it is sufficient to expect continual efficiency gains – both in terms of catch up efficiency and efficiency improvements stemming from shifts in the frontier (i.e. market-wide efficiency improvements) – without the need to identify them in advance;

(iv) BT's argument that there cannot be the same gains from preventative maintenance as there were in the past mirrors exactly the fallacious arguments that it has put forward in relation to efficiency improvements generally during previous charge control consultations – i.e., that past gains are not repeatable and the future scope for efficiency is vastly reduced. Given that BT's actual efficiency improvements have proven to be far larger than BT has claimed was possible and more in keeping with historic performance, Ofcom should place little or no weight on BT's submissions in this regard; and

26 In an email from Will Pinkney to Andrew Heaney (TalkTalk) dated 6 February 2014, Ofcom stated that "*The reduction in preventative maintenance activity (measured in thousands of man hours or Kilo Man Hours [KMH]) was about 10% between that in 2009/10 and 2010/11 combined and that in 2011/12 and 2012/13 (prorated) combined.*"

27 Paragraph 5.83.

(v) BT appears to be inconsistent in arguing that high rainfall causes more faults but that there is no more weatherproofing to be done.

5.22 Also, the current inefficient fault rate – caused by asset replacement rates below steady state levels and insufficient compensating preventative maintenance - does not accord with the rate that would be expected under Ofcom's anchor pricing approach whereby prices are set by reference to the costs of an ongoing hypothetical copper network which assumes no FTTC.

5.23 In addition to reduced preventative maintenance and the lower replacement rates for older network elements, in its response to the July Charge Control Consultation Sky argued that WLR and LLU fault rates could have risen as a result of BT's FTTC deployment. Ofcom, in the Consultation, presented evidence from CSMG that, it suggests, demonstrates that there has been no such effect. Sky considers that the CMSG report is not robust enough to draw this conclusion. Frontier Economics has identified specific weaknesses in CSMG's approach and has suggested improvements which we recommend Ofcom adopt before finally concluding on this matter.

5 (C) BT is likely to have profited from reduced investment and higher fault rates

5.24 Furthermore, to the extent that reduced copper replacement CAPEX (and subsequent depreciation) and lower preventative maintenance levels led to lower BT costs than anticipated by Ofcom when it set previous charge controls, BT would have made additional gains that exceeded its regulated cost of capital. It is likely that these additional returns would have exceeded much of any concomitant increases in repair costs and, in any event, BT could limit the full extent of any potential repair cost increases by simply throttling the level of engineering resource available to remedy faults.

5.25 Additionally, the full cumulative impact on fault rates of reduced replacement capital and preventative maintenance would take some time to reach its peak. It is likely that there would be some lag such that the elevated level of repair costs could be foreseen and recovered from subsequent charge controls – as is apparent from Ofcom's current proposed approach to quality of service whereby Openreach's customers are expected to pay for improvements in service quality through higher regulated charges.

5.26 Therefore, BT would gain in terms of increased profits from reducing its costs below the level forecast within the charge control but, to some extent, would be protected from the resultant increased operating costs (due to reduced reliability of the copper network) by being able to recover them through its future regulated prices.

5.27 We agree with Ofcom that it should consider making a one-off reduction in base year costs in the charge control model to reflect high faults rates should it be proven that a reduction in preventative maintenance was the cause. However, we disagree with Ofcom that there is insufficient data to demonstrate under-investment as the main cause of elevated fault rates.

5.28 Sky also notes that the data which Ofcom says it requires but does not have was data that BT used to gather but which for a short period it stopped collating[28]. Clearly, not making a reduction to the base year costs on this basis would incentivise BT to no longer collect information that was not favourable to it.

5.29 In any event, Sky does not consider that Ofcom requires these data in order to conclude that a reduction in replacement CAPEX without any off-setting preventative maintenance has caused an increase in fault rates (as one would reasonably expect) and to be able to

28 Section 2.2 of the 2014 Frontier Report and paragraphs 5.12 – 5.15 of the Consultation.

estimate robustly the scale of this increase. Were it to do so, Ofcom would then be able to make an appropriate reduction in base year costs.

6. Price differentials

6.1 Sky remains of the view that Ofcom's approach to the price differentials between the core rental services – MPF, SMPF and WLR – to be flawed for the following reasons:

(i) it is likely to be more efficient in this instance to 'aim up' from a price differential that is notionally based upon LRIC differentials; and

(ii) Ofcom's approach to assessing the costs of the core rental services means that its estimates of LRIC differentials may be an inaccurate representation of their true level and, in particular, it may understate the difference.

6.2 In any event, MPF operators could not have reasonably expected that the price differential between WLR+SMPF and MPF would have narrowed to the extent estimated by Ofcom. Sky made business decisions predicated on a wider margin and could have acted differently if it had known that the differential would be lower. Therefore, should Ofcom persist with setting prices such that the differential reflects its estimates of the incremental cost differences, then Ofcom's proposal to reduce the price differential over a longer period (for example, to 2020) is more appropriate.[29]

6(A) Basing price differentials on estimates of incremental cost differences is likely to result in inefficiencies

6.3 In its response to the July Charge Controls Consultation, Sky (supported by a report by Frontier Economics) explained that inefficiencies would stem from setting the price differentials below their true incremental cost differences but that if they were set above their true level then productive inefficiencies would be offset to some degree by other efficiency gains[30]. Given the strong likelihood of estimation errors and Ofcom's policy of 'cost equalisation'[31] for certain cost categories it is probable that the true incremental cost differences will be different to Ofcom's estimates.

6.4 While Ofcom has not addressed all of the issues raised by Sky in its response to the Consultation, it has provided a partial reply to some of Sky's arguments in order reiterate its view that aiming up would not be appropriate[32].

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29 Paragraph 8.64.1.

30 Paragraphs 4.7 to 4.11 of Sky's response to the July Charge Controls Consultation.

31 Given that Ofcom equalises certain cost allocations between MPF and WLR because it considers that there is insufficient evidence to adopt an alternative – potentially causal – allocation, it is axiomatic that incremental cost differences will trend toward zero. It cannot be reasonably argued however that this demonstrates that the cost of providing MPF and WLR lines is broadly the same and, as such, Ofcom's approach is competitive neutral.

32 Specifically, Ofcom states that it is not clear whether off-setting allocative efficiencies would arise from aiming up or down from its estimates of the incremental cost differential because it is unclear whether voice or broadband services were more inelastic (such that it may be more appropriate to recover relatively more costs from the more inelastic service). It argues that lower broadband penetration levels (which Sky cited as evidence of higher price sensitivity amongst consumers) may merely demonstrate that older consumers were less interested in taking broadband. Sky considers that this argument merely reinforces its case that the demand for voice services may be more inelastic than broadband. Ofcom also appears to suggest that fixed to mobile substitution for voice services may demonstrate higher elasticity for voice. We note however that the proportion of mobile-only households has remained the same for several years.

6.5 Sky maintains that Ofcom should aim up in its estimation of the LRIC differences between the core rental services as this would likely deliver a more efficient outcome than Ofcom's current proposals.

6(B) Incremental costs differences are likely to be underestimated

6.6 Moreover, Sky considers that Ofcom could have underestimated the incremental cost differences between WLR and MPF. While it is clear that Ofcom's approach of equalising the allocation of certain costs between MPF and WLR – which Ofcom does where it concludes that there is insufficient evidence to assign costs on a causal basis – will result in estimates of incremental cost differences that are not an accurate reflection of the true differences, Sky also argues that Ofcom's approach to certain cost allocations may have resulted in further underestimation.

6.7 Sky continues to rely on its arguments outlined in its response to the July Charge Controls Consultation relating to reasons why the cost differences may be too low[33]. In addition, we remain concerned that the incremental cost differences are understated because:

(i) Ofcom's provisional estimates of the LLU TAM costs – now to be completely allocated to MPF rental - appear to be too high, at an inefficient level and, potentially, insufficiently robust[34];

(ii) If, as Ofcom is now proposing, LLU TAM costs will only be recovered by the service that uses it (i.e. MPF), it also follows that EvoTAM costs should only be recovered from the SMPF lines that use it (i.e. a subset on SMPF lines currently only consumed by BT Wholesale). Therefore, as opposed to removing EvoTAM cost recovery entirely from SMPF rental prices, Ofcom should instead require that those costs are recovered from SMPF lines that use EvoTAMs (but not other SMPF lines). This is because while only BT consumes these lines today, they are still required to be offered to all CPs on an EoI basis and CPs that may in the future purchase them should, on the basis of causality, pay for the costs of the EvoTAM. To do otherwise could result in inefficient consumption of SMPF lines by CPs. We argue that, in the interests of fairness, the timing of the change in allocation of EvoTAM costs away from SMPF lines that do not use it should be made on the same basis as the change to LLU TAM costs. We also consider that Openreach should create two SMPF products and prices that reflect the two different testing methods; and

(iii) BT's allocation of more service assurance costs to MPF than to WLR+SMPF appears flawed as it is unsupported by any cogent evidence or explanation to support the allocation. Moreover, as BT does not consume MPF itself but competes in downstream retail markets with LLU operators that do, it has an incentive to maintain relatively higher cost allocation to MPF. Therefore, and in the absence of any supporting evidence, we agree with Ofcom that it could be appropriate to equalise cost allocations of service assurance costs.

6(C) If the differential between MPF and WLR+SMPF is required to reflect only incremental cost differences then this should occur no earlier than 2020

6.8 As MPF operators made investments reasonably predicated on a wider differential, it is justified to extend the period to which prices ultimately reflect Ofcom's estimated cost differences to 2020.

33 Paragraphs 4.24 to 4.29 of Sky's response to the July Charge Controls Consultation.

34 TAM cost data from BT's RFS appear to have been applied inconsistently between services and TAM types. There have also been allocation errors to certain TAM cost categories. Ofcom's adjustments to this data are largely redacted and provisional.

6.9 Sky considers that:

(i) it could not have reasonably expected the price differential between WLR+SMPF and MPF to be reduced to the level proposed (£0 to £4) during the period of the next charge control;

(ii) expectations regarding Ofcom's approach to the price differential and the amount of that differential are important factors when Sky makes its investment decisions with respect to LLU;

(iii) even if it were appropriate for Ofcom to reduce the price differential between WLR+SMPF and MPF such that it reflects only their incremental costs differences and Ofcom's approach to estimating those costs was robust, as Ofcom notes[35], it would be unreasonable for the respective rates to converge by the end of the next charge control period (i.e. before 2017); and

(iv) therefore, as Ofcom identifies[36], moving prices such that they reflect the estimated LRIC differential by 2016/17 would undermine the stability and predictability of the regulatory regime[37].

6.10 Sky could not have reasonably expected that the price differential between MPF and WLR+SMPF would have reduced to the extent proposed in the Consultation. CEG, who were instructed by EE, notes in its memorandum on the July 2013 Charge Control Consultation that "*CPs were made aware in 2009 of Ofcom's intention to align charges with the LRIC differential (or a proxy of it) by 2012/13*"[38]. Even if this were correct (which Sky does not accept), this is beside the point. The issue at hand is not just whether communications providers were given clear and unambiguous guidance that, in future, price differentials would be based upon estimates of LRIC differentials but also whether those estimates at the time implied a differential of the order being proposed now. It is Sky's position that communications providers ("CPs") had no way of anticipating that the price differential would be eroded to near to zero.

6.11 Moreover, if Ofcom had positioned its approach to price adjustments from 2005 clearly and unambiguously as a form of entry assistance to support investment in MPF unbundling, then it may have been more reasonable to expect that that assistance may be temporary and the price differential would be reduced. However, Ofcom has never positioned the price adjustments in this way. As such, Sky (and other CPs) could not have contemplated that the price differential was temporary in nature (other than by reference to Ofcom's justifications for the adjustments in the first place).

6.12 As recently as 2012, Ofcom signalled to CPs that there would continue to be a significant price differential between MPF and WLR+SMPF despite the move to prices for the core rental services based upon their respective LRIC differentials. In its 2012 Statement, Ofcom considered the estimated LRIC differential to be between £10 and £14 and the CCA FAC differential to be £18.14[39]. Indeed, Ofcom placed greater weight on the higher CCA FAC differential, which it considered to be "reasonable from the point of view of efficiency for

35 Paragraph 8.63.

36 Paragraph 8.58 and 8.63.

37 Paragraph 8.4 and 8.58.

38 Paragraph 31, 'Memorandum from CEG Europe to Everything Everywhere (now EE)', 4 September 2013.

39 Ofcom, Charge Control Review for LLU and WLR services, Statement, 7 March 2012 (the "2012 Statement"), figure 7.3.

the LLU/WLR charge controls"[40]. This is unsurprising given, as Ofcom recognises, that unlike providers using WLR+SMPF, MPF-based operators can provide additional advantages to consumers through product differentiation (e.g. call features).[41]

6.13 Even after 2012, Ofcom indicated that there would continue to be a differential. In July 2013, Ofcom estimated the LRIC differential to be £9.90 for 2016/17[42], which is significantly different to the differential presented only five months later in the Consultation.

6.14 EE asserts that operators should have been aware about the proposed price reductions and CEG points to Ofcom indicating that it may require MPF to contribute fully to its relevant Test Access Matrices ("LLU TAM") costs[43]. However, the TAM pricing adjustment is only one of several contributing factors to the overall price differential and, as such, is a discrete issue. No case has been made as to why Ofcom's earlier statements on TAMs (which were not specific on the type, scale or pace of pricing changes) should have signalled a change to the MPF/WLR+SMPF price differential overall.

6.15 The price differential was a material factor when Sky decided to invest in full unbundling (via MPF), and continues to be a factor when considering unbundling further exchanges. In 2008, Sky undertook an assessment of whether to roll out voice services using MPF. Sky noted that through investing in MPF it could deliver a step change improvement in the economics of its broadband and telephony services by competing over more of the value chain and delivering enhanced voice services at a greatly reduced price compared to BT. Opening up more the market to infrastructure competition in this way has been a key pillar of LLU regulation because it has been considered by Ofcom as an effective way in which to promote innovation, investment and downstream competition.[44]

6.16 The original Sky investment required to deliver these improved services for consumers was [CONFIDENTIAL] over a period of five years. Sky considered extensively whether it could justify such a substantial investment. In deciding to proceed, Sky placed significant weight on the access fee saving, i.e. the price differential between MPF and WLR+SMPF. The impact of the access fee saving on the viability of MPF roll out was highly material.

6.17 If the differential was lower, then the business case would look less favourable and may not have proceeded in its proposed form or scale (or not at all) because Sky, like most other businesses, will have limited capital and resources with which to pursue business opportunities and focus only on the most attractive investment opportunities.[45] At no point did Sky contemplate (nor did it have reason to contemplate) that the access fee saving would be eradicated entirely; nor did Sky have a reason to contemplate such a scenario.

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40 *Ibid*, paragraph 7.65.

41 Paragraph 8.46.

42 Annex 6, Table A6.2 of the July Charge Controls Consultation.

43 Memorandum from CEG Europe to Everything Everywhere (now EE), dated 4 September 2013, paragraph 27.

44 Ed Richards recently stated: "*We know that some of these good outcomes are the results of regulatory initiatives. In the fixed voice and broadband markets, competition, innovation and choice at the retail level has been significantly enhanced by regulation to ensure non-discriminatory access to the upstream network. A good example of this is Local Loop Unbundling, where regulatory mandate created the ability for CPs to install their telecoms equipment in local exchanges. The result was investment in networks and increased choice and value for consumers. Between 2005 and 2012 the number of unbundled lines increased from 123,000 to 8.8 million, and at present, 94% of UK customers are able to access an LLU enabled exchange.*" 'Speech for Consumers and Citizens in the Communications Sector conference', 16 September 2013.

45 We note that this does not accord with standard corporate finance theory but nonetheless is widely considered to be normal business practice.

6.18 Sky faces higher ongoing costs as a result of its decision to invest in MPF. These costs include switch costs, equipment costs, installation costs, colocation charges and additional power consumption for equipment in the exchange. Sky would not face all of these costs if it had adopted the WLR+SMPF model. These costs were all considerations taken into account by Sky when it developed its business case to invest in MPF. Had Sky known that the price differential would be eroded so significantly, it may have taken different investment decisions in 2008 and 2009.

6.19 As Ofcom observes, Sky continues to unbundle smaller exchanges, where the business case for doing so is increasingly marginal[46]. This indicates, according to Ofcom[47], that it is likely to remain profitable for it to unbundle exchanges for the large majority of the population. Ofcom does not, however, appear to consider that Sky's continued decision to unbundle exchanges and use MPF is a consequence of Sky having developed the necessary scale to make continued unbundling possible, at a time before Ofcom indicated that the price differential between MPF and WLR+SMPF would reduce so drastically.

6.20 Sky continually evaluates the business case for rolling out to new exchanges. [CONFIDENTIAL] This demonstrates the marginal benefits associated with unbundling and using MPF. Ofcom's policy proposals would be fundamentally flawed if it has relied on a presumption that Sky would continue to unbundle small exchanges because it has done so in the past.[48]

6.21 To the extent that Ofcom intends to reduce the price differential, Ofcom should continue to be mindful of the fact that CPs had no indication of the proposed reduction and could not have anticipated this when investing substantially in LLU roll out programmes. As Ofcom states in the Consultation, "*it would be reasonable for stakeholders to expect Ofcom to gradually phase in the changes to MPF, WLR and SMPF charges to reflect the differences in LRIC*"[49] and moving to a LRIC differential of £0 to £4 by in the next charge control period "*would risk undermining the stability and predictability of the regulatory regime*"[50].

6.22 As set out above, Ofcom's previous consultations and statements have always indicated that there would be a significant price differential between MPF and WLR+SMPF products. This is most clearly evident in the chart in Table 8.1 of the Consultation, which shows the differential over time. It is clear from that table that the differential is reducing. However, if the differential shown in table 8.1 were projected into the future at a constant rate of reduction, then the differential would only be removed in 2020 at the earliest. Moreover, this extrapolation has only been possible now and previously the differential would have reduced more slowly and by a smaller amount.

6.23 On this basis, Sky agrees with Ofcom that reducing the differential before the end of the charge control period after next (and, indeed, before 2020) would have a detrimental effect on the regulatory regime. Specifically, future investment incentives for CPs would be undermined thus resulting in dynamic inefficiency.

6(D) Relative fault rates

6.24 In light of the new evidence presented by Ofcom in relation to relative fault rates between MPF and WLR (+SMPF) and in addition to generic factors affecting overall fault rates

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46 Paragraph 8.46.

47 *Ibid.*

48 Sky has since unbundled 2,355 exchanges.

49 Paragraph 8.58.

50 Paragraph 8.4.

discussed in Section 5 above , Sky considers that the efficient level of MPF fault rates relative to WLR and SMPF may be overstated because:

(i) MPF early life failure ("ELF") rates appear to be at an inefficiently high level due to provisioning process issues at Openreach (which are currently being investigated by the OTA[51]);

(ii) MPF in life failure ("ILF") rates are 6% lower than those for WLR+SMPF[52] indicating that, if it was not for the unduly elevated MPF ELF rates detailed above, MPF fault rates would be relatively lower;

(iii) WLR ELF rates will be understated because they are calculated against total activities conducted on a WLR line including software and/or records only changes and not just those that relate mostly to engineering activity (which is the case when calculating MPF fault rates); and

(iv) BT's cost minimisation incentives will be tempered with respect to MPF fault costs by its incentive to raise the costs of its main rivals in retail communications markets.

6.25 Given the above, there is a case for an immediate one-off downward adjustment to MPF ELF rates as opposed to allowing the efficiency gain arising from fixing the issues identified by the OTA to contribute to BT's overall efficiency target within the charge control glide path.

6.26 Sky recognises that ELF costs could be considered to be caused by connection and provisioning activity and, as result, its associated repair costs could be recovered from connection and provisioning charges as opposed to rental prices. While this allocation of costs may be more causal, Ofcom should also consider whether raising the costs of acquiring new customers will have the effect of dampening competition and switching and unduly penalising successful businesses. Either way, Ofcom will need to ensure that the relevant MPF ELF repair costs are at an efficient level - which Sky contends they are not today.

6.27 We also recommend that, given the higher incidence of faults on young lines compared to older ones and the known trend of reducing proportions of young MPF lines, Ofcom should forecast reducing ELF repair costs over time.

7. Charge controls for TRCs/SFIs

7.1 Sky welcomes Ofcom's provisional conclusion that charge controls are necessary for TRCs and SFIs. We have long held the view that there are fundamental problems with the provision of TRCs and SFIs, where the lack of any real competition has left CPs with little or no effective choice other than to pay excessive prices for these services[53].

7.2 Sky considers that Ofcom has correctly identified that:

(i) TRCs and SFIs are not subject to a sufficient competitive constraint;

(ii) BT has SMP in relation to these services;

(iii) its prices are significantly above cost;

(iv) a charge control is the proportionate and correct remedy in the circumstances (though Sky has some comments regarding the charge control design); and

(v) a one-off reduction in these charges is required in order to reduce immediately the consumer harm from the current excessive prices.

51 See OTA January 2014 Newsletter - http://www.offta.org.uk/updates/otaupdate20140402.htm.

52 Table 5.4 of the Consultation.

53 See Paragraphs 2.7-2.10 of Sky's response to the July 2013 Consultation.

7.3 However, while we agree with the proposal to impose charge controls, we consider that Ofcom should also be implementing measures to improve the contestability of these services.

7.4 Sky sets out below its views on Ofcom's provisional conclusions regarding TRCs and SFIs (as listed above) and suggests how Ofcom should improve the competitiveness of these services, as well as raising our concerns regarding other weaknesses in the current regime.

7(A) TRCs and SFIs are not subject to a sufficient competitive constraint

TRCs and SFIs are currently non-contestable

7.5 Ofcom recognises that there are a number of barriers faced by CPs using third party engineers to provide certain TRC and SFI services. Ofcom notes the restriction on non-Openreach engineers working on Openreach's network and issues arising from the inaccuracy of locating the customer's problem prior to despatching an engineer, which results in CPs being left with little alternative but to use an Openreach engineer to carry out all the work to ensure that it is completed in a single visit[54].

7.6 Sky highlighted these issues to Ofcom in its previous submissions regarding TRCs and SFIs and pointed out that the lack of competition gives BT the incentive and ability to price the services above the competitive level.[55] However, in addition to addressing the harm that arises from excessive pricing, Ofcom also needs to take measures to improve contestability for TRCs and SFIs.

Measures that Ofcom should take to improve contestability

<u>Line Testing</u>

7.7 Ofcom notes that that it is difficult for CPs to identify with sufficient accuracy the location of a fault when using Openreach's system line test[56] and notes in support of this point that BT suggests that the location accuracy of its line tests is 90% for TRCs[57]. Sky considers that BT's estimate is likely to understate the extent of the problem. [CONFIDENTIAL][58]. Furthermore, where the Openreach line test does not indicate a fault condition, 7.7% of the resulting SFI visits reveal that the fault was in fact on the Openreach network.[59]

7.8 This makes it impossible for third party engineer (i.e. non-Openreach engineers engaged by CPs) visits to be a viable option because in instances where the line test inaccurately reports that the fault is not on Openreach's network when it is, the third party engineer visit is wasted. By comparison, where an Openreach engineer visit is requested, despite

54 See Paragraphs 5.28-5.33 of the January 2014 Consultation.

55 See Paragraphs 2.7-2.10 of Sky's response to the July 2013 Consultation, and Sky's response of 7 November 2013 to Ofcom's 2nd section 135 Notice.

56 Openreach's System Line Test (which, as Ofcom correctly points out, is carried out once a customer has reported a fault and the CP has carried out remote diagnostics) is relied upon by Sky to indicate: (a) whether a fault exists: and if so, (b) if the reported problem is close to the home, whether it is possible for a third party engineer to carry out the remedial work.

57 Paragraph 5.31 of January 2014 Consultation. BT suggests that the location accuracy of line tests is 10%. Sky assumes that BT is implying that it is accurate in 90% of cases.

58 [CONFIDENTIAL]

59 Openreach presented a statistic to the Test and Diagnostics Forum on 27th November 2013 that suggested that, based on 1 week's data, the line test inaccuracy was 7.7%. See also, Sky's Informal response relating to TRCs and SFIs dated 7 November 2013, at the response to Q2(f), [CONFIDENTIAL].

the inaccuracy of the line test, the engineer can continue to carry out repair work on any part of the network (unlike third party engineers).

7.9 Openreach therefore has an incentive to maintain the inaccuracy of its line testing because it is less likely that a CP will risk engaging a third party engineer (particularly given that the CP will likely wish to minimise disruption for its customer). BT will lose a valuable source of revenue and profits should CPs like Sky be able to engage third party engineers viably more often.

7.10 Given BT's incentives to maintain a low accuracy line test system, Ofcom would be justified in requiring BT to take measures to improve the accuracy of its system line testing. For example, we suggest that Ofcom should consider introducing a SLA relating to the accuracy of Openreach's line tests with corresponding SLG payments to CPs where this is not met. In addition, Ofcom should require Openreach to publish data on the accuracy of its system line testing.

<u>Access to the face plate (NTE5)</u>

7.11 In its response to Ofcom's July 2013 Consultation, Sky referred to an SoR submitted in April 2013 by TalkTalk to Openreach requesting third party access to the NTE5[60.] Access to the NTE5 would enable CPs to provide a more efficient installation service to customers in a single visit and would avoid any of the benefits of a wires-only install being negated (if an Openreach engineer visit is necessary in any event)[61].

7.12 In reviewing the NTE5 SoR, Openreach has made it clear that it is extremely reluctant to allow third party engineers such access[62] and has failed to deal fully with the SoR. No consideration of this SoR has been given by Ofcom in the January 2014 FAMR Consultation and Sky considers that Ofcom should require BT to provide access to NTE5 to non-Openreach engineers as this would enhance the ability of third parties to provide competing TRC and SFI services on a more efficient basis.

7.13 In any event, by failing to provide a full and proper justification regarding the NTE5 SoR, Openreach is undermining the SoR regime and inhibiting TalkTalk (and interested CPs) from considering whether to take further action relating to its request (for example, making a dispute referral to Ofcom). Sky has previously flagged to Ofcom the inadequacy of the current SoR process and requested that Ofcom review the process due to BT's failure in responding to its customers' requests[63]. TalkTalk's NTE5 SoR request is yet another example of this and we encourage Ofcom to require BT to deal with TalkTalk's request fully and promptly, as well as improving its SoR process as a whole.

7.14 Moreover, dependent upon the outcome of BT's conclusions with regard to the NTE5 SoR and given BT's incentives to restrict growth in the use of third party engineers by CPs, Ofcom may also need to consider whether it is appropriate to require BT to allow third party access to the NTE5.

7(B) BT has SMP in relation to TRCs and SFIs, the prices of which are significantly above their costs

60 NTE5 or Network Termination Equipment is the copper network termination point within an end-user's premises. See paragraphs 3.53-3.54 of Sky's response to the July 2013 Consultation.

61 Paragraphs 3.53-3.54 of Sky's response to the July 2013 Consultation.

62 This point has been made by Openreach when providing an update on the progress on the TalkTalk SoR. See, for example, the CPCG Actions Update slide of 7 January 2014.

63 Paragraphs 4.1-4.4 of Sky's response to the July 2013 Consultation.

7.15 Ofcom's provisional conclusion in the January 2014 Consultation is that TRC and SFI prices are likely to be in excess of costs. In forming this view, Ofcom reviewed the annual cost, revenue and volume data provided by BT for the period 2009/10 to 2012/13 for TRCs and SFIs. Ofcom raises significant concerns regarding the cost information for TRCs and SFIs.[64.] In particular, Ofcom refers to Openreach's labour-related operating costs decreasing in absolute terms between 2011/12 and 2012/13 despite volume increases, which BT has not been able to fully explain. Ofcom was also concerned by BT's approach to calculating TRC costs, which it said "*cast doubt on the reliability and consistency of BT's TRC cost data*".[65]

7.16 These concerns led Ofcom to decide that it could not fully rely on the data provided by BT and so had to supplement it with other information. In relation to TRCs, this additional information allowed Ofcom to compare: (a) estimated average hourly cost to the average revenue per billed TRC hour (which implied prices would need to fall by 40% to bring them in line with costs); and (b) basic hourly cost estimates to the standard hourly price charged by BT (which indicated that prices would need to fall by 12% to bring them in line with costs).[66] Ofcom considered that this shows revenues are in excess of costs for TRCs and that a one-off price reduction at the start of the charge control period is necessary.

7.17 For SFIs, Ofcom again only used the information provided by BT for an indicative view of costs relative to revenue. Ofcom considered that, based on the limited data available to it, total revenues were in excess of FAC in 2012/13 even before the changes made since 2012/13, which are expected to increase revenue and EBIT margin further.[67]

7.18 As mentioned above, for some time Sky has pointed out that SFIs and TRCs are non-trivial components of the costs faced by CPs and that the lack of competition gives BT the incentive and ability to price TRC and SFI services above the competitive level and agrees with Ofcom's assessment that Openreach's prices are in excess of cost.[68]

7(C) A charge control is the proportionate and correct remedy

7.19 Sky agrees with Ofcom's proposal to implement a charge control for TRCs and SFIs. Openreach currently charges prices significantly in excess of costs (as evidenced above) and has the ability and incentive to continue to do so unless such a remedy is imposed. However, Sky has some comments regarding the design of the charge control, in particular in relation to:

(i) the appropriate cost standard;
(ii) the level of price reduction; and
(iii) the rate of indexation.

7.20 We discuss each of these in the following sections.

64 Paragraphs 5.54-5.71 of the January 2014 Consultation.

65 Paragraphs 5.66 of the January 2014 Consultation.

66 Paragraphs 5.76-5.77 of the January 2014 Consultation.

67 Paragraphs 5.99-5.101 of the January 2014 Consultation. We note that, as with many values in the January 2014 Consultation, the revenue and EBIT data has been redacted from the consultation and so it is difficult to comment on the extent of the expected changes.

68 See Sky's response to the July 2013 Consultation and to July 2013 Charge Controls Consultation.

The appropriate cost standard

7.21 Ofcom states that it considers that FAC remains an appropriate cost standard for analysis, in particular because it considers that BT should be able to recover more than just its incremental costs of providing TRCs and SFIs.[69] In Ofcom's view, "*the presence of large common costs for services provided over BT's network mean a mark-up over LRIC for individual services is usually seen as necessary for sustainability so as not to undermine overall cost recovery*".[70] Ofcom considers that typically services are only priced at LRIC where justified by policy, competition and/or efficiency reasons (which it claims is the case for GEA migration).

7.22 To the extent there is a meaningful difference between FAC and LRIC[71], Sky's position remains as set out in its submission of October 2013[72]. For similar reasons as referred to by Ofcom for justifying an incremental costs-only approach to key migrations, Sky remains reliant on TRC and SFI services provided by Openreach in part to deal with early life failures (ELFs) near to or at the point of sale.[73] The costs of TRC and SFI services, which often relate to connecting new customers, are passed on to consumers and can impact switching in the same way as migrations costs. Sky therefore considers that LRIC is the appropriate standard by which to set TRC and SFI charges.

7.23 Ofcom also refers to a need to remain consistent with the cost allocations used in the LLU and WLR charge controls, due to the risk of costs being over-recovered or under-recovered from TRCs and SFIs if the approach is not consistent.[74] Sky does not consider this a valid argument. Ofcom has proposed to apply LRIC-only charge controls in certain other areas (such as SMPF rental and migrations) and, as such, its charge control modelling already allows for certain services to make lower or no contributions to common cost and for other services to make larger contributions as a result.

The price reduction for TRCs should be greater than 16%

7.24 Ofcom has identified a range of 12-40% for the reductions in charges for TRCs and has exercised its judgement to propose that a 16% reduction is likely to be reasonable.[75] Ofcom says that it considers issues around the upper bound of this range[76] would tend to suggest that a figure towards the lower bound is more appropriate. Ofcom then carries out a review of current prices and adjusted cost estimates (uplifted by its proposed 0.2% indexation rate) to arrive at an estimated hourly TRC cost which, when compared to the 2013/14 "Additional Hour" prevailing price, indicates that a price reduction of 16% from current levels is required[77].

7.25 Sky has the following concerns with Ofcom's methodology used to arrive at its proposal of a 16% reduction in charges:

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69 Paragraph 5.57 of the January 2014 Consultation.

70 Paragraph 5.58 of the January 2014 Consultation.

71 The difference is not made available in the January 2014 Consultation.

72 Paragraphs 7.13-7.16 of Sky's Response to the July 2013 Charge Controls Consultation.

73 See paragraph 4.1 of Sky's response to the Consultation regarding service quality. [CONFIDENTIAL].

74 Paragraph 5.59 of the January 2014 Consultation.

75 Paragraph 5.90 of the January 2014 Consultation.

76 Paragraph 5.86 of the January 2014 Consultation - Ofcom says that it does not place significant weight on the 40% figure because: (a) it is based on BT's reported volumes, which BT state are likely to be too low and contribute to counterintuitive average TRC revenue trends over time; and (b) it would result in a charge substantially below Ofcom's estimates of the 2012/13 hourly costs.

77 Paragraphs 5.88-5.90 of the January 2014 Consultation.

(i) Sky considers that Ofcom has not justified its decision to disregard the upper bound of its range while continuing to give weight to the lower bound. While, with respect to the upper bound of the range, Ofcom says it has "*significant concerns with* [its] *reliability*"[78], in our view such concerns should apply equally to the lower bound due to the reliability of the data. Ofcom's other reason for dismissing the upper bound – which BT says would be too large because resultant prices would be substantially below cost - shows an unjustified bias towards BT. In a similar vein, Sky considers that 12% is too small a decrease as it could equally result in prices that are substantially above costs. Therefore, if Ofcom's reasoning were applied consistently, a reduction towards the lower bound should also be rejected.

(ii) Ofcom has used its proposed indexation rate of 0.2% in order to uplift its hourly cost estimate and compared this with the 2013/14 "Additional Hour" prevailing price of £60 in order to calculate its suggested 16% reduction.[79] Sky considers that applying the uplift is an unnecessary and unjustified step which implies that current cost inflation is in step with Ofcom current proposed future indexation. It is also not clear why Ofcom should give additional weight to the prevailing price for "Additional Hour". Sky considers that a more reasonable approach would be to reduce prices to reflect Ofcom's view of the correct level (for example by taking the middle point of Ofcom's range).

(iii) Ofcom states that the 16% reduction would still ensure that Additional Hour charges make a "*significant contribution to common costs*"[80]. For the reasons set out at paragraphs 7.20 to 7.22 above, Sky does not consider that there is a need to allow for the recovery of common costs from charges for TRCs and SFIs, let alone significant contributions towards them.

7.26 For these reasons, Sky does not consider that Ofcom has justified its proposal to set the reduction to charges at 16%. Sky considers that it would be more equitable for Ofcom to select the middle of its range and therefore set the price reduction at 26%.

Indexation

7.27 Ofcom is proposing an indexation of +0.2% per year for the proposed TRC and SFI charge controls. Ofcom has reached this proposal by using a combination of the wage inflation rate and efficiency assumption proposed for the WLR and LLU charge controls (which is still to be determined), weighted according to the relative proportion of labour and non-labour costs in order to come up with a range for indexation of -0.1% to +2.8%. Based on the mid-point of the efficiency range currently proposed, this would give an indexation of +0.2%.[81]

7.28 In relation to Ofcom's calculation of its range for indexation, as stated in its previous submissions, Sky considers that Ofcom's pay inflation assumption of 2.8% is too high[82] and its proposed efficiency rate of 5% is too modest[83]. As a result, we consider that Ofcom's starting point for its indexation calculation is flawed.

[78] Paragraph 5.64 of the January 2014 Consultation.

[79] Paragraph 5.89 of the January 2014 Consultation.

[80] Paragraph 5.90 of the January 2014 Consultation.

[81] Paragraphs 5.109-5.114 of the January 2014 Consultation.

[82] See paragraphs 5.12-5.15 of Sky's Response to the July 2013 Charge Controls Consultation.

[83] See paragraphs 6.1-6.4 of Sky's Response to the July 2013 Charge Controls Consultation.

7.29 Ofcom proposes to apply the index to each TRC and SFI charge, rather than adopting a basket approach, because of the difficulties BT says it will face in providing volume and revenue weightings for these services. Sky agrees with this approach as it would be disproportionately burdensome on BT to adopt a basket approach with limited gains.

7(D) Alignment of TRC and SFI charges

7.30 Sky supports Ofcom's view that SFI prices should be aligned with TRC prices[84] on the basis that both services require almost identical engineering skills and resources. An example of the current disparity between the prices for the two services is that (from 1st April 2014) Openreach will charge CPs £134.25 for its SFI Base Module, whereas the TRC call out charge is £120.00[85]. Both services involve an Openreach engineer to be on site for up to an hour and essentially involve the Openreach engineer carrying out the same type of work. Sky cannot see why the same price is not charged for the two services.

7(E) A one-off reduction to these charges is required

7.31 Ofcom proposes to apply a one-off reduction in prices at the start of the control period, rather than reducing prices more gradually through a glide path mechanism, in order immediately to reduce the consumer harm from excessive prices. In particular, Ofcom considers that this is appropriate because: (a) BT's high margin is not necessarily the result of previous efficiency gains; (b) these services were not previously subject to a charge control; and (c) the disruption of a one-off change is likely to be limited given the comparatively low revenue from TRCs (compared to WLA as a whole) relative to the benefits of reducing prices.[86]

7.32 Sky agrees with Ofcom that a one-off reduction is most appropriate. A reduction by reference to a glide path would be inappropriate in this instance because prices would remain excessive for too long thus prolonging consumer harm unnecessarily.

7(F) Further points regarding SFIs – weaknesses in the current regime

7.33 Sky has additional concerns in relation to (i) the way that BT structures its SFI product; and (ii) in turn the modular pricing of SFIs which result in increased charges. We address each of these points in turn below.

SFI module structure

7.34 The way that the SFI product works is that the CP "pre-approves" Openreach to undertake different modules. Following the running of its own diagnostic tests and Openreach's system line tests, and no fault being identified on Openreach's network, the CP will require an engineer to resolve the fault. As Ofcom has correctly concluded[87], in the majority of cases the CP will request that an Openreach engineer attempts to resolve the fault (rather than risk calling out its own engineer only to discover that the fault is in fact on Openreach's network).

7.35 Due to the way Openreach's SFI modules are structured, in the vast majority of cases Sky "pre-approves" all SFI modules, i.e. the SFI2 Base Module and the additional five SFI2

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[84] Paragraph 5.104 of the January 2014 Consultation.

[85] See Table 5.1 in the January 2014 Consultation and the Openreach LLU price list: http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=totid5BwFmkf9vLcBITRyZF9loRxWIbIKK6V7YWmlYAlMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AIlSgtIFAKw%3D%3D.

[86] Paragraph 5.93 of the January 2014 Consultation.

[87] Paragraph 5.28-5.33 of the January 2014 Consultation.

modules. This is because it is not possible for Sky to predict accurately which of the SFI2 modules might be required in order to resolve the customer's issue prior to the Openreach engineer arriving to resolve the fault. Sky pre-authorises all additional modules in order to save unnecessary costs (i.e. the cost of an Openreach engineer having to make a repeat visit) and to avoid any delay to the customer in resolving the fault, which would arise if the Openreach engineer had to wait for prior authorisation/make a repeat visit to undertake the necessary modules.

7.36 Sky therefore considers that the SFI module structure necessarily results in Sky pre-authorising the Openreach engineer to carry out more modules than is likely to be required in almost all cases. Given the lack of competition for the provision of these services, as Ofcom has highlighted, Sky has no choice but to instruct Openreach's engineers and pre-authorise modules in this way. Likewise, without appropriate action by Ofcom, Openreach has no incentive to alter a structure from which it benefits through charging for more modules than it would otherwise need to. As part of its review, Ofcom should investigate how Openreach can change the way it structures SFI modules to avoid this issue.

Transparency and module pricing

7.37 Sky supports Ofcom's view that, as part of its review, it should investigate whether Openreach engineers carry out work as part of the SFI modules on an efficient basis. One of Sky's concerns is that Openreach has pre-approval to charge Sky for as many SFI modules as it wishes (since Sky "pre-approves" all SFI modules when placing an SFI – as explained above). There is currently very little visibility afforded to CPs regarding how Openreach engineers decide whether or not they should undertake each SFI module. Ofcom should, therefore, as part of its review, include this aspect of Openreach's behaviour when reviewing the efficiency of its engineers and consider requiring Openreach to provide more information on the work carried out and charges made to CPs as a result.[88]

7.38 Finally, whilst Ofcom is proposing to set the maximum hourly rate in an SFI module, BT will have discretion over the average module duration that ultimately informs the module price.[89] We encourage Ofcom, as part of its review, to guard against Openreach over-stating the amount of time that each SFI module takes to complete. Throughout the January 2014 Consultation, Ofcom has referred to its significant concerns with the data provided by BT (including information provided in response to section 135 notices). We urge Ofcom to scrutinise Openreach's estimates regarding the average time it take to complete each SFI module accordingly.

8. Other points

8.1 In addition to the issues raised above, Sky raises three further, discrete issues relating to (i) forecast MPF migration charges, (ii) the mechanism by which BT is required to make repayments to its customers if prices exceed those required by the charge controls, and (iii) interim charging arrangements once the current charge control expires.

88 See, for example, Sky's Informal response relating to TRCs and SFIs dated 7 November 2013. Sky refers to various issues it faces regarding billing, operational issues and testing, most of which involve a lack of transparency and/or inaccurate information provided by Openreach regarding TRCs and SFIs.

89 Paragraph 5.107 of the January 2014 Consultation.

8(A) MPF migration charges should reflect the growing use of MPF Stopped Line orders without engineering (frame) activity

8.2 Sky is now able to re-start some 'stopped' MPF lines without any engineering activity. When such orders are placed this requires only a software and/or records-only change and, as such, costs are far lower than the list price for these orders. Both Sky and TalkTalk have substantially increased the volumes of these order types such that BT's overall costs of providing MPF stopped lines will reduce.

8.3 It is essential that the cost forecasts for the charge control adequately reflect this trend (it is not apparent that this is the case). Otherwise, charges for these services would be set too high and BT would make excess returns as a result of its customers being more efficient.

8.4 Moreover, in order to incentivise the efficient use of BT's engineering resource, Sky requires (and has requested from Openreach) a dedicated price and product for MPF Stopped Line orders where no engineering activity is required – as is already catered for with equivalent WLR order types – because it will reward efficient activity by MPF operators and set appropriate incentives for cost minimisation. Openreach is yet to formally approve this request for development.

8.5 The alternative of blending the cost savings in one single MPF Stopped Line Provide or WLTO order would reduce cost minimisation incentives as an MPF operator would pay the blended price without being more efficient itself by ordering more records-only restarts. We ask Ofcom to consider whether Openreach should be required to offer this lower prices migration product in order to optimise cost, promote cost minimisation and to maintain competitive neutrality between WLR and MPF services.

8(B) Communications providers will require sufficient information to validate any refunds provided by BT as a result of charge controls being exceeded in any year

8.6 Ofcom is requiring BT to repay its customers in the event that its prices at the end of any year exceed the level prescribed by the charge controls. While there is little in the way of detail currently as to how this mechanism will work in practice, Sky urges Ofcom to ensure that CPs are provided with sufficient data in order to validate any refunds provided to them by BT.

8.7 Should it be considered that some data cannot be shared with CPs due legitimate confidentiality concerns, then Ofcom (or an independent third party) should review the repayments and provide assurance that they have been appropriate calculated.

8(C) Interim pricing arrangements need to be fair

8.8 In its response to the July Charge Controls Consultation, Sky explained that any interim pricing arrangements during the regulatory lacuna from when the current charge controls expire and the new ones begin should be fair.

8.9 Specifically, the approach to interim pricing during the previous lacuna resulted in prices that reflected a continuation of the expiring charge controls. An alternative approach of basing interim prices on the latest view of the likely charges had the new charge control started on time would have resulted in significantly lower prices.

8.10 Sky pointed out that these respective pricing effects would reverse if the same approach were adopted this time - i.e., a continuation of the current charge control would likely result in lower prices.

8.11 Sky reiterates that it would be grossly unfair for Ofcom to adopt an approach based upon estimates of what prices would have been had the new charge controls started on 1st April because, irrespective of the merits of the two approaches, moving from the method adopted last time (continuation of the charge control) to the one based upon the new charge controls favours BT such that it gains both times.

8.12 These points were raised by Sky in some detail in its response to the July Charge Controls consultation and in subsequent meetings with Ofcom. We expect Ofcom to consider carefully Sky's view before finalising any interim pricing arrangements.

Sky **February 2014**