Wholesale Fixed Telecoms Market Review 2021-26

Further consultation on certain proposed remedies

TalkTalk submission

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NON-CONFIDENTIAL

1 Summary

1.1 This document is TalkTalk's response to Ofcom's 6 November 2020 WFTMR consultation titled "*Further consultation on certain proposed remedies*" which proposed price changes for PIA, DFA and some other services as well as modified DFA implementation timing.

1.2 As TalkTalk has described to Ofcom before, the combination of lax proposed price regulation (an above cost CPI+0% price cap *only* on the 40Mbps anchor product), a shift in consumer demand to higher bandwidths and the stop-sell regulation grants Openreach unprecedented pricing freedom. This will cause significant harm to end customers through excessive and unaffordable retail prices as well as by weakening competition and reducing choice in the retail market as retail providers exit the market or reduce their investment. The changes that Ofcom is now proposing in this consultation will weaken regulation still further, exacerbating the harm.

1.3 Our key comments on Ofcom's new proposals are as follows:

- The change in the method of calculating certain PIA charges, and the consequent increase in prices for PIA products, will harm consumers by reducing altnet investment, and thereby also reducing Openreach FTTP investment. It is also contrary to Ofcom's objectives of ensuring a level playing field for altnets and cost recovery for Openreach. Ofcom claims that the revised approach has the advantage of providing pricing stability – however, in practice the revised approach will not lead to stability. In any case certainty of future pricing is considerably more important than stability and the new approach creates uncertainty as it is capricious and poorly grounded in economic logic. The proposal suggests to us that Ofcom is not genuinely committed to encouraging altnet investment and instead is giving in to pressure from Openreach to weaken the threat posed by altnets. We consider that PIA prices should be derived using the utilisation approach and reflect that Openreach has already recovered much more than the book value implies – such an approach will better meet Ofcom's stated objectives
- DFA/DFX prices are proposed to be higher as a result of changes in BT's cost allocations. Given Ofcom's new approach of not setting cost based prices, Openreach now has a strong incentive to manipulate allocations to inflate prices and profits – as it has done here. After creating this problem, Ofcom must now proactively review whether changes in allocations are reasonable and not presume that BT's changes are reasonable given that they have strong incentives to be biased and exploitative.
- Ofcom has proposed delays of up to 13 months in DFA implementation – some components are delayed by 3 months and some up to 13 months. This is based on claims by Openreach that the previous timing was not feasible. We think that a faster implementation on SLA/SLGs, billing and QoS obligations is both necessary and achievable – these components should be implemented within 6 months.
- We agree with the change to the SoGEA pricing obligation but with an amendment to reflect the fact that SoGEA costs are lower than the sum of MPF plus FTTC costs.
- We agree with the change in the interpretation of the basis of charges obligation – that prices should be below FAC costs – which applies to PIA ancillary and contractor ECC charges. There is no consumer benefit to allowing prices to be above FAC cost

level. Further, DSAC cost – which was the previous cost benchmark proposal and is an Oftel invention from the 1990s that is used by no other regulatory authority – has no grounding in economic theory and is open to exploitation by BT.

1.4 We have consistently highlighted to Ofcom the significant customer harm that its regulatory proposals will cause. Further, from the consultation and subsequent discussions with Ofcom it appears to us that Ofcom has already determined what its approach will be irrespective of evidence provided in consultations; is closed to understanding or assessing the significant impacts of its proposals on consumers; and is unwilling to amend regulation to ensure that customers are properly protected. Our view has been reinforced by the additional consultations published since January which in almost every case propose further weakening of regulation and do not address the harm that Ofcom's proposals will inflict on consumers. It appears that Ofcom has not used this time to properly assess the impact of its proposals on consumers.

1.5 Accordingly we are now exploring with a QC options for legally challenging Ofcom's upcoming, pre-judged, decision.

2 PIA pricing

2.1 In its January 2020 consultation, Ofcom proposed to set certain PIA prices (2-bore and 3-bore spine duct, joint boxes and manholes) on the basis of current utilisation levels. For instance, for 2-bore spine duct, based on there being on average 5.2[1] 25mm sub-duct equivalents, the PIA charge for a 25mm sub-duct would cover a 19.3% share of unit cost of the duct. The unit cost of the duct includes the existing book value plus ongoing capital and operating costs (e.g. maintenance and repair).

2.2 In this consultation, Ofcom has fundamentally changed its proposed method for deriving the unit cost share, seemingly driven by a desire for 'stable prices'. Under the utilisation method the unit cost share would fall (as FTTP was rolled out by Openreach and altnets) and then rise (as the copper network was removed) which Ofcom said "*was not its intention*" (§3.12).

2.3 Ofcom explained to TalkTalk[2], that the intent of the new method was for the charge for a particular asset to reflect the share of customers that an altnet would have of the total of the customers that used/relied on that asset – it referred to this as a 'fair' share. For example, in the case of a 2-bore spine duct, Ofcom assumed that an altnet's network would pass 50% of the customers whose circuits use that duct and that the altnet's share of these customers would be 50%. Thus an altnet would serve 25% of the customers whose circuits used that duct and so the appropriate unit cost share for a 25mm sub-duct was therefore 25% of the cost of the duct (= 50% x 50%). For other assets (such as spine ducts with 3 or

[1] This is derived from the 19.3% share of unit cost (table 3.2). Given Ofcom's methodology and that the share of the unit cost is 19.3% it implies that there are, on average 5.2 25mm sub-duct equivalents in 2-bore ducts (5.2 = 1 / 19.3%).

[2] Meeting with Ofcom 24 November 2020.

more sub-bores) because the asset served more customers the assumed altnets share of these customers would be less – 10% in the case of 3+-bore spine duct.

2.4 Ofcom says that its new approach is consistent with its objective to "*ensure a level playing field exists*" and "*providing Openreach with an opportunity to recover its efficiently incurred costs*" (§3.18). Ofcom's other highly relevant objective that must be considered is to promote altnet FTTP investment.

2.5 We consider that there is a different method that meets these objectives better than either the previous utilisation method or new method.

2.6 Ofcom calculation of the PIA price is based on the <u>book value</u> of the existing assets. However, Openreach has already recovered far more cost than the book value implies[3]. This is because Ofcom has – over the last 15-20 years – intentionally allowed Openreach to set prices far above cost in order to encourage entry (via regulatory structures such as the HON adjustment and the lack of price cap on very high bandwidth Ethernet products) or encourage migration from legacy products (e.g. ISDN and TISBO price caps being set in excess of costs). Over the last 15 years total over-recovery has been about £11.8bn[4]. Not all of this is over-recovery of the PIA assets:

- some of this total over-recovery may have been due to outperformance (e.g. cost reduction) above reasonable forecast though this is likely to be small[5].
- some of this total over-recovery may be attributable to other assets beyond those used to serve the PIA market.

2.7 However, even making adjustments for this, it is likely that Openreach has already recovered all or the majority of the existing book value of PI assets which is £5.5bn through Ofcom's regulatory decisions, and thus the unrecovered PI asset is much less than £5.5bn.

2.8 PIA prices should therefore be based on the <u>unrecovered PI asset value</u> (rather than the book value). This would reduce PIA prices. It would unequivocally be in consumers' interests and better meet Ofcom's objectives than Ofcom's current proposals:

- it would promote altnet FTTP investment by lowering altnet costs in rolling out networks;
- it would promote Openreach FTTP investment by increasing the competitive pressure being imposed by altnets, creating races to invest in FTTP in areas where there is the potential to see altnet entry. There would be no detrimental impact on Openreach's

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[3] The book value is based on initial asset value less depreciation and it is the depreciation that is used to derive cost. If prices are above cost then it implies that the cost recovery Is greater than the depreciation

[4] comprised of £10.5bn for the period up to 2016/17 from 2017 Frontier report (Frontier Economics "Profitability and the Incentive to Invest" 28 September 2017) plus £1.3bn calculated from BT's RFS for the three years to 2019/20. See CityFibre response to the WFTMR *Further consultation on certain proposed remedies* for details.

[5] It would be expected over the long run that this form of over-recovery would be around zero (if Ofcom's forecasts were unbiased) since Openreach would be as likely to over-recover as under-recover.

FTTP investment since lower PIA prices will not reduce Openreach profits from investing in FTTP;

- it would ensure a more level playing field between Openreach and altnets – the underlying cost to Openreach of using its existing duct/pole assets does not include the existing asset costs since these are sunk costs and so Openreach does not incur any incremental cost associated with the existing asset. Thus reducing PIA prices (reflecting the unrecovered asset cost) will bring the cost level that altnets face closer to the cost that Openreach faces, improving effective competition;
- it would increase allocative efficiency, which will be maximised in this case at a price close to zero. In order to maximise allocative efficiency, prices should be set in line with incremental cost- and the incremental cost to Openreach of having altnet fibre in an otherwise underutilised duct is zero. In such a case, the allocatively efficient cost structure would be a payment reflecting the cost of installing the fibre in the duct, and then no further payments at all;
- it would reflect the natural monopoly characteristics of duct, by encouraging altnets to use Openreach duct rather than construct their own duct. This will enhance productive efficiency[6]. There is no need for higher prices to encourage efficient entry in passive assets since this is not (and should not be) Ofcom's objective;
- it would not threaten Openreach cost recovery, which has largely already been achieved;

2.9 Notably this approach is consistent with the approach outlined by the European Commission[7]:

> *In the recommended costing methodology the Regulatory Asset Base (RAB) corresponding to the reusable legacy civil engineering assets is valued at current costs, taking account of the assets' elapsed economic life and thus of the costs already recovered by the regulated SMP operator. This approach sends efficient market entry signals for build or buy decisions and avoids the risk of a cost over-recovery for reusable legacy civil infra structure. <u>An over-recovery of costs would not be justified to ensure efficient entry and preserve the incentives to invest because the build option is not economically feasible for this asset category.</u>*

2.10 Thus we consider that PIA prices should be derived based on the unrecovered PIA asset cost rather than the book value of PIA assets.

2.11 In terms of the unit cost share that PIA attracts, we consider that the new approach has a number of key problems that Ofcom has not considered in its consultation:

- There is little benefit from having a stable price, and Ofcom does not identify any advantages of a stable price. Altnets are well able to factor changing PIA prices into their financial planning, which is detailed and involves many factors which are

[6] It is always productively inefficient to replicate natural monopoly assets.

[7] Commission Recommendation of 11 September 2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment

expected to change over time. What is important is predictability and certainty of prices, which can best be provided through a robust basis for price setting.

- In any case, the new approach will not result in a stable price or provide certainty to market participants:
  - because the new method is based on arbitrary assumptions that do not have any underlying justification or supporting evidence, it is highly vulnerable to being changed in future, whether as a result of an appeal or through future Ofcom periodic reviews. Ofcom seems to be under a misapprehension that it thinks that because it currently *wants* the new approach to apply in the long term, it *will* apply in the long term.
  - Even if the method remains in place it only results in a stable unit cost share. Since the total cost of duct will change then the actual price will not be stable. Such prices may go up or down over time.
- Ofcom suggests that setting a low price now would risk setting an expectation of a low or lower prices in future (§3.14). This is nonsense – provided Ofcom transparently explained the position, it could easily set realistic expectations about potential changes in prices in the future, which altnets could build into their financial modelling. Ofcom seems to presume that stakeholders will not read its final statement or will lack the competence to understand potential future changes, despite all significant market participants having specialist regulatory staff to monitor and interpret such documents.
- The estimate for the proportion of circuits that an altnet's network will serve at 50% is a figure plucked out of thin air which has no evidential basis. Also, the estimation of a 50% market share (as between Openreach and altnets) for an altnet entrant using 2-bore duct appears is unfounded. Ofcom fails to reflect the incumbency advantage of Openreach, and Openreach's vertical integration with the largest retail ISP, BT Consumer which will place a large proportion of the market out of the reach of an entrant. Even if Ofcom wished to adopt such a back-of-the-envelope approach to determining altnet PIA charges, it should reduce the market share of altnets to perhaps 40%, reflecting the weak position of an entrant network, even in the long-term.
- The market share estimate also does not reflect the lag involved in an altnet building share. If the new method is used, the unit cost share and prices during this period (2021-26) should reflect that market share will be much lower than the long term market share – perhaps, on average in this period, less than half of the long term share.[8] Prices would then increase in future periods once altnets are more established. This would also enable Ofcom to recalibrate its market share assumptions if outturn market share was higher or lower than predicted. At present, entrants with low market shares will have to bear costs as if they had the scale of an incumbent monopolist.
- The uncertainty inherent in Ofcom's arbitrary approach will favour Openreach since they will have the data available to challenge its reasonableness. If data and

[8] The precise proportion will depend upon when in the period the majority of roll-out occurs, and how long it takes altnets to build their customer bases up.

evidence they have available justifies a higher price Openreach will challenge the existing price, whereas if the data and evidence justifies a lower price Openreach will remain silent. For example, in 5 or 10 years Openreach may press for a change to a utilisation method since it would result in a higher price due to the then lower utilisation following copper retirement. Given Ofcom's approach of setting forward-looking prices based on then extant market conditions, and the prospects of appeal to the CAT, it is unlikely to be able to resist Openreach's submissions on this point.

- Increased PIA prices (for no discernible consumer benefit) in the current regulatory period will both reduce competitive FTTH investment and reduce the pressure on Openreach to roll-out FTTP quickly itself. It is therefore likely to lead to materially lower FTTP availability in the UK over the next regulatory period.
- Ofcom has provided no explanation of how the new approach better meets its objectives (level playing field and cost recovery); instead it just asserts that the new method is "*appropriate*" (§3.18).

2.12 We consider that the utilisation approach is superior to the new method since it will better serve consumers' interests.

2.13 Whereas the new method is arbitrary and therefore inherently uncertain, the existing approach is based on a justifiable and well-established methodology and evidenced assumptions which provides greater certainty and predictability – allocating and recovering costs based on utilisation has been used for BT's regulatory financial statements for over 20 years and for PIA prices for 9 years.

2.14 The existing method also better meets Ofcom's stated objectives:

- it promotes greater altnet investment. Artificially attempting to force stable prices (although the proposals will not actually do so) is harmful since, in this case, it raises the PIA price above the appropriate level thereby creating inefficient pricing signals reducing altnet investment and, in turn, Openreach investment;
- it provides a level playing field and allows cost recovery since the PIA charge reflects the allocation of cost in BT's regulatory accounts.

2.15 We also have other comments on the calibration of each method.

2.16 For the utilisation based method the unit cost share is 1 / n (where n is the existing number of 25mm sub-ducts; 5.2 in the case of 2-bore). However, the correct share should be 1 / (n + 1) since once an altnet rents a 25mm sub ducts, then the number of 25mm sub ducts is 'n + 1' since there is one more user than currently. Thus, for 2-bore duct example, the correct share should be 16.2% (= 1 / (5.2 + 1)[9]. Consequently, Ofcom's '1 / n' method leads to over-recovery even on the basis of its own assumptions.

2.17 The assumptions used in the utilisation method should be based on a forecast of average utilisation during the period (2021-26) or mid-period rather than the level of utilisation prior to the period. Ofcom's standard approach to setting cost based prices that has been used in all other market reviews is based on costs during the period not before it. There is no

[9] Alternatively, it may be appropriate to do on the basis of average usage across the UK in which case the share should be 1 / (5.2 + x) where x represents the average use of 2-bore duct nationally

reason to use old and irrelevant data, and Ofcom has not sought to justify this stark divergence from its regulatory practice.

2.18 Thus we see there a number of flaws in Ofcom's approach in deriving PIA prices. The three changes below will better meet Ofcom's objectives and deliver more certainty than Ofcom's approach:

- the existing PI asset cost used to derive the PIA price should be the unrecovered cost rather than book value of PI assets;
- the unit cost share used to derive the PIA price should be based on the utilisation method rather than the arbitrary 'finger in the air' method Ofcom has used;
- the utilisation assumption should be based on utilisation during the review period (not a point before the review period) and also the utilisation after PIA use occurs.

3 DFA/DFX pricing

3.1 Ofcom has proposed changes for regulated DFA/DFX pricing (DFA in Area 3 and DFX between BT Only exchanges). The key changes are that:

- initial (FY21) access tail prices are materially higher (£830-£1,120 compared to £701 in the January consultation);
- initial main link prices per metre are lower (£0.08-£0.11 vs £0.15).

3.2 The net aggregate effect of these changes (given the overall mix of tails and main link) is to increase the cost of DFA/DFX.

3.3 The changes arise as a result of changes in BT's cost attribution and in particular three changes in the 2019/20 accounts:

- Access Fibre allocation (3.25 in Change Control Notification FY20[10])
- Interexchange Fibre allocation (3.26)
- Access Fibre usage factors (3.27)

3.4 Amongst other things, the impact of these changes is to allocate more cost to LLA/IEC services and less to WLA services – this explains why the aggregate effect is to increase charges for leased line products.

3.5 It seems that Ofcom is accepting of these changes without question. According to BT's Change Control Notification all of these attribution changes are based on 'BT Judgement' which implies they are subjective, and Ofcom does not cite any reasoning why the new attributions are an improvement on previously used assumptions. Yet Ofcom has not assessed these changes or challenged them[11].

[10] Change Control Notification 31 March 2020.

[11] When we met Ofcom they explained that the changes had been audited and Ofcom was reviewing them in parallel to the consultation.

3.6 Due to its other WFTMR proposals, Ofcom now needs to be much more attentive of changes in cost attributions proposed by Openreach than has been the case previously. Previously almost all wholesale products' prices were cost based. This meant that reallocations between SMP markets (e.g. WLA to LLA/IEC) had limited impact on the overall prices Openreach could charge (and on Openreach's revenues and profits) since an increase in the cost of one price-regulated product would increase its price but this would be offset by a fall in cost and price of another price-regulated product[12]. However, Ofcom's proposal to depart from cost based prices for many products means that Openreach now has a strong incentive to manipulate the cost attributions between products – and in particular move costs from products which are not regulated on the basis of costs to those regulated in line with costs – to increase prices, revenue and so profit. For example, since WLA products' prices are no longer cost based but some LLA/IEC prices are (notably DFA/DFX) then it is clearly in Openreach's interests to reallocate costs from WLA to LLA/IEC (as they have done here).

3.7 Ofcom must be alert to this, particularly since it is Ofcom's mis-conceived departure from cost-based prices that has created this problem. It took Ofcom 10 years to get on top of cost attributions and eliminate BT's manipulation of the system by, amongst other things, allocating excessive amounts of BT Group costs to SMP products. If Ofcom does not get on the front foot here it may take another 10 years to address the new manipulation that is now starting, and on the basis of experience is likely to accelerate over time. Therefore Ofcom must be far more proactive in reviewing changes in cost attributions – stakeholders cannot do this since they lack the detail and transparency necessary. Indeed, TalkTalk's view is that in this new environment where many prices are not cost based, BT should be unable to reallocate any costs between products without prior approval from Ofcom, and a consultation with stakeholders being undertaken.

3.8 As well as this central point we have a number of other concerns:

- It is also notable that Ofcom has not assessed the corollary of the attribution of more cost to LLA/IEC which is that WLA costs are lower and so the excessive profits resulting from its proposed CPI+0% indexation for WLA products will now be even higher. Has Ofcom confirmed that the trade-off of benefits (putative increased altnet investment) versus costs (excessive wholesale prices, weakened competition, less Openreach investment) still works in consumers' interests? This is an omission in Ofcom's analysis which has been exacerbated by the reallocation of costs between products. If Ofcom has not undertaken such analysis, then it should conduct it, and publish the results for consultation, before finalising its WFTMR proposals.
- Openreach has argued that DFA/DFX prices need to be higher to cover additional costs (which appear to be unspecified migration costs and stranded active assets[13]). This is unjustified for two reasons:

[12] Though Openreach/BT can manipulate cost allocations in other ways that harm consumers e.g. to allocate cost away from markets where there was more competition or where BT had a high downstream market share

[13] Openreach response §9.17 (iv) and (v)

- There is no threat to Openreach cost recovery since the CPI+0% indexation for Ethernet products will results in £540m excess profit[14]. There is no need to recover these costs (if they exist) from DFA customers, as many of them are shared costs both across geographies and between DFA and EAD products.
- There are unlikely to be any material costs that will not be anyway recovered. For instance: active electronics costs are recovered over 3 years which aligns with the contract period and therefore there is no stranding risk; and migration costs are covered by DFA connection and migration charges. If Ofcom wishes to assert that there are stranded active assets, it should specify precisely which assets are stranded.

- Ofcom has changed the proposed dark fibre ancillary charge price cap from CPI-CPI to CPI+0% to align with other charge controls. It justifies this change on the basis that CPI+0% is Ofcom's 'policy position'. 'It's our policy' is not an adequate justification for imposing CPI+0% – Ofcom needs to demonstrate that CPI+0% is in consumers' interests, and why a CPI+0% price cap will support Ofcom's goals better than a cost-oriented approach.
- The ranges look implausibly wide (particularly for the initial charges) – the top of range is 35% higher than the bottom of the range for access tails. Four months before its final statement Ofcom surely should have a more robust view of costs than this, and if not it should urgently undertake work to obtain a robust view of costs before finalising its proposals.

4 DFA Implementation timing

4.1 In the January consultation Ofcom proposed that the DFA product (the dark fibre variant of Ethernet access products e.g. EAD-LA and EAD-standard) would be launched within one month of the statement with QoS obligations after 12 months. Ofcom has now made a substantial change to this proposal, with implementation of DFA in stages starting in 4.5 months and finishing in 14 months. The timing of different elements of implementation under the two proposals is shown in the table below.

[14] January WFTMR consultation Table A16.7

DFA implementation timing proposals (months after statement)

Component	January 2020 proposal	November 2020 proposal
Provision	1	4.5
Repair	1	6
'Non-essential' functionality e.g. novation, billing	1	14
SLAs/SLGs	1	14
QoS reporting	1	4.5
QoS obligations	12	14

4.2 It seems that the reason for the change is that Openreach has claimed the original timing was not feasible. Ofcom's proposals are almost exactly what Openreach claimed was feasible (§5.10), seemingly without any further analysis being undertaken by Ofcom.

4.3 We think that there is evidence that indicates that faster implementation is both necessary and possible.

- as a result of the DFA obligation imposed in BCMR16, Openreach came close to launching a DFA product. Whilst we recognise that this cannot be resurrected because it was to be implemented on a different system (Eco rather than EMP) there must be some learning that can be leveraged; this is not a product where Openreach has to start development from scratch.
- in the last 12 months DFX (the dark fibre product for inter-exchange circuits) has been implemented in much faster timescales – 1.5 months for the majority of capabilities (product functionality, billing, SLAs/SLGs and QoS reporting) and 12 months for QoS obligations[15]. Openreach also launched the OSA Filter Connect product (a product that is more complex than dark fibre). It achieved this in 4 months from starting the product design: initial industry consultation in October 2017; started the product design process in December 2017; and launched the full product by April 2018. This shows that a more rapid implementation is possible for leased line type products – indeed DFX/DFA is less complex than OSA-FC products. Further, some of the DFX experience can be used to accelerate DFA implementation.
- if Openreach expects delays, then it can and should start work on the product now, in the same way as it has given 12 months' notice of stop-sells on copper in anticipation of Ofcom's statement allowing it to introduce such stop-sells. Market participants other than Openreach have, as a result of these stop-sells, had to incur costs on the basis of possible future regulation. Given that there seems to be no meaningful uncertainty that DFA will be introduced in some parts of the UK, there is no reason why development could not start in 2020.
- there is no compelling justification for delays in implementing SLA/SLGs. These are critical components of a DFA product; end customers demand them given the

[15] BCMR June 2019 vol 2 §12.251

importance of the circuits and so CPs must offer SLA/SLGs to end customers. It is not feasible for a CP to offer these without Openreach providing a corresponding SLA/SLG for the parts of the delivery that they are responsible for. Also there is not significant system development required to be able to offer SLA/SLGs. Therefore, the long delay (14 months) before SLA/SLGs are provided by Openreach seems likely to be a ploy to make the product unattractive at launch, which Openreach will then use to argue that there was in any case no market demand for the product. We consider that SLA/SLGs can be offered at the soft launch stage (for those components provided e.g. not for novations). Similarly QoS obligations can and should be imposed earlier. The need for a high quality product is essential and without QoS obligations Openreach will have no incentive to provide high quality on a product which it has had to be forced to provide, rather than willingly commercially undertaking.

- We are also rather perplexed about the suggestion that billing functionality is 'non-essential' unless Openreach are proposing not charging for the product until billing functionality is introduced. If Openreach is charging for the product, robust billing functionality is essential.

4.4 Also, when considering the approach to DFA, Ofcom needs to consider the context.

- In its BCMR16 statement Ofcom rightly imposed DFA nationally since it would deliver significant consumer benefits – it would have been implemented in October 2017. However, BT successfully appealed an aspect of the BCMR market definition as a result of poor analysis on Ofcom's part and a weak and misdirected defence[16]. Consequently, Ofcom decided to withdraw the DFA remedy, due in part to Ofcom's ill-conceived active minus pricing approach[17], an approach which TalkTalk warned Ofcom was unsustainable and unjustified at the time. Thus the absence of a mature and effective DFA product today, and the harm to consumers resulting from this is squarely a result of Ofcom's poor analysis and decisions (Ofcom subsequently corrected these in BCMR19[18]).
- The second important element of context is that Ofcom has proposed (incorrectly in our view) to allow leased line prices to rise at CPI+0% leaving them substantially above cost. The reason for this is that they expect CPs to be able to use cost based DFA instead of leased lines [reference]. Under Ofcom's proposed implementation this opportunity will not exist until well into the market review period.

4.5 In light of this it is incumbent on Ofcom to reduce the harm to consumers caused by its failures by pushing for the earliest possible DFA implementation. We consider a more appropriate implementation timing would be as follows.

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[16] Ofcom based its decision that there was a single market covering all bandwidths on demand side substitution. Ofcom could and should have based its decision on supply side substitution which is what it did in the BCMR19 decision

[17] Active minus meant that DFA was not viable to use for circuits under 1Gbps. Ofcom rightly reversed this decision in BCMR19

[18] For instance, it in BCMR16: Ofcom's market analysis focussed on demand side substitution; it argued that a steep pricing gradient should be protected; and it imposed active minus pricing. All these errors were reversed in BCMR19.

Suggested DFA implementation timing proposals (months after statement)

Component	January 2020 proposal	November 2020 proposal	TalkTalk suggestion
Provision	1	4.5	3
Repair	1	6	6
Billing	1	14	6
'Non-essential' functionality e.g. novation	1	14	12
SLAs/SLGs	1	14	3
QoS reporting	1	4.5	3
QoS obligations	12	14	6

4.6 Ofcom must also impose penalties if Openreach does not meet this timetable.

5 SoGEA pricing obligation

5.1 In the January 2020 consultation Ofcom proposed that SOGEA prices must be 'fair and reasonable' and indicated that it currently considered this to mean that the price should be less than the sum of the MPF and FTTC prices.

5.2 Ofcom is proposing to change the obligation and make it more specific to provide greater certainty. The revised proposal is that there should be a price cap on SOGEA40 charge which would equal the MPF price cap plus the FTTC40 price cap. This would, in effect, set the price cap in FY21 at £147.83 with a CPI+0% indexation in subsequent years.

5.3 We agree with the approach of providing greater certainty by setting a price cap on SoGEA. However, we disagree with the level proposed for this price cap.

5.4 The current SoGEA40 price is less than the sum of MPF and FTTC40 prices:

- MPF (SML1) price: £85.38
- FTTC40/10 price: £59.97
- MPF + FTTC = £145.35
- SoGEA40 price: £145.11

5.5 This difference reflects that SoGEA has a lower cost to provide (albeit currently only slightly lower) than MPF and FTTC40. The cost saving from SoGEA will increase substantially when Openreach moves to SoGEA day 2 testing where the testing is provided from the cabinet removing the need for e-side copper. Therefore, a price cap on SoGEA equal to the MPF cap plus FTTC cap will allow Openreach to set excessive prices.

5.6 Instead the pricing obligation should be set as follows:

- the SoGEA price cap should equal the MPF price cap plus the FTTC price cap less the cost saving from providing both together;
- the cost saving figure will be compliant if it is judged to be a fair and reasonable estimate of the actual saving from time to time.

6 Basis of charges obligation on PIA ancillary and contractor ECC

6.1 For PIA ancillary charge and contractor ECC Ofcom had previously imposed a 'basis of charges' obligation and said that its 'first order test' of compliance with this obligation was that prices were below DSAC (distributed stand alone cost). DSAC costs are above LRIC+/FAC costs (but below SAC) since fixed costs can be recovered multiple times – consequently if all prices were set at DSAC then Openreach would recover considerably more than its total costs.

6.2 Ofcom is now proposing that prices should be based on actual incremental costs incurred plus an appropriate mark-up and return on capital employed. This is similar to the LRIC+ and FAC costs standards.

6.3 We fully agree with rejecting the DSAC standard as a test of compliance. There is no justification for using DSAC either generally or in this specific case.

- There is no economic or consumer interest justification for PIA ancillary or contractor ECC costs to be set above LRIC+/FAC.
- Even if there were an economic or consumer interest justification for certain prices to be above cost there is no reason to use DSAC as the appropriate cost level:
  - There is no basis in economics that prices equal to DSAC are in anyway efficient, rather prices as high as DSAC allow over-recovery by the monopolist.
  - DSAC is an Oftel invention (from the 1990s we think) that is, on the basis of TalkTalk's research, not used by any other regulator in any sector or jurisdiction, for the good reason that it is an unjustifiable cost standard.
  - The assumptions that are used to derive DSAC prices (e.g. the products over which fixed costs are recovered) are arbitrary and set by BT.

6.4 There is no logical merit or consumer interest justification in using DSAC for any role in price setting. Ofcom should clearly reject using DSAC once and for all.

6.5 With regards to using FAC/LRIC+ method that Ofcom is proposing to use we have the following comments:

- whilst the incremental (internal and external) costs will not be liable to significant manipulation by Openreach, the allocation/mark-up for common costs could be manipulated. To address this the method used to derive the mark-up and the level of mark-up should be transparent (as it is for electricity charges). Also the method used should be consistent with the regulatory financial accounts (which have the advantage of being audited and, in some cases, reviewed by Ofcom) .

- Ofcom should impose a true-up mechanism so that if, in any one year, the price is too high or low the following years' prices are adjusted down or up accordingly.