Sky's Response to Ofcom's Fixed access market reviews: Approach to setting LLU and WLR Charge Controls Consultation

SECTION 1 – SUMMARY

1.1 This is the response of British Sky Broadcasting Limited ("Sky") to Ofcom's consultation on its approach to setting LLU and WLR charge controls (the "Consultation").[1] Sky considers that, while Ofcom's proposals for the LLU and WLR charge controls appear broadly reasonable, there are a series of key issues that, if addressed differently, would better promote Ofcom's policy objectives including the promotion of competition such that consumers enjoy lower prices and increased choice.

1.2 While Ofcom's new approach to charge control modelling is simpler and easier to understand than its predecessor, there remain significant unresolved concerns that the level of **base year costs** (2013/14) in the new model are too high when compared to other benchmarks. In particular, to address these issues, Sky considers that Ofcom must ensure that:

- all indirect and direct Generic Ethernet Access ("GEA") costs are thoroughly purged from the base data; and
- the assumed fault rate reflects that of an efficient operator of a copper-only network (in accordance with Ofcom's 'anchor pricing' principles) and not the unduly elevated fault rate that prevails today.

As a result, it may be necessary to lower the base year cost level as well as the estimates of efficient costs in the final year of the charge controls.

1.3 Setting the **price differentials** between MPF and WLR/WLR+SMPF rentals such that they only reflect incremental cost differences can support productive efficiency, but Ofcom's approach:

- gives insufficient weight to the promotion of allocative and dynamic efficiency;
- is likely to underestimate the true incremental cost differences (not least because not all costs have been allocated on a causal basis) resulting in productive inefficiency;
- fails to recognise that, for services that BT does not consume itself, its cost minimisation incentives are tempered;

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[1] Ofcom Consultation entitled "Fixed access market reviews: Approach to setting LLU and WLR Charge Controls" updated 20 August 2013. http://stakeholders.ofcom.org.uk/consultations/llu-wlr-cc-13/

- conflates its economic arguments for reducing the differentials through changing or reversing a series of pricing adjustments and cost allocations with the often separate bases upon which those adjustments and allocations were originally made; and

- reduces the differentials too quickly thus undermining the principle of regulatory certainty.

Ofcom can address these weaknesses in its approach by allowing differentials, where appropriate, to exceed its estimates of incremental cost differences. This flexibility will allow Ofcom's assessment of price adjustments and certain cost allocations to turn objectively on the respective relevant facts.

1.4 Sky considers that Ofcom's proposal to replace RPI with CPI in the charge controls formulae is appropriate. CPI is the most apposite inflation index to use in the charge control formula as it is more closely correlated to the inflation of the key fixed access cost components, whereas RPI includes mortgage costs which are not relevant. In light of this and known trends in wage growth, Sky considers that Ofcom's proposed **cost forecasts** for pay and non-pay operational expenditure ("opex") are too high.

1.5 There remains considerable scope for both further **cost efficiency** at Openreach and improvements in service quality. Statements by BT and the current high levels of inefficiency indicate that Ofcom's proposed efficiency rate to be applied to the charge controls is too low.

1.6 While Sky supports Ofcom's **charge control design** and its proposal to set individual charge controls for more key migration services and to lower their prices to promote competition, it should:

- retain a cost orientation condition for each of the services;

- replace prior year weighting in the charge control formulae with current year weighting to prevent the risk of gaming by BT; and

- place tie-cables in a separate ancillary services basket.

Further, while Sky welcomes the proposal to apply a Fully Allocated Cost ("FAC") based cost orientation condition to certain other essential services outside of the baskets, there are clear benefits in applying a charge control to Time Related Charges ("TRCs") and Special Fault Investigations ("SFIs").[2]

1.7 Due to the economic downturn and the effects of quantitative easing ("QE"), Ofcom when estimating BT's **weighted average cost of capital** ("WACC") has recently placed less weight on falls in yields on index linked gilts ("ILGs") as an indicator of the risk-free rate ("RFR"). Therefore, Ofcom should be slow to make upward revisions to the RFR should gilt yields begin to rise. Moreover, Ofcom has set Openreach's WACC too high because it has overestimated its relative economic value. Were Ofcom to adopt better methods by which

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[2] See further paragraphs 2.7 – 2.10 of Sky's response to the 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 "FAMR Consultation") and paragraphs 12.76 – 12.79 of the FAMR Consultation.

to estimate its appropriate weight, these would result in a lower asset beta and, subsequently, a lower WACC for Openreach.

1.8 It is likely that the new charge controls will not start when the current ones expire on 31 March 2014. Ofcom's failure to implement the current charge controls on time cost industry over £30m because BT's voluntary **interim pricing commitments** were based upon the prices that would have prevailed if the previous charge controls had continued for a further year even though it was known that these prices were significantly above the latest view of BT's costs.[3] Therefore, this time it would be appropriate and fair to broker interim pricing arrangements by reference to the prices that would have resulted had the current control continued, i.e. further price reductions.

SECTION 2 – INTRODUCTION

2.1 As the market changes to reflect the growth in next generation access ("NGA") services, it is arguably more important than ever that the WLR and LLU charge controls support Ofcom's policy objectives of preventing excessive prices, promoting sustainable competition and investment, and providing a stable regulatory environment.[4] Crucially, Ofcom proposes not to regulate the price of BT's Generic Ethernet Access ("GEA") product, in part on the basis of the constraining effect exerted on super-fast broadband ("SFBB") prices by current generation access ("CGA") services based on LLU. Moreover, sustainable infrastructure competition may evolve at a point upstream of GEA.

2.2 However, by placing less emphasis on the benefits of MPF-based competition and embedding unduly high levels of inefficiency within LLU and WLR prices, Ofcom's approach risks undermining these objectives. Sky considers that there are a number of issues that if addressed objectively and in accordance with Ofcom's goals would result in more appropriate prices.

2.3 Sky's response to the Consultation comprises the following sections:

- **Section 3** covers **base year costs** issues in the charge controls model;
- **Section 4** deals with Ofcom's approach to **price differentials**;
- **Section 5** addresses **cost forecasting**;
- **Section 6** considers Ofcom's proposals for the **efficiency rate**;
- **Section 7** discusses the proposed **charge control design**;
- **Section 8** responds to Ofcom's proposed approach to estimating Openreach's **cost of capital**;
- **Section 9** explains Sky's position in relation to **interim pricing** should the next charge controls fail to commence on 1 April 2014; and
- **Appendix 1** details Sky's views on the **individual pricing adjustments and cost allocations** that are relevant to its response to Section 4 (price differentials).

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[3] See further, paragraph 2.5.3 of Sky's response to the FAMR Consultation.

[4] Paragraph 2.30 of the Consultation.

2.4 In support of its response, Sky (along with TalkTalk Telecom Group, "TalkTalk") commissioned two reports:

- *Ofcom's LLU and WLR Charge Control Proposals*, October 2013, Frontier Economics (the "Frontier Report"); and
- *Disaggregating the BT Group Asset Beta*, October 2013, Europe Economics (the "EE Report").

Where appropriate, we refer to these reports.

SECTION 3 – BASE YEAR COSTS

3.1 In this section, we explain that while Ofcom's new charge control model is simpler and more transparent than previous models, the base year level of costs is too high and if unadjusted would result in excessive regulated prices. More appropriately, the base year costs should be reduced such that:

(i) all direct and indirect GEA costs are removed; and

(ii) unreasonably high inefficiency at Openreach is not embedded into prices.

Ofcom's new charge control model is simpler and more transparent

3.2 Ofcom's new charge control model is different to its approach to the current charge controls for LLU and WLR (that expire on 31 March 2014) in that it no longer involves cost-forecasting and cost-allocation models derived from BT's Oak model. Instead, it is based on:

- network component costs drawn from BT's regulated financial statements ("RFS"); and
- a 'top down' model that uses asset volume and cost volume elasticities ("AVEs" and "CVEs") to forecast costs.[5]

The new approach is, as a result, simpler and relatively more transparent.

3.3 Ofcom has also improved its approach by introducing a line volume forecasting model.[6] Forecast line volumes[7] play a significant role in determining forecast costs for WLR and MPF rental because of the high fixed costs that typify access to BT's network.[8]

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5 Paragraph 1.14 of the Consultation.

6 Paragraph 1.15 of the Consultation.

7 We note that, subsequent to the line volumes forecasts proposed in the Consultation, Ofcom has published revised forecasts for MPF as part of its provisional conclusions in the *Dispute between TalkTalk and Openreach relating to single jumpered MPF* (see paragraph A2.155). http://stakeholders.ofcom.org.uk/binaries/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01019/Provisional_Conclusions_nonconfidential_v2_1_Oct_13.pdf. Ofcom should update its volume forecasts for all fixed access rentals when it finally determines the LLU and WLR charge controls.

3.4 However, despite these improvements, there remain aspects of Ofcom's charge controls modelling that, in Sky's view, require further justification or amending. We discuss the issues arising from Ofcom's approach to base year costs (2013/14) below.[9]

The new model's base year costs are significantly above other benchmarks suggesting that BT is operating at an inefficiently high level

3.5 Setting the appropriate level of base year costs for the charge control model is important because it is from this starting point that future cost levels (and, hence, future prices) are projected. Ofcom proposes using BT's RFS for 2011/12 as the starting point for the network component costs in the base year of the control and then cross-checking these with:

- outputs from the current charge controls model; and
- the RFS for 2012/13.[10]

3.6 There are significant cost differences between the base year costs derived from the charge control model and these two other data sources:

(i) Fully Allocated Costs ("FAC") for MPF are £3.35 more (and WLR £2.47 more)[11] in the new model than anticipated when the current charge controls were set, implying that Openreach is less efficient than forecast; and

(ii) the FACs for MPF and WLR published in the original 2011/12 RFS, upon which Ofcom intends to derive base year costs, are significantly above the restated figures published with the 2012/13 RFS (£4.14 and £4.60 respectively).[12]

3.7 Given the above, it may not be appropriate for Ofcom to embed the (implied) higher cost levels into the base year costs of the proposed charge control because they may not accord with Ofcom's anchor pricing approach. This should be a key focus of Ofcom's further consultation on faults and service quality[13] and its investigation into the basis for BT's latest RFS.

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8 As part of their appeal of the current LLU and WLR charge controls, Case 1192/3/3/12 British Sky Broadcasting Limited and TalkTalk Telecom Group plc v Ofcom, Sky and TalkTalk successfully argued that Ofcom's approach to volume forecasting was not sufficiently robust such that it had underestimated likely line volumes which, in turn meant that rental prices had been set too high.

9 In addition to the issues raised in the remainder of this section, we refer Ofcom to Section 5 of the Frontier Report which deals with two apparent methodological errors relating to the treatment of Net Current Assets and Holding Gains on Disposals in the model. These should be corrected in the final version of the model.

10 The latest RFS were published after Ofcom published the Consultation and therefore could not be used as a basis for setting network component costs in the model.

11 See 'Other' category, Figure 1, Frontier Report.

12 We understand that further work is ongoing between Ofcom and BT to understand the basis of preparation of the latest set of RFS. Both BT's summary of the basis for its changes in the methodology adopted in the 2012/13 RFS and its re-statements of the 2011/12 RFS to reflect these changes are incomplete. As such, it is too early for stakeholders to ascertain what weight, if any, should be given to this latest data when considering the new charge controls for WLR and LLU. Therefore, Sky reserves the right to make further submissions to Ofcom on this issue once further information on the 2011/12 RFS and 2012/13 RFS has been provided.

13 Paragraph 1.20 of the Consultation.

3.8 Below, we address the implications that an anchor pricing approach has for base year costs before discussing the evidence that Openreach's current fault rates are inefficiently high.

All GEA costs should be eliminated from the base year costs

3.9 Under Ofcom's anchor pricing approach to the LLU and WLR charge controls, costs are modelled on the basis of a hypothetical efficient copper-only network which assumes that there is no NGA deployment in the network at all.

3.10 Therefore, the base year (2013/14) costs used as a starting point for the charge controls need to be completely uncontaminated by any direct or indirect costs that may have stemmed from BT's roll out and provisioning of GEA. Ofcom should be mindful that BT has an incentive to recover as much of its GEA costs from WLR and LLU as possible. Specifically, Ofcom needs to be certain that the 2011/12 RFS data upon which it relies for its base year calculations do not include any GEA-related costs.

3.11 On the face of it, this may not appear to be an issue as BT's RFS do not explicitly report on dedicated GEA costs (as BT is not under any regulatory requirement to do so). However, it is far from certain whether any of the reported costs for WLR and LLU are in fact caused by GEA – either directly or indirectly. It is notable that Ofcom has not stated unequivocally that its base data is not contaminated in this way. The data (2011/12 RFS) from which Ofcom derives its estimates of base year costs for the charge controls post-date the start of BT's fibre-to-the-cabinet ("FTTC") roll out and, therefore, could have been distorted.

3.12 It is likely that certain costs caused by GEA are in the costs stacks for copper access services. For example, such a significant amount of BT Group and Openreach management time and effort would have been dedicated to consideration of BT's GEA roll out that it is likely that an element of overhead costs would have been attributable to GEA. However, it is unlikely that these elements of overhead costs have been removed from the overhead costs that are allocated to WLR and LLU, and the total amount of such costs may even have increased.

3.13 Frontier Economics has identified two examples from the 2011/12 RFS where costs that are incremental to GEA may have been allocated to WLR and LLU:

- overhead costs; and
- repair costs.[14]

There does not appear to be any sound basis for these allocations.

3.14 A key concern for Sky is that the current high level of WLR and LLU faults are a function of:

(i) resources being redirected to GEA from WLR and LLU;

(ii) increased intervention in the access network when rolling out and provisioning GEA;[15] or

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14 Paragraph 2.53, Frontier Report.

15 This could include cases where copper from the cabinet to the home is replaced because it cannot satisfactorily support GEA services even though it is suitable for LLU and WLR.

(iii) faults being registered on WLR and MPF lines which would not occur if GEA were not present.

3.15 Including GEA-related costs within WLR and LLU prices would not accord with Ofcom's anchor pricing approach and would result in inefficiently high consumption of SFBB and inefficiently low consumption of current generation broadband.

3.16 In any event, it is clear that current fault rates are excessively high. We discuss this issue below.

Ofcom should estimate fault repair costs in the base year by reference to those of an efficient ongoing copper-only network

3.17 While, for now, Ofcom has proposed to rely on fault rates from the 2011/12 RFS for its base year data, it is conducting further analysis into elevated fault rates in order to inform its final position.

3.18 Currently, fault repair costs account for around 16% of the MPF and 14% of the WLR Basic cost stacks[16] but have been much lower in the recent past. The current fault repair costs are very high and, in Sky's view, do not reflect an efficient level of costs. Further, as noted above, Openreach's WLR and LLU costs appear to be higher than anticipated under the current charge controls which could be caused by increases in fault costs.

3.19 BT has, in part, argued that current high fault rates are due to:[17]

- elevated rainfall levels; and
- increased broadband penetration.

3.20 However, Frontier Economics show that:

- Openreach's fault rates have continued to rise when rainfall levels have been in decline and vice versa;[18] and
- when broadband penetration has grown most significantly, fault rates have, in fact, declined.[19]

3.21 Moreover, efficiency improvements in fault rates up to 2009 appear to be a direct result of copper access network investment programmes and improvements in provisioning processes while subsequent declines may have been a result of Openreach no longer investing in these activities and instead, amongst other uses for its cash, focussing on the roll out of GEA.

3.22 In this regard, we note that while on the one hand BT may have an incentive under the charge control mechanism to reduce fault costs (because it will earn additional returns or reduce losses),[20] there are likely to be incentives pulling in the opposite direction. For

16 Paragraph 5.23 of the Consultation.
17 See Annex 10 of the FAMR Consultation.
18 Figure 3, Frontier Report.
19 Paragraphs 2.25 – 2.27, Frontier Report.
20 This incentive mechanism to reduce costs under a charge control, in fact, applies irrespective of whether the firm reduces them below the forecast level.

example, the knock-on effects of higher fault rates (such as longer provisioning times) will slow both subscriber losses at BT's retail division and migration from higher value wholesale services to lower value ones (e.g. MPF). Additionally, BT may reduce discretionary cash expenditure on access network investment if it considered that subsequent higher fault rate costs would be recoverable through higher regulated charges in the future (as is effectively being proposed by Ofcom now).

3.23 In light of these conclusions, Sky concurs with Frontier Economics that, given Ofcom's anchor pricing approach to the LLU and WLR charge controls is predicated on modelling the costs of an ongoing efficient copper-only network, it is appropriate for Ofcom to assume a more efficient fault rate not only for the last year of the charge control but also for the base year cost calculations.

3.24 A reasonable estimate of an efficient fault rate would be to take the fault rate from 2009 – the point from which faults started to increase – and reduce it by 5% annually to reflect the typical rate of improvement up to that date. Adopting this approach indicates that the efficient level of faults in 2012 was 47% lower than BT's reported level. This, in turn, would reduce the MPF price by £6.59 by 2016/17.[21]

SECTION 4 – DIFFERENCES IN PRICES BETWEEN WHOLESALE PRODUCTS

4.1 Ofcom is concerned, appropriately, with differences between wholesale charges for (i) MPF and WLR and (ii) MPF and WLR+SMPF, given that these services are substitutes and differences in charges can therefore affect purchasing and investment decisions.

4.2 In this section, we discuss the economic arguments for basing the pricing differentials of the fixed access rental services on their incremental cost differences as proposed by Ofcom before outlining important weaknesses in its approach.

4.3 Ofcom proposes that the price differences in 2016/17 between MPF, SMPF and WLR rentals should reflect only the differences in the incremental costs of providing those services.[22] Ofcom plans to achieve this end through a series of changes in approach to cost allocations and certain pricing adjustments such that the price difference between MPF and WLR (and WLR+SMPF) reduces.

4.4 In summary, we conclude that:

(i) basing price differentials on incremental cost differences can promote productive efficiency but at the expense of allocative and dynamic efficiency;

(ii) there are important reasons to promote dynamic and allocative efficiency through the pricing differential;

(iii) the scope for productive efficiency will be tempered because BT has less incentive to minimise costs for MPF services as it does not significantly consume MPF itself;

(iv) Ofcom's approach to allocating costs and calculating the differentials will underestimate the true incremental cost differences and, as such, will result in productive inefficiency without any offsetting allocative or dynamic efficiencies; and

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21 Table 3, Frontier Report.

22 Paragraph 3.77 of the Consultation.

(v) reducing cost differentials and removing certain pricing adjustments in the manner proposed is discordant with MPF operators' legitimate expectations and Ofcom's previously stated position.

4.5 Ofcom can address these issues by allowing differentials, where appropriate, to exceed its estimate of the incremental cost differences. This flexibility will allow Ofcom's assessment of price adjustments and certain cost allocations to turn objectively on the respective relevant facts.

4.6 In considering these issues, we review Ofcom's approach to cost allocation and pricing adjustments for certain key costs:

(i) broadband line testing;

(ii) line lengths;

(iii) directories;

(iv) frames;

(v) relative faults;

(vi) service assurance; and

(vii) cumulo rates.

Price differentials based on differences in incremental costs can promote productive efficiency but at the expense of allocative and dynamic efficiency

4.7 Setting the rental charges for MPF, SMPF and WLR such that their respective price differentials only reflect differences in long run incremental cost ("LRIC") can, as Ofcom argues, promote productive efficiency because MPF and WLR/WLR+SMPF can be substitutes and, as a result, communications providers have an incentive to purchase those wholesale inputs that minimise total costs.

4.8 However, promoting productive efficiency can come at the expense of allocative and dynamic efficiency. Ofcom has considered it important to promote allocative and dynamic efficiency in all previous LLU and WLR charge controls since 2005 and continues to consider it appropriate to promote allocative efficiency within the LLU ancillary service baskets, where it proposes to allow BT flexibility in how it recovers its common costs.[23] Allowing price differences to exceed differences in incremental costs could:

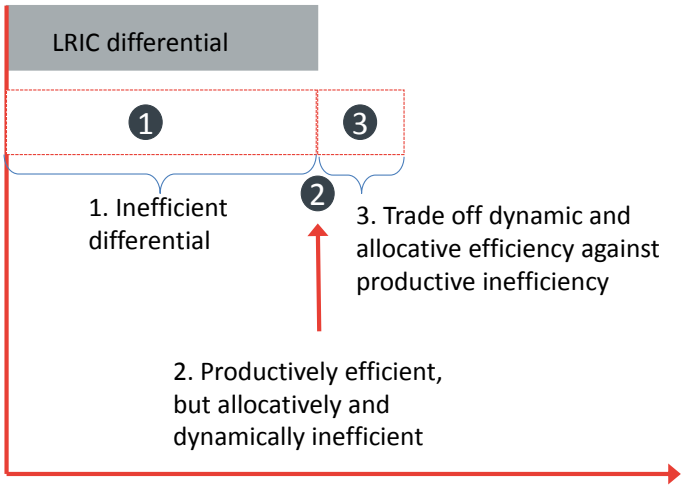
- be allocatively efficient where the common costs mark-ups in the differentials reflect demand elasticity; and
- promote dynamic efficiency if common cost mark-ups result in increased competition, investment and/or innovation.

[23] For example, see paragraphs 4.19 – 4.21 of the Consultation.

4.9 If price differentials are below the true level of incremental cost differences then prices would be productively inefficient. As such, productively efficient pricing is at the extreme end of a range of possible prices that trade-off static and dynamic efficiency.

4.10 This point is illustrated in figure 18 in the Frontier Report.

Figure 18. The appropriate range to set the price differential to maximise efficiency



4.11 If Ofcom continues to adopt a LRIC-based approach to price differentials, then it should consider LRIC to be the lower bound of an appropriate differential as any differential below this level would increase productive inefficiency with no dynamic or allocative efficiency gains. Conversely, while above-LRIC differentials may also result in increased productive inefficiency, there could be dynamic and allocative efficiency gains. Given that the downsides of setting the differential too low outweigh the downsides of setting it too high, Sky considers it appropriate for Ofcom to 'aim up' if it persists with its proposed approach to pricing differentials.

There are important reasons to promote dynamic and allocative efficiency through pricing differentials

4.12 Sky considers that setting the price differentials between MPF and WLR/WLR+SMPF such that allocative and dynamic efficiency are also promoted can be justified.

4.13 Allocatively efficient pricing could reflect demand elasticity and, while the fixed access rental services can be substitutes, it is likely that WLR by itself faces more inelastic demand than WLR+SMPF and MPF.

4.14 This is indicated by the respective levels of fixed broadband and fixed voice penetration in the UK. Fixed broadband penetration currently stands at 75% of premises whereas 84% of homes have a fixed phone line / analogue exchange line.[24] The lower, but growing, level of broadband penetration at a time when retail prices remain low or are falling implies that, for some consumers, price affects their demand, whereas the higher and more stable levels of fixed voice penetration, despite steadily rising line rental prices, could indicate relative

[24] Figure 5.51 of Ofcom's Communications Market Report for 2013 - http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr13/UK_5.pdf.

price inelasticity. Therefore, it is likely that increases in the price differential between MPF and WLR could result in increased allocative efficiency.

4.15 While Ofcom accepts that allocative efficiency could be promoted by setting mark-ups to price differentials so that they reflect demand elasticities, it argues that it does not have sufficient information on those elasticities reliably to settle on the optimal level of mark-up.[25] However, Ofcom has neither presented any data for review by stakeholders nor sought to elicit any further information itself. Sky considers that Ofcom has failed to place sufficient weight on the importance of promoting allocative efficiency through the price differentials for fixed access rental services.

4.16 To date, Ofcom's approach to LLU and WLR charge controls has promoted dynamic efficiency (such as through the 'TAM adjustment'). Ofcom now argues that, as MPF-based competition is well established, there is no longer a case to promote dynamic efficiency.[26]

4.17 However, the case for competition to be promoted as far upstream as is economically sustainable remains strong not least in light of developments in NGA. Not only does strong competition in current generation broadband services play a key role in ensuring that the price of SFBB services is appropriately constrained, but maintaining a deeper level of infrastructure competition could provide the basis for more effective competition to evolve in NGA markets in the future.

4.18 For example, MPF operators compete over more of the value chain than those operators who use WLR or WLR+SMPF services. This deeper level on infrastructure deployment by MPF operators means that they will be better placed to move to more 'passive' wholesale NGA products such as sub-loop unbundling ("SLU") should they prove viable as demand for SFBB increases.

4.19 In Sky's view, Ofcom's approach to price differentials does not place sufficient weight on either allocative and/or dynamic efficiency considerations.

The scope for productive efficiency will be tempered because BT has less incentive to minimise MPF costs as it does not significantly consume MPF itself

4.20 A further flaw in Ofcom's proposed approach is that it incorrectly assumes that optimising productive efficiency is only contingent upon purchasers seeking to minimise their total costs through their choice of BT's fixed access products. However, in reality, BT is also required to lower its costs of production for all services and, while CPI-X price caps can incentivise BT to earn additional profits by reducing costs by more than forecast, BT also faces other, profit maximising incentives that work in the opposite direction.

4.21 BT's incentive not to minimise its costs of production is most evident in relation to MPF. Unlike WLR and SMPF, BT's retail arm does not consume MPF in any significant scale whereas two of its main competitors in residential broadband and telephony markets (Sky and TalkTalk) do. So, while the incentive to earn additional profits through over-achieving on cost reduction remains relevant for all fixed access rental services, BT's retail division could earn additional profits (through higher retail margins and/or rising market share) if cost minimisation was less pronounced for MPF than for WLR and SMPF. Therefore, Openreach may prioritise cost reductions for WLR and SMPF services.[27]

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25 Paragraph 3.80 of the Consultation.

26 Paragraphs 3.87 and 3.88 of the Consultation.

27 As MPF would still be provided on an equivalence of inputs ("EoI") basis – albeit mainly to BT Retail's competitors – such an outcome may not breach the BT Undertakings.

4.22 This incentive can be countered by:

- pooling and spreading MPF-specific costs with the costs of the other fixed access services and then recovering them equally from all services. Such an approach, however, can result in services no longer reflecting their costs of provision; or

- ensuring that MPF costs reflect the costs of an efficient operator (assuming these were possible to identify) where cost minimisation incentives were not weakened by the incentive to raise the costs of downstream rivals.

4.23 Each of these possible solutions is discussed in more detail in **Appendix 1**.

Ofcom's approach to calculating the differentials will underestimate true incremental cost differences and therefore will result in productive inefficiency with little or no offsetting allocative or dynamic efficiencies

4.24 Even if Ofcom's proposed approach to price differentials – to focus solely on the optimisation of productive efficiency at the expense of other forms of efficiency – was an appropriate exercise of its regulatory judgement, its proposed method of calculating the incremental cost differentials will provide inaccurate results and, if anything, will underestimate their true level. As stated above, price differentials between services that are lower than their respective incremental cost differences will result in productive inefficiency without any compensating allocative or dynamic efficiency.

4.25 Ofcom's method[28] does not actually calculate the true LRIC differential. Instead it:

- calculates FACs for MPF, SMPF and WLR;

- estimates LRICs for each service by estimating their respective LRIC:FAC ratios; and

- distributes common costs equally across each of the services.

4.26 While Ofcom has not provided sufficient information in the Consultation for stakeholders to analyse properly its calculations, it is evident from the method adopted that, at best, it would only provide rough approximations of the true LRIC differentials. Given the asymmetric risk of efficiency loss from setting the price differentials too low, it would be imprudent to give these approximations undue weight.

4.27 Sky notes that Ofcom's estimated LRIC differentials are similar to estimated FAC differentials, with the FAC differentials being larger. However, even the FAC differentials will not offer a true reflection of cost differences not least because when they are calculated by Ofcom some costs are applied equally across all the fixed access services irrespective of whether some services 'cause' more of those costs.

4.28 Furthermore, certain cost allocations to MPF (such as those for service assurance and fault repair costs) appear to be too high.[29]

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[28] Paragraph 6.147 onwards and Annex 6 of the Consultation.

[29] See further Appendix 1 and paragraphs 3.55 and 3.59 – 3.62 of the Frontier Report.

4.29 Therefore, Ofcom's approach to setting fixed access prices such that they reflect its estimates of their respective incremental cost differences by 2016/17 will result in pricing differentials that are too low and hence result in productive inefficiency.

Ofcom conflates its economic arguments for reducing the differentials through changing or reversing a series of pricing adjustments and cost allocations with the often separate bases upon which those adjustments and allocations were originally made

4.30 Sky considers that the proposed reductions in price differentials are greater than MPF operators could have reasonably expected and therefore undermine the principle of regulatory certainty, which (a) Ofcom usually considers important in order to support investment incentives[30] and (b) does not accord with Ofcom's previous statements on this issue.

4.31 Further, in order to require prices to reflect Ofcom's estimate of their incremental cost differences by the end of the charge controls period, Ofcom proposes to remove or change a series of pricing adjustments that it has adopted for previous LLU and WLR charge controls since 2005. However, while Ofcom advocates this approach to pricing differentials because, it says, it is now placing more weight on productive efficiency and less on dynamic efficiency:

- the basis for the introduction of some of those adjustments has nothing to do with promoting dynamic efficiency (for example, the proposed change in relation to directories); and
- their removal or change will decrease productive efficiency (for example, the TAM adjustment).

4.32 In short, while Ofcom seeks to justify a reduction in the price difference between MPF and WLR/WLR+SMPF as a simple case of reprioritising productive efficiency over dynamic (or even allocative) efficiency, the series of pricing adjustments and cost allocations that make up the LRIC+ cost differentials today were not all made in order to promote dynamic (or allocative) efficiency *per se*.

4.33 As such and given that Ofcom need not entirely eschew other forms of efficiency, it is reasonable for it to consider its approach to each of these allocations and adjustments on their own merits and by reference to the basis for their imposition in the first place.

We discuss Ofcom's approach to pricing adjustments and cost allocations for certain key cost categories in **Appendix 1**.

4.34 If the regulated prices of rental services themselves do not reflect cost causation then neither the price nor the price differences will be fully effective in promoting productively efficient consumption choices in the manner intended by Ofcom.

4.35 For these reasons, we recommend that Ofcom:

(i) corrects errors and inconsistencies in its approach to cost allocations and pricing adjustments;

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30 Paragraphs 3.88 and 3.188 of the Consultation.

(ii) continues to place some weight on dynamic and allocative efficiency considerations;

(iii) allows for a gradual implementation of the LRIC-based approach where appropriate; and

(iv) errs on the side of caution by 'aiming up' when setting the price differentials.

SECTION 5 – COST FORECASTING

5.1 This section addresses Ofcom's proposed approach to inflation. Inflation is relevant to the charge controls for two reasons:

(i) first, a measure of inflation such as RPI or CPI is used within the charge control formula that caps prices; and

(ii) second, when forecasting costs, Ofcom makes assumptions about how unit costs change over time.

5.2 In summary, Sky considers that:

- it is appropriate to use CPI instead of RPI as the inflation index in the charge control formulae;
- Ofcom's forecasts of pay inflation and non-pay inflation costs are too high and should be reduced; and
- using RPI to index forward duct and copper asset valuations is preferable to using CPI.

CPI is likely to be a better inflation measure to use within the charge control formulae

5.3 The purpose of using an inflation measure within a charge control formula is to prevent unforeseen levels of exogenous cost inflation (i.e. outside of the regulated firm's control) rendering the charge control either:

- unduly lenient - whereby costs as a result of general inflationary pressure do not rise as quickly as anticipated which can result in the regulated firm reducing its emphasis on its own efficiency programmes;[31] or
- overly onerous - in that costs rise more quickly than forecast, reducing returns below the regulated cost of capital and making it more difficult for the regulated firm to meet efficiency targets.

5.4 One of the advantages of indexation within a price cap is that it can incentivise the regulated firm to take more control of achieving or exceeding its regulated cost of capital

[31] In these circumstances consumers may pay higher prices for longer, downstream competition may be inhibited and future charge controlled prices may be higher than would be the case had the regulated firm placed more emphasis on its own cost reduction projects.

and not to rely on (or be inhibited by) exogenous factors.[32] A further advantage in using an index is that it can reduce short term uncertainty in costs for both the regulated firm and its customers caused by unforeseen, exogenous effects.

5.5 In assessing whether to adopt CPI over RPI, Ofcom considers whether the index exhibits:

(i) systematic forecast bias;

(ii) correlation with movements in the firm's relevant costs;

(iii) exogeneity, i.e. it cannot be influenced by the firm;

(iv) availability of independent forecasts for the charge control period; and

(v) regulatory predictability.[33]

5.6 Of these factors:

- while the Office of National Statistics ("ONS") has recently concluded that RPI has an upward bias[34] of, most recently, around 1%, it does not appear to have a forecast bias (i.e. there is no evidence that forecasts of RPI have systematically been biased relative to the outturn RPI). Equally, there is no evidence of forecast bias in CPI;

- BT cannot influence either index;

- there are robust, independent forecasts available for both CPI and RPI; and

- regulatory predictability does not preclude changes in policy *per se* but requires any changes to be well-reasoned, consulted upon and signalled with sufficient notice.

Applying these criteria does not appear to favour strongly one index over another.

5.7 However, Sky considers that CPI has two advantages over RPI as the appropriate inflation index for price controls on BT:

(i) it is more likely to exhibit a closer correlation to the movements in BT's relevant costs compared to RPI; and

(ii) CPI is less volatile.

5.8 Dealing with the first of these advantages, we note that, unlike CPI, RPI includes mortgage costs. These costs are not relevant to BT either directly or, even, indirectly as it does not

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32 Although, arguably, there will continue to be an incentive for the firm to reduce its costs generally, it is likely that there would be minimum efficiency targets where, once these are met, further cost reduction programmes would be more discretionary.

33 Paragraph 3.170 of the Consultation.

34 This bias is a function of the formula ('Carli') used in the RPI calculation which uses arithmetic means to calculate average price changes. CPI uses a different formula ('Jevons') which uses geometric means and, therefore, does not have an upward bias. The ONS has developed a new index (RPIJ) that uses a 'Jevons' geometric calculation and, therefore, will not have the same upward bias as RPI. However, this new index has yet to be given official status.

face these costs and even if there were a correlation between mortgage costs and the costs of commercial property, this would not be relevant to BT because its accommodation cost increases have been fixed since 2002 (as part of its sale and leaseback agreement with Telereal Trillium).

5.9 Second, the inclusion of mortgage costs within RPI has caused it to be more volatile than CPI in recent years, although both exhibit a strong correlation to inflation shocks. To the extent that reducing the scale of inflation shock within the charge control formula is considered to be important, then this would suggest that CPI is a better measure.

5.10 A further reason why a less volatile index could be better relates to the way the charge controls operate in practice. BT is typically required to give 90 days' notice for price changes and, as a result, often issues these in late December prior to the start of each relevant charge control year (i.e. 1 April). Therefore, in order to set prices in accordance with the price caps, BT uses the latest official inflation data that is available to it at the time (i.e. November).[35] This inflation figure, however, relates to a period that is over four months prior to the start of the relevant year. As such, there is a risk that the inflation number used to set prices is no longer similar to the cost changes in the charge control year. The more volatile the index, the greater the risk of deviation between the inflation figure used and the actual changes in costs.

5.11 Given RPI is more volatile, adopting CPI will be better in reducing this risk.

Ofcom's forecasts for pay and non-pay costs are too high

5.12 The second aspect of cost inflation that is relevant to setting the charge controls is the forecast of BT's relevant costs at the end of the period. In relation to Ofcom's forecasts of operational expenditure, Sky considers that the pay and non-pay inflation assumptions are too high.

Pay Inflation

5.13 Ofcom proposes to set pay inflation throughout the charge control period at 2.8% per annum. It bases its forecast on the latest (April 2013) one year pay deal brokered between BT and the Communications Workers Union ("CWU"). Ofcom argues that using the latest pay deal to forecast pay costs in the charge control is justified because there is uncertainty in the wider economy and in the recent relationship between inflation and wage growth. Ofcom also appears to suggest that using 2.8% p.a. is appropriate because it lies between current CPI and RPI levels.

5.14 Sky considers this approach to be flawed for the following reasons:

- It sends the wrong signal to BT and the CWU that whatever pay bargain is struck will be recoverable through regulated charges. While BT may still have a cost minimisation incentive to beat that forecast level of wage costs, the CWU will not and will be in a stronger bargaining position as BT will not be able to argue that it cannot afford wage rises.

- 2.8% p.a. pay inflation is unlikely to be an efficient level of wage growth because it is significantly above the national average with no objective reason put forward by Ofcom explaining why this should be the case. For example, there is no evidence

[35] Ofcom normally formalises this process within the charge controls legal instruments.

pointing to a particular scarcity of skills for BT when recruiting or a requirement to 'catch up' due to historically lower pay awards from preceding years (in fact, despite economy-wide wage growth being far lower, BT had agreed a similar level of wage growth - just over 3% p.a. - from 2010 to 2013).[36]

- Pay inflation over the next three years is not expected to be as high. While there is uncertainty in the economy and the pace and scale of any recovery, there is no evidence to suggest that pay inflation of the order proposed by Ofcom will prevail:
  - average wages have been declining in real terms since 2010;[37] and
  - any additional nominal wage growth due to the economic recovery is likely to be more than off-set by a return to interest rate increases thus maintaining stable or falling real wages.
- Even if, for whatever reason, it was appropriate to adopt a measure for pay inflation that lies between CPI and RPI;
  - RPIJ – the new index that avoids the upward bias of the older RPI – is currently just below CPI at 2.6% (vs. 2.7% for CPI) and, therefore, is well below Ofcom's proposed pay inflation forecast; and
  - all inflation indexes are forecast to fall over the charge control period – CPI is forecast to be 2.3% on average over the period.[38]

5.15 In light of the above, Sky considers that a more appropriate forecast of pay inflation would be one that shows negative real wage growth and properly anticipates reductions in CPI. Frontier Economics argues that CPI-0.5% would be in line with recent trends.[39]

Non-Pay Inflation

5.16 Ofcom applies the same inflation forecast to non-accommodation operational expenditure as it does to accommodation costs. However, there is no evidence that BT's accommodation costs will increase at the same rate as its other non-pay operational costs. BT's accommodation cost increases of 3% p.a. are fixed in the long term as part of the Telereal Trillium leaseback deal and, even if they were not fixed, there is no obvious commonality between either of the cost categories such that it is appropriate to adopt the same inflation forecast for non-accommodation costs.

5.17 On the contrary, it is far more appropriate to adopt an economy-wide inflation measure for the variety of cost components that make up the non-accommodation category as it is more likely that this would reflect the average cost increases in that category.

5.18 Therefore, forecast CPI would be an appropriate forecast of cost inflation for non-accommodation costs. Sky considers that the resulting impact on the forecast of non-pay inflation would be to reduce it from 3% to 2.75%.[40]

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36 http://www.cwu.org/bt-pay-campaign-2010.html.
37 Figure 22 of the Frontier Report.
38 Table 7 of Frontier Report and footnote 104 of the Consultation.
39 Paragraph4.50 of the Frontier Report.
40 Paragraph4.52 of the Frontier Report.

RPI is still an appropriate index by which to increase capital asset costs

5.19 Conversely, for the purposes of forecasting changes in capital asset costs (i.e. duct and copper), the benefits of using CPI are less clear cut. Ofcom proposes to continue to use RPI to index forward the costs of these capital assets. The reason for this lies in the way in which BT's duct and copper costs are treated in the LLU and WLR charge controls.

5.20 Less emphasis is placed by Ofcom on precisely estimating the replacement costs of these assets (particularly those that pre-date 1997) because the economic efficiency benefits of doing so are less pronounced. At the same time, Ofcom places more weight on preventing the over-recovery of costs over the assets' lifetimes. This latter objective requires the consistent application of a cost inflation index while the lower emphasis on requiring asset values to reflect replacement costs means that it is not as necessary to use the index that best reflects changes in replacement costs (even if CPI were superior to RPI in that regard).

5.21 Sky agrees that this approach is appropriate.[41]

SECTION 6 – EFFICIENCY AND SERVICE QUALITY

6.1 Sky considers that Ofcom's proposed efficiency rate of 5%[42] is too modest because:

(i) the current high level of inefficiency at Openreach means that there is greater scope for efficiency gains than in the recent past;

(ii) even using recent past performance as a guide to potential future gains, based upon an appropriate measure (which includes all cost movements other than those related to input prices and volume effects[43]), Openreach has achieved cash cost reductions in the range of 5% - 6% p.a.;[44]

(iii) while BT's internal targets imply a range of 4% to 6%[45], its most recent and therefore likely to be its most accurate planning documents (the Biannual Rolling Forecast, "BRF2") could indicate efficiencies in the upper part of this range[46]; and

(iv) statements made by BT to investors and analysts which imply that there is continued scope for efficiency gains in the order of past performance[47] with most of those gains expected to come from Openreach and BT Global Services.[48]

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41 However, Sky continues to consider Ofcom's approach to copper valuation should make some allowance for its residual scrap value – such as through an adjusted depreciation method.

42 This is Ofcom's base case from a proposed range of 4% – 6% net of the costs of achieving efficiencies.

43 While 'all costs' includes one-off cost reductions that could be considered to be unrepeatable, it is appropriate when forecasting future efficiency to anticipate that other one-off cost reductions will occur during the charge control period.

44 Paragraph A7.27 of the Consultation.

45 Paragraph A7.36 of the Consultation.

46 Paragraphs A7.28 – A7.36 of the Consultation. While the respective efficiency targets of BT's internal planning documents are redacted in the Consultation, it is clear that the Medium Term Plan ("MTP") and the BRF2 produce different rates. Paragraph A7.31 implies that Openreach consider the BRF2 to set stretch targets whereas a similar comment is not made with respect to the MTP. Clearly, Sky would be in a better position to comment more effectively on this issue if the different efficiency rates implied by BT's internal planning documents were not redacted.

47 Paragraph A7.33 of the Consultation.

6.2 Ofcom should be mindful that BT has argued in its regulatory submissions to Ofcom prior to the setting of regulated price caps that there is little scope for further efficiency gains at the level previously enjoyed but subsequently manages cost reductions significantly greater than the level prescribed by Ofcom.[49]

6.3 It does not follow that gains in cost efficiency should come at the expense of service quality. In Sky's view, it is possible for Openreach to improve quality and save costs (in part, because service quality can be improved by marshalling resources more effectively as opposed to necessarily increasing full time employees).

6.4 Moreover, Sky does not consider it appropriate to rely on the most recent, elevated fault rate (and resultant costs) as the starting point for the base year of the control. We note that Ofcom has chosen at this stage to adopt the fault rate from the previous year (i.e. 2011/12). As argued by Sky and TalkTalk in its appeal of the previous LLU charge control, if anything, fault levels for MPF should be reducing as a result of the growing maturity of MPF lines which means that there are relatively fewer young lines (which are prone to more faults). Accordingly, we continue to argue for a reduction in fault costs allocated to MPF throughout the charge control period (including the base year allocation).[50]

SECTION 7 – CHARGE CONTROL DESIGN

7.1 In this section on charge control design, we respond to Ofcom's proposals to set individual controls on key migration services, set price caps for ancillary service baskets (for MPF, SMPF and Co-mingling respectively) and to subject out of scope services, such as power charges, TRCs and SFIs to a cost orientation (or "basis of charges") condition.

It is appropriate and proportionate to set individual controls for the core rental services and key migrations

7.2 Sky considers that it is appropriate and proportionate to set individual controls for the core rental services and key migrations as these are the most significant cost items such that there is a greater risk of adverse consequences as a result of excessive or unduly discriminatory pricing in relation to these services.

7.3 Further, Ofcom is proposing to set the prices for key migrations services to reflect their incremental costs. Ofcom argues, and Sky agrees, that lowering migration prices will, at the margin, lower barriers to switching and foster increased retail competition.

7.4 However, where a migration requires engineering activity (through, say, jumpering work), most of the associated costs are incremental and, as such, price reductions are not pronounced. It is also unlikely that Ofcom's estimates of the LRICs of the key migration services will be very accurate. Nonetheless, Sky supports Ofcom's approach (in contrast to its views on Ofcom's approach to price differentials).

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48 [CONFIDENTIAL]

49 For example, see paragraph 5 (e) , *A New Pricing Framework for Openreach - Openreach Response to the Ofcom Second Consultation of 5 December 2008*, 6 March 2009, BT. http://www.btplc.com/thegroup/regulatoryandpublicaffairs/consultativeresponses/ofcom/2009/openreach/openreach.pdf.

50 Sky notes that if Ofcom were to adopt this approach of modelling the fault costs of an efficient operator for the base year of the controls, then it may not be appropriate to set an efficiency target that takes full account of the greater scope for gains implied by the current high level of inefficiency.

Ofcom's approach to the ancillary service baskets should use a current year weighting mechanism, separate out tie-cables from the co-mingling basket and apply concurrent cost orientation obligations

7.5 With respect to the three ancillary service basket controls (MPF, SMPF and Co-mingling) that capture the remaining, services, Sky has three main concerns:

(i) a prior year weighting mechanism affords BT too much scope to game the charge control (particularly for those services whose demand fluctuates significantly from year to year);

(ii) tie-cables should be removed from the co-mingling basket and controlled separately, not least because these are the only services in that basket that BT consumes itself; and

(iii) sub-caps, sub-baskets and inertia causes cannot prevent BT's prices from being excessive and, therefore, a cost orientation condition should continue to be applied as well.

Prior Year Weighting

7.6 While Ofcom accepts that prior year weighting (where the aggregate price change for a basket of services is weighted by reference to the relative revenues of each of the services in the prior year) is open to gaming by BT[51], it argues that current year weighting – Sky's preferred approach – is too complicated and reduces pricing certainty for communications providers.

7.7 We consider that, the same can also be said of prior year weighting which already allows for any under- or over-shooting in one year of the control period (i.e. BT setting its prices too high or too low with respect to the price cap) to be carried forward into the following year (which would also be an essential feature of a current year weighting approach). As such, both methods would result in a degree of pricing uncertainty.

7.8 In any event, if Ofcom considers that certainty in pricing is important for BT's customers, then the complete lack of transparency in the carry-over provisions each year should be rectified by greater disclosure annually when Ofcom reviews charge controls compliance with Openreach.

7.9 More importantly, the proposal to set individual controls for mass and bulk migrations will do most to mitigate the risk of BT gaming the basket controls. This is because whilst volumes for these services can fluctuate markedly from year to year, as they typically are planned well in advance as part of major acquisitions or network migration programmes, they are often predictable.

7.10 Despite the reduced risk of gaming, Sky considers there is still too much scope for BT to focus price changes on services within the baskets such that it can earn returns in excess of its costs (without it being more efficient than forecast or as a result of exogenous factors).

[51] Paragraph 4.213 onwards of the Consultation.

Tie-cables

7.11 There are three reasons why we consider that tie-cables should be removed from the Co-mingling basket and either individually controlled or placed in a separate tie-cable basket:

(i) first, the revenues from tie-cables are sufficiently large to warrant being treated separately;

(ii) second, the Co-mingling basket would no longer be unduly dominated by tie-cables such that the price cap for the basket would have more influence over the price changes for the other services in the basket; and

(iii) third, as BT does not consume the other basket services itself, there would no longer be any risk that BT would focus price changes or cost reductions only on the tie-cables that it purchases.[52]

Cost orientation

7.12 Sub-caps, sub-baskets and inertia clauses can only restrict the rate at which the relative prices of services within a basket can change. Only a cost orientation condition can orientate prices to their costs and, for this reason, Sky considers it appropriate to impose a concurrent cost orientation condition.[53]

While requiring power, SFIs and TRCs to be cost orientated to FAC is welcome, there is a strong case for SFIs and TRCs to be charge controlled

7.13 At the outset, Sky notes that charges for power, SFIs and TRCs are non-trivial components of the costs faced by communications providers. By revenues alone, power should be included within the charge controls but, Ofcom argues, the lack of control BT has over these costs warrants an approach whereby all the risk of cost increases are passed onto its customers and, ultimately, consumers.

7.14 While we note that as Ofcom is now applying a FAC-based cost orientation condition[54] on BT's power charges, in theory its customers could also gain if prices fall. In reality, however, inflation in power costs is likely to prevail in the long term.

7.15 SFIs and TRCs are also important as there is little or no effective competition in the provision of these services in practice but they are often essential in order to resolve faults or to provide non-standard services. High prices for these services may also lower their consumption which may not be in the interests of consumers.

7.16 Unlike power, BT has far more control over the costs of these services and, accordingly, subjecting TRCs and SFIs to a charge control will encourage greater levels of efficiency in the delivery of these services. Given that similar engineering activities – such as provisioning and standard fault resolution – will be subject to the general efficiency targets

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52 We accept that, because tie-cables revenues are so large compared to other co-mingling services, if tie-cables were in the co-mingling basket it would have to focus price changes on these in order to comply with the basket cap.

53 See further paragraphs 2.4 to 2.6 of Sky's response to the FAMR Consultation

54 Sky has long held that in certain circumstances, setting cost orientation ceilings at or close to FAC can be a more appropriate pricing constraint than distributed standalone costs ("DSAC") based ceilings.

embedded within the charge control formulae it would be appropriate for TRCs and SFIs to be subject to the same efficiency programmes.[55]

SECTION 8 - WEIGHTED AVERAGE COST OF CAPITAL

8.1 Sky considers that Ofcom's overall method for estimating BT's WACC is generally sound. However:

- there is a lack of clarity in how Ofcom weighs the evidence when aiming higher in its estimates of the risk free rate ("RFR") than contemporaneous evidence – which, prior to the credit crisis, would have carried more weight – would necessarily support. This can lead to: inconsistency in its approach between charge controls; uncertainty in how its estimates will be affected by future movements in key indicators; and final estimates that are not objectively justified;

- the latest data points towards a lower BT debt premium than that adopted by Ofcom for the Business Connectivity Market Review ("BCMR") in 2013. Ofcom acknowledges that it will need to re-estimate the debt premium when it finally determines prices early in 2014; and

- Ofcom's approach to disaggregating Openreach's cost of capital from BT Group is insufficiently robust because it overestimates Openreach's economic value relative to the rest of BT, resulting in an estimate of Openreach's asset beta that is too high.

8.2 We discuss these issues below.

Any future increases in gilt yields need not flow through fully to final estimations of the RFR

8.3 Since the credit crisis and subsequent QE programme, traditional indicators of the RFR (yields and forward rates on ILGs) have reached historically low levels. While temporary deviations from historical averages are to be expected, the scale and duration of the current deviation in yields is unprecedented.

8.4 Consequently, Ofcom, like other regulators, has reduced the weight that it applies to these indicators when estimating the RFR.

8.5 Moreover, as these indicators continue to decline Ofcom has remained cautious about reducing its estimate of the RFR by the same amount (if at all):

- In the 2011 Wholesale Broadband Access Market Review, Ofcom originally proposed 1.5% for the RFR before ultimately settling on 1.4%. At the time, short term average yields in 5 year and 10 year gilts were slipping into negative territory and deviating from longer terms averages (although these too were falling well below historic levels). As a result, Ofcom placed more weight than it would normally have done on longer term historic averages. These showed 5 year and 10 year averages for 5 year ILGs of 1.2% and 1.6% respectively with a similar range for 10 year ILGs (dropping 20

[55] See further paragraphs 2.7 to 2.10 of Sky's Response to the FAMR Consultation.

base points between the consultation in January 2011 and the final statement in July 2011).[56]

- In the BCMR, 5 year and 10 year averages as of December 2012 for 5 year ILGs had fallen further to 0.2% and 1.0% (and, for 10 year ILGs, 0.6% and 1.2%). However, Ofcom only adjusted the RFR down from 1.4% to 1.3% i.e. by much less than the fall in ILGs yields over the same period.[57]

- In this Consultation, Ofcom explains that, by June 2013, there have been further falls. 5 year / 10 year averages for 5 year ILGs were -0.2% / 0.8% and, for 10 year ILGs, 0.4% / 1.0%.[58] At this stage, however, Ofcom is not proposing a reduction to the RFR but it will assess the latest indicator data when it finally determines the charge controls early in 2014.

8.6 Ofcom also points out that there is likely to be some inverse correlation between changes in the RFR and the Equity Risk Premium ("ERP") such that the total market return ("TMR") will be more invariant.[59] Sky agrees with this view. Ofcom cites a lack of evidence of offsetting increases in the ERP[60], as a justification for not reducing the RFR further despite recent falls in yields. However, it may not be that the TMR is entirely fixed and the weakness of the post credit crisis macro-economy may be indicative of a permanent or long term reduction.[61] If this is the case, then Ofcom may have been overly cautious in not reducing the RFR further than it has to date.

8.7 Moreover, irrespective of whether there is evidence of off-setting reductions in the ERP such that the TMR stays stable, Ofcom must arrive at a robust estimate of the RFR because it is also used in the cost of debt calculation, not just for estimating the cost of equity.

8.8 In this respect, Ofcom states:

> *"In estimating the WACC, we take account of a range of data sources and in particular consider movements in the trend to assist us in exercising our regulatory judgement."*[62]

Ofcom also states:

> *"We propose to continue to estimate the WACC using historical averages of the yields on index linked gilts and estimates of forward yields."*[63]

8.9 On the evidence of its approaches to estimating the cost of capital since 2009, it is clear

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56 Paragraphs 6.49 – 6.50 and Table 6.6, *WBA Charge Control: Charge control framework for WBA Market 1 services – Statement*, 20 July 2011, Ofcom. http://stakeholders.ofcom.org.uk/binaries/consultations/823069/statement/statement.pdf

57 Paragraph A14.71 and Figure A1406, BCMR 2012, Ofcom.

58 Table A15.3 of the Consultation.

59 Paragraph A15.54 of the Consultation.

60 Paragraph A15.47 of the Consultation.

61 Ofcom has presented HM Treasury evidence of the range of independent forecasts for GDP growth which could be considered an indicator of the RFR (see paragraph A15.57 of the Consultation). This range lies above relevant ILG yields and are consistent with Ofcom's own estimate of the RFR. However, we note that these forecasts are produced by commercial organisations – such as investment banks - who may have an incentive to promote the view that the RFR will rise (especially should there be resulting falls in the ERP).

62 Paragraph A15.58 of the Consultation.

63 Paragraph A15.60 of the Consultation.

that Ofcom does not have a defined model for weighing these data sources and that it has not consistently applied trend data. Specifically, it remains unclear how movements in any of the data sources will affect the estimate of the RFR used by Ofcom.

8.10 Now that ILG yields have become established below historic averages and forward rates have deviated from longer term averages, the absence of a transparent model[64] that shows how Ofcom weighs the different indicators of the RFR - including both forward and historic yields on ILGs of differing vintages and decisions by other regulators - is a key weakness in Ofcom's pragmatic approach to estimating the RFR.

8.11 While flexibility in its approach has enabled Ofcom to rely less on the traditional weightings that these indicators may have been given, this approach gives rise to a number of issues:

(i) over time there has become an increased risk of inconsistency between respective charge controls decisions;

(ii) it is more difficult for evidence to be judged objectively; and

(iii) it is unclear how Ofcom will weigh the available evidence once, or if, yields and forward rates start to rise again.

8.12 A particular concern is that if ILG yields begin to recover Ofcom will raise its estimates of the RFR even though it had not lowered its estimates by the same amount when the indicators had been falling (as they have been to date). Such an asymmetric approach would not be justified or fair.

8.13 Therefore, when it comes to setting the charge controls early next year, if the very latest data have improved (as a result, say, of an improved economic outlook or the unwinding of the effects of QE), it may not be appropriate for Ofcom to flow through the full extent of those increases into its new estimates for the RFR. In relation to the cost of equity, we also note that increases in the RFR are likely to be at least partially off-set by reductions in the ERP resulting in a more stable TMR.

Recent data points towards a lower BT debt premium than used for the Leased Lines Charge Control ("LLCC") earlier in 2013

8.14 Ofcom proposes a debt premium range of 1.7% - 2.3% based upon its assessment of historic data on the spread of BT's 2016 and 2017 sterling denominated debt over benchmark yields up to December 2012. Ofcom does not, at this stage, take further account of subsequent falls in spreads to March 2013. It argues that the 12 month average in spreads to March 2013 still falls within its proposed range. Ofcom also says that it will update these data before making its final decision.

8.15 Sky notes that, based on the spread data to March 2013[65], a debt premium range of 1.7% - 2.3% would be too high (the mid-point of 2.0% would be well above the average for the period). A range of 1.1% - 1.7% would appear to be more appropriate. If the lower spreads prevalent from September 2012 are shown to have persisted when Ofcom re-runs its analysis, then a lower range of this order would be justified.

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64 We note that a lack of a robust model by which to estimate line volumes was a key weakness in Ofcom's approach to setting the current LLU and WLR charge controls and which, as a result of a successful appeal of Ofcom's approach, has now been addressed in the Consultation.

65 Figure A15.1 of the Consultation

8.16 If it is found that BT's debt premium has fallen then this may imply that its debt beta has also fallen (if the fall in debt premium was, at least in part, attributable to reduced default risk stemming from improved economy-wide conditions). To the extent that Ofcom's current base case estimate of BT's debt beta (0.15) includes an 'allowance' (i.e. 0.025) for the correlation between default risk and the economic downturn, then it may be appropriate to make a corresponding downwards adjustment if any reduction in BT's debt premium is caused by an economic upturn.[66]

Ofcom's estimate of Openreach's asset beta is too high

8.17 Ofcom has overestimated the cost of capital for Openreach's copper access business because its approach to disaggregating the BT Group asset beta overstates the economic value of Openreach relative to other BT lines of business.[67]

8.18 In summary:

(i) Ofcom, considers that Openreach's copper access business has a lower cost of capital relative to the other parts of BT (because it is less risky) and, consequently since 2005, has estimated Openreach's relevant cost of capital[68] by disaggregating BT Group's asset beta in order to determine an appropriate asset beta for Openreach.

(ii) In order to disaggregate BT Group's asset beta, Ofcom needs to ascribe 'weights' to Openreach and to other BT lines of business that correspond to their relative economic values.

(iii) Ofcom estimates these weights by reference to the relative book values of mean capital employed ("MCE") in Openreach and the Rest of BT and, consequently, is proposing a 50:50 weighting.

(iv) However, this approach is likely to lead to an overestimate of the weight (and, hence, asset beta) that should be ascribed to Openreach for two reasons:

a) first, book values are a poor proxy for economic value where there are sizeable intangible assets within one of the lines of business (which is the case with the Rest of BT); and

b) second, even if it were appropriate to use book values (which Sky does not consider to the case), Ofcom has incorrectly included, in its calculation of Openreach's MCE, assets that are not relevant to the LLU and WLR charge controls and, thus, should be excluded.

(v) In its paper, Europe Economics puts forward a cogent series of different asset-based and income-based weightings which show Ofcom's proposed Openreach-to-Rest of BT weighting of 50:50 to be a clear outlier and places too much weight on Openreach. The alternative non-book value approaches all fall within the range

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66 Paragraph A15.127 of the Consultation.

67 For a fuller explanation, please see the EE Report.

68 For simplicity and in accordance with Ofcom's terminology, we use the term "Openreach' here to mean only Openreach's copper access business and not the other activities in which it is engaged but which are out of scope of the proposed LLU and WLR charge control. Where these other services (such as Connectivity Services and GEA) are relevant to this discussion, they are considered part of the scope of the "Rest of BT" cost of capital.

17:83 to 30:70.

(vi) While noting that no one alternative weighting is perfect, a weight of 30:70 (if not lower for Openreach) is clearly supported by the evidence. Europe Economics considers that moving to 30:70 could be appropriate if there is a continuation in the trends for alternative weightings.

(vii) Keeping stable asset betas for BT Group and the Rest of BT in accordance with Ofcom's proposals, a 40:60 weight would reduce Openreach's estimated asset beta from 0.60 to 0.57 resulting in an Openreach pre-tax nominal WACC of 8.6% compared to the 8.8% originally proposed by Ofcom (a 30:70 weight would result in an 8.2% nominal WACC for Openreach).

(viii) A reduction in Openreach's asset beta to 0.57 is consistent with a cross-check conducted by Europe Economics from observed falls in Openreach's operating leverage relative to BT Group (which produced an Openreach beta of 0.55).

(ix) Reductions in the Openreach cost of capital of this order are significant. A reduction of 0.6% in Openreach's WACC would mean that MPF and WLR prices were over £1.50 - £2.00 p.a. lower.[69] Lower MPF and WLR prices could lead to increased competition and innovation and lower retail prices.

8.19 In conclusion, Sky has advocated for some time that Ofcom should consider further improvements to its approach to disaggregating BT's asset beta such that it can be more objectively justified. The proposals put forward by Europe Economics support that objective and we therefore recommend that Ofcom incorporates them into its disaggregation method. We consider that the approach currently used by Ofcom produces estimates of Openreach's asset beta that are too high. A more appropriate approach would result in a lower asset beta for Openreach, and therefore a lower estimate of Openreach's WACC.

SECTION 9 – INTERIM PRICING ARRANGEMENTS

9.1 There is a strong possibility that Ofcom will not impose the new LLU and WLR charge controls in sufficient time so that they commence as soon as the current controls expire on the 31 March 2014. Ofcom needs to act now to prevent communications providers and, ultimately, consumers from overpaying during any lacuna between the two charge controls.

9.2 There is still a significant amount of work to be completed by Ofcom during the remainder of the administrative phase. There are many unresolved important issues (such as further investigation of fault rates, service quality and BT's 2012/13 RFS), some of which Ofcom has indicated will involve further consultation and will be reliant upon BT providing Ofcom (and stakeholders) with further information.

9.3 In Sky's view, much of the delay is attributable to BT, whose records and statements have been either of poor quality, missing, never collected or prepared on an inconsistent basis. Were BT to benefit from a lacuna between the charge controls, it would be further incentivised to cause additional delay both during the rest of the current charge control review, and in future charge control reviews.

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[69] See further Table 6.10 of the Consultation.

9.4 A similar situation arose with the current LLU and WLR charge controls, which did not commence until more than a year after the expiry of their predecessors. BT made voluntary "bridging" commitments to Ofcom that it would not raise prices above a certain level during the lacuna. Ofcom accepted these, in part, because it considered the prices caps offered by BT to be the same as those that would have been imposed had the older expired charge controls continued for a further year.

9.5 In the case of MPF, this meant that BT made a voluntary commitment for the rental price not to exceed £91.50 p.a..[70] This proved beneficial to BT because, had the charge control started on time, then the implied price for MPF would have £87.85.[71] [72] Even by reference to the proposed base case prices for MPF during the March 2011 consultation, the price would have been £90.[73] On this basis, BT's voluntary pricing was between £1.50 and £3.65 too expensive. Taking into account similar effects for SMPF and WLR the total value of the gain to BT from the lacuna potentially exceeded £30m in 2011/12.[74]

9.6 This time, if Ofcom's proposals for the new charge controls are found to be appropriate[75] then, were interim pricing to be based upon a continuation of the current charge controls (as per the method adopted last time)[76], the voluntary bridging prices (for MPF) would be lower than the current base case proposals for the new charge controls. Sky estimates that industry could pay over £30m less if it paid these lower prices for 2013/14.[77]

9.7 Therefore, it would be manifestly unfair and unreasonable to adopt a different approach to the voluntary price caps this time. In its negotiations with BT over the interim pricing arrangements, Ofcom should ensure that BT is held to this approach. If Ofcom considers that this cannot be achieved through voluntary arrangements it should act quickly now to implement the appropriate formal measures to continue the existing charge control until the new one is in place.

9.8 Further, Ofcom should plan now for future instances of regulatory lacunas in charge controls as they are becoming increasingly frequent. We consider there are several options that Ofcom could consider to ensure that communications providers, BT and consumers are protected from periods of unregulated prices:

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70 Figure 2.2, *Charge control review for LLU and WLR services- Consultation*, 31 March 2011, Ofcom (the "March 2011 Consultation"). http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/summary/wlr-cc-2011.pdf.

71 We note that had the charge control started on time then Ofcom may not have adopted the same glide path but it is reasonable to assume that the price for MPF in this year would still be considerably below the voluntary price cap.

72 Figure 6.21, *Charge control review for LLU and WLR services – Statement,* 7 March 2012, Ofcom (the "2012 Statement"). http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/statement/statementMarch12.pdf.

73 Figure 1.1 of the March 2011 Consultation, Ofcom.

74 Source: Sky calculations. Volumes from Sections 7.3 and 7.10, BT's Regulatory Financial Statements for 2011/12 *Current Cost Financial Statements for 2013 including Openreach Undertakings.* http://www.btplc.com/thegroup/regulatoryandpublicaffairs/financialstatements/2012/rfs_2012.pdf.

75 For the avoidance of doubt, Sky considers them to be too high.

76 We acknowledge that a continuation of the annualised price reductions of the current charge controls may not have been the outcome had the current charges controls model estimated costs for 2014/15. However, it is reasonable to assume that unit costs, and hence prices, would have continued to decline to reflect efficiency improvements.

77 Source: Sky calculations. 2014/15 rental volumes are from Annex 9 (V*olumes Forecasting Model)* to the Consultation.

(i) consult on interim pricing arrangements at the same time as the next charge controls;

(ii) consult in advance of the next charge controls consultation (perhaps at the 'call for inputs' stage);

(iii) impose a cost orientation condition as part of the relevant market review remedies with special guidance as to how this condition would be (temporarily) interpreted when charge controls have lapsed (for example, such that cost oriented prices would be similar to those that would be likely under a charge control);

(iv) impose a SMP obligation for charges to be fair and reasonable and to give guidance on how this will be interpreted when a charge control lapses (similar to the above);

(v) issue a SMP direction that sets the prices; or

(vi) maintain a continuous charge control model and only consult on a sub set of the elements of the model at any one time.[78]

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[78] Sky notes that, in Ireland, ComReg avoids periods where there are no charge controls effective on SMP operators by typically maintaining open-ended charge controls. For example, in Market 5, ComReg found eircom to have SMP in 2011 and in 2012. ComReg set a price floor on eircom's wholesale charges, for the purpose of amongst other things, "maintaining an economic space" between Market 5 and Market 4 (ComReg Document No. 12/32). This charge control imposed in 2012 related also to Market 4. ComReg found eircom to have SMP on Market 4 in 2010 and imposed on it the full suite of SMP remedies, including an obligation to charge cost oriented prices for access services and products and an obligation not to create a margin squeeze (ComReg Document No. 10/39). Importantly, the EU Commission's 'Article 7 taskforce' has approved this approach by ComReg on successive occasions.

APPENDIX 1 – PRICING ADJUSTMENTS AND PRICING DIFFERENTIALS

10.1 In this Appendix, we discuss in more detail Ofcom's approach to certain price adjustments and cost allocations. In particular, we argue that Ofcom is wrong to approach each of these issues with the sole aim of lowering the price differential between WLR and WLR/WLR+SMPF. We consider that Ofcom must reappraise itself of the original bases for these adjustments and allocations before assessing whether there is a case for change.

10.2 We look at the following areas:

(i) broadband line testing;

(ii) line lengths;

(iii) directories;

(iv) relative fault rates;

(v) service assurance; and

(vi) cumulo rates.

Broadband Line Testing

10.3 In Sky's view, Ofcom's preferred approach of no longer recovering MPF-specific broadband line testing costs from SMPF ("the TAM adjustment) is flawed for three reasons:

- it places insufficient weight on dynamic efficiency (see Section 4, above);
- it undermines the principle of regulatory certainty by removing the adjustment too quickly; and
- it may not promote cost minimisation for MPF because BT does not consume it.

10.4 While each of the three fixed access services – MPF, SMPF and WLR – share some common line testing infrastructure (known as 'test heads'), there is also dedicated testing equipment that is not common:

- line cards are used to conduct testing for WLR and '20CN' SMPF lines;
- EvoTAMs are used to test '21CN' SMPF lines; and
- Test Access Matrices ("TAMs") are used to test MPF lines.

10.5 Ofcom's proposed approach to broadband line testing costs is two-fold. First, as a point of principle, it wants to discontinue the TAM pricing adjustment whereby broadband line testing costs specific to MPF have been recovered from all LLU lines including SMPF. Second, as a point of practicality, as Ofcom does not yet have full confidence in the relevant data in the 2011/12 RFS, its initial approach is to pool all broadband line testing costs and then distribute them equally across all LLU lines.[79]

[79] Paragraphs 6.141–6.142 of the Consultation.

10.6 Since 2005, Ofcom has recovered broadband line testing costs specific to MPF from both SMPF and MPF even though SMPF makes no use of TAMs. Meanwhile, broadband line testing costs for SMPF were not recovered from MPF.

10.7 Ofcom's has justified the TAM pricing adjustment on the basis that these costs could be viewed as system set-up costs and it could be appropriate to spread cost recovery beyond MPF in order to establish effective competition, i.e. it would promote dynamic efficiency.

10.8 BT appealed this approach to the treatment of broadband line testing costs when the current LLU and WLR charge controls were imposed. The CC upheld Ofcom's approach, explaining that Ofcom was exercising its regulatory judgement/discretion when striking a balance between dynamic efficiency and static efficiency.[80]

10.9 In this Consultation, Ofcom has proposed removing completely the contribution to TAM costs made by SMPF by the end of the charge controls period, i.e. by 31 March 2017.[81] The effect of removing the TAM adjustment would be to reduce the price differential between MPF and WLR/WLR+SMPF services.

10.10 Ofcom argues that, as competition has developed, it has become less important to promote dynamic efficiency through the adjustment and, as such, it is appropriate to favour productive efficiency through its removal.[82] Specifically, Ofcom argues that cost minimisation would be best achieved by requiring both SMPF and MPF to recover only their respective broadband line testing costs.

10.11 However, there are two problems with Ofcom's proposed approach:

(i) it reduces the TAM adjustment too rapidly and, thus, undermines the legitimate expectations of MPF operators; and

(ii) it does not promote cost minimisation for MPF to the same extent that it does for SMPF because BT does not consume MPF.

<u>The rate of reduction is too rapid</u>

10.12 Ofcom has stated that, in order to maintain regulatory consistency and a stable investment environment (for MPF operators), any changes to these cost adjustments would be properly signalled and with sufficient notice.

10.13 Ofcom recognises, that too rapid a reduction in the differential between MPF and WLR/WLR+SMPF "*could undermine reasonable expectations and threaten the provision of a stable regulatory framework with consequences for investment incentives in general*".[83]

10.14 In March 2012, Ofcom considered the issue of removing the TAM adjustment and considered that such removal, without sufficient signposting, would be likely to have a chilling effect on investment incentives.[84]

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80 Paragraph 3.86 of the Consultation and see section 7 of the Competition Commission's determinations of appeals 1192/3/3/12 and 1193/3/3/12, paragraphs 7.120-7.121.

81 Paragraph 3.95 of the Consultation.

82 Paragraph 3.87 of the Consultation.

83 Paragraph 3.85 of the Consultation.

84 Paragraph 7.58 of the 2012 Statement.

10.15 Therefore, instead of removing the TAM adjustment, Ofcom proposed reducing it and stated that: *"In future price controls, we expect to continue reducing the MPF vs. WLR/WLR+SMPF price differential"*.[85]

10.16 As stated above, the CC endorsed Ofcom's approach to maintaining the TAM adjustment and recognised the importance of not undercutting MPF-based investors' reasonable expectations about the returns from that technology.[86]

10.17 The proposal in the Consultation to remove the TAM adjustment over the charge control period (i.e. by 31 March 2017) is inconsistent with Ofcom's position before the CC that the price differential between MPF and WLR/WLR+SMPF services should be reduced *"over time in a measured fashion."*[87]

10.18 Whilst Ofcom has signalled its intention to continue to reduce the price differential in future, its proposal to remove the TAM adjustment over a single charge control period does not give sufficient weight to the reasonable expectations of MPF operators. Rather, should Ofcom continue to consider it appropriate to remove the adjustment then it would also be appropriate – and consistent with Ofcom's position before the CC – for Ofcom to reduce it over the 2014/17 charge control period and to indicate its intention to remove the adjustment entirely over the course of the subsequent charge control period (should one be required).

10.19 Ofcom presents evidence of the decline in the price differential between MPF and WLR+SMPF to support its case for the removal of the TAM adjustment.[88] It argues that removing the adjustment would result in a lower differential that was in keeping with recent trends. However, the cost delta has not declined principally as a result of active decisions by Ofcom to place less weight on dynamic efficiency as competition evolves. The reduction in the differential has been largely driven by the unsubstantiated claims by BT that there are no longer significant differences between MPF and WLR line lengths and, as such, copper costs for each have equalised over time.

<u>Cost minimisation for MPF will not be promoted through the removal of the adjustment</u>

10.20 As discussed in Section 4 above, MPF is not consumed in any material volume by BT's retail divisions and, therefore, BT's incentives to reduce costs for MPF are tempered by the incentive to raise the relative costs of its rivals in retail markets. This is most relevant for MPF costs that are unique to it – as is the case with TAM costs. To date, because the TAM adjustment shares TAM costs with SMPF – which is consumed by BT's downstream divisions – cost minimisation incentives have not been tempered in this way to the same extent.

10.21 However, if Ofcom removes the TAM adjustment, the cost minimisation incentives with respect to TAM costs will be reduced.

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85 Paragraph 7.58 of the 2012 Statement. We note Ofcom is conflating two separate issues here: (i) the case for reducing the price differential between MPF and WLR/WLR+SMPF; and (ii) the case for the removal of the TAM adjustment.

86 Paragraph 7.128 (d), *Competition Commission determinations in Case 1193/3/3/12 BT v Ofcom and Case 1192/3/3/12 Sky/TalkTalk v Ofcom, 27 March 2012* (the "CC Determinations").

87 Paragraph 7.79 of the CC Determinations.

88 Paragraph 3.94 of the Consultation.

MPF costs are already too high because of weak cost minimisation incentives at Openreach[89]

10.22 Moreover, Ofcom depicts the removal of the adjustment (and the reduction in the pricing differentials generally) as merely removing historic 'assistance' that enabled MPF-based competition to become established and which is no longer required for the promotion of efficient choices and competition. However, this view fails to recognise the factors which do not work in MPF's favour and which result in its price being above an efficient level.[90]

10.23 For example, while it is apparent that the most efficient wiring configuration for MPF has always been a single jumper[91] solution as opposed to the double jumpers that are used to provide MPF today, Ofcom continues to base the MPF charge control on the less efficient set-up. This issue is important because double jumpers and the resultant MPF wiring configuration in the local exchange:

(i) are a key driver in the allocation of frame costs;[92]

(ii) are likely to be correlated to the number of faults (as there are more points of failure); and

(iii) result in longer (tie-cable) runs and less efficient TAMs which, in turn, may reduce broadband speeds.

10.24 BT has rejected requests from TalkTalk to provide single jumper MPF and, this refusal, is now subject to a dispute that is currently being investigated by Ofcom. It is likely that one factor that militates against BT adopting a more cost efficient method of providing MPF will be that it would lower the costs of rivals to BT Retail and improve the efficiency of their broadband products.

10.25 In Sky's view, Ofcom should set the price of MPF on the basis of a single jumper i.e. a modern equivalent asset ("MEA") approach – as this would reflect the wiring configuration in an efficient copper-only network. If Ofcom adopted this approach, then MPF rental costs would be lower.[93]

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89 We note that Ofcom has for now equalised TAM costs across all LLU lines because it does not have sufficient confidence in BT's cost data – which showed that TAM costs per line were much higher than for EvoTAMs. It is difficult to envisage why this should be the case in an efficient network and, as such, should BT's costs be correct then it may be indicative of weak cost minimisation incentives for BT in relation to MPF services.

90 [CONFIDENTIAL] While 20CN SMPF relies on the PSTN line card for testing (the cost of which is recovered from WLR), 21CN SMPF has dedicated testing equipment (EvoTAMs) whose costs are recovered from all SMPF lines. [CONFIDENTIAL]

91 'Jumpers' refer to the connecting wires on the Main Distribution Frame ("MDF") in the local exchange.

92 'Local exchanges general frames capital and current' costs for MPF in 2016/17 are, as a result, forecast to be £2.82 higher than for single jumper WLR. Table 6.8 of the Consultation.

93 We note that, for MPF operators to use a single jumper solution, they would need to incur higher costs for different tie-cables and lower utilisation rates but these could be more than off-set by lower MPF rental prices. In practice also, MPF operators would likely only adopt single jumper MPF for net new additions while retaining double jumper MPF for its existing stocks. However, such an approach does not necessarily infer that the MPF rental costs should be calculated on the basis that only a proportion of MPF lines were single jumpered. This is because it has been apparent for several years that single jumper MPF was more efficient and, despite requests, BT has failed to develop it while MPF operators' double jumper MPF stocks have risen. Therefore, it may be appropriate when modelling the efficient level of MPF costs to assume that single jumper MPF was available at an earlier date.

Line Lengths

10.26 Ofcom has proposed removing the adjustment to MPF and WLR costs to account for differences between their respective average line lengths (the "line length adjustment"). The line length adjustment was initially introduced in 2005 to reflect the fact that MPF lines were expected to be shorter on average than WLR lines. Sky disagrees with Ofcom's proposal.

10.27 Ofcom, at the time, was clear that the basis for the adjustment was a technical one, and not intended to promote dynamic efficiency:

> *"For the purposes of determining E-side and D-side costs relevant to LLU, Ofcom proposes adjusting these costs on the basis of line length. BT has provided data which suggests that currently the average length of a copper loop that can be used to provide a 2Mbit/s broadband service is approximately 19% shorter than the average copper loop. This situation arises because DSL does not technically work over long line lengths and full LLU is mainly used to provide broadband, and broadband and voice services, but not voice only services. It is unlikely that line lengths constraining the provision of DSL will occur on the E-side and therefore Ofcom is only proposing to adjust the D-side costs to reflect shorter loop lengths for broadband services."*[94]

10.28 Ofcom's reason for removing the line length adjustment, however, is that it does not promote efficiency and would give too strong an incentive, at the margin, to use MPF over WLR/WLR+SMPF:

> *"We are therefore of the view that making an adjustment to average MPF charges to reflect differences in the average line length would not promote efficiency and would risk distorting choices between MPF and WLR/WLR+SMPF at the margin, giving too strong an incentive to use MPF. This could mean that it might sometimes be cheaper for a CP to use MPF even though it would be more efficient to use WLR/WLR+SMPF."*[95]

10.29 Ofcom has not, therefore, considered whether its underlying reasons for introducing the line length adjustment in 2005 still prevail.

10.30 Although the line length difference was expected to become shorter as technology improved, there is no evidence in the Consultation that this is the case or, indeed, that this has been considered by Ofcom beyond a reliance on:

- BT's explanation that "*it believes there is likely to be no material difference in line lengths*";[96]
- unspecified BT data disclosed within a confidentiality ring that does not appear to have been interrogated by Ofcom;[97] and
- conjecture arising from Sky and TalkTalk's decision to withdraw a ground of appeal from the 2012 Statement that the appropriate line length adjustment should be significantly in excess of that applied by Ofcom in the 2012 Statement.[98]

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94 Paragraph3.27, *Local loop unbundling: setting the fully unbundled rental charge ceiling and minor amendment to SMP conditions FA6 and FB6, Consultation document* – 7 September 2005, Ofcom. http://stakeholders.ofcom.org.uk/binaries/consultations/llu/summary/llu.pdf.

95 Paragraph 3.104 of the Consultation.

96 Paragraph 3.102 of the Consultation.

97 Paragraph 3.100 of the Consultation.

10.31 In adopting a conservative line length adjustment in 2005, Ofcom noted that BT would be able to make representations to Ofcom to review the adjustment in the event that it could not materially recover its relevant costs and charge below the ceiling. It is not evident from the Consultation that any such representations have been made.[99]

10.32 Ofcom should consider the underlying reasons for the imposition of line length adjustment prior to deciding to remove the adjustment. Ofcom's justification for introducing the adjustment was not based on dynamic efficiency considerations but on what was considered to be an underlying difference in costs between MPF and WLR. As such, Ofcom is wrong to consider its removal on a different basis.

10.33 If a difference in average line lengths still exists then it remains appropriate to maintain a line length adjustment because the amount of copper consumed by a line has a direct impact on costs.

10.34 Removing the adjustment when there remains a line length difference would mean that real cost differences between WLR and MPF lines would no longer be reflected in the price differentials.

Directories

10.35 Ofcom proposes that WLR costs should no longer include a contribution to the cost of providing telephone directories. This reduces the 2011/12 WLR rental cost by £1.43.[100] Ofcom's justification for this is that:

> "*there appears to be demand for a WLR service that excludes printed directories and because the bundling of directory delivery activities with WLR is not part of the remedies imposed by Ofcom in the wholesale fixed analogue exchange line market.*"[101]

10.36 Sky also notes that the original rationale for recovering these costs from WLR services was:

> "*because of an obligation in the contract for WLR that requires BT to distribute telephone directories to end users on behalf of CPs purchasing that service.*"[102]

10.37 In effect, therefore, the decision of whether or not to include these directories costs in the WLR cost stack is not one that is directly related to dynamic efficiency considerations (or the case for no longer promoting dynamic efficiency). As such, Ofcom is incorrect in seeking to couple the issues relating to the appropriate treatment of directory costs with broader objectives that it may be seeking to promote through the reduction in price differentials between fixed access services to reflect their incremental cost differences.

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98 Paragraph 3.99 of the Consultation.

99 We note that during the March 2011 Consultation (paragraphs A8.134 – A8.137) Ofcom originally proposed to remove the line length adjustment and that this proposal was predicated on statements made to it by BT that there was no longer a material difference in the line lengths of WLR and MPF. It was only once stakeholders challenged this assertion, that Ofcom requested more information from BT to support its statement. Although Ofcom did not make public the information that was subsequently provided, it elected to reinstate the line length adjustment in the 2012 Statement.

100 Table 6.7 of the Consultation.

101 Paragraph 3.112 of the Consultation.

102 Paragraph3.106, of the Consultation

10.38 Ofcom is also proposing that directories costs should be removed immediately from the base year costs and prices for WLR. Sky considers this approach to be wrong. Ofcom already recognises that there may be a case for transitional arrangements because BT may wish to change the way its funds and distributes directories as a result of Ofcom's proposed change. Specifically, Ofcom recognises that there is a risk of disruption and harm to consumers.[103]

10.39 Given this risk, Sky considers a more appropriate approach to no longer recovering directories costs from WLR prices would be to taper down the adjustment over the course of the charge control period. In doing so, this will allow BT and industry more time to make the appropriate transitional arrangements.

Relative fault rates

10.40 Earlier, in Section 3, we explained that the current absolute fault rate does not reflect that of an efficient ongoing copper-only network. According to Ofcom, faults account for 14% of the 2011/12 cost stack for WLR, 16% of MPF costs and 27% of SMPF costs.[104] Ofcom, for now at least, does not propose to use more recent elevated fault rates for the base year of the cost model.

10.41 We rely on our comments above regarding absolute fault levels and in this section focus on the appropriate relative fault rate between WLR, MPF and SMPF.

10.42 Relative fault rates between the three fixed access rental services are important as they drive the allocation of repair costs to each of these services[105] and, hence, contribute to cost differentials. There are three steps to determining the different 'usage factors':

(i) first, Ofcom adopts the fault rate allocation from BT's RFS 2011/12 i.e. WLR = 1.0, MPF = 1.04 and SMPF = 0.16;

(ii) second, a subsequent adjustment is made to reflect the higher costs that result from LLU services being on a higher care level (factored by WLR=1.0, MPF = 1.054 and SMPF = 1.054); and

(iii) third, the first and second stage usage factors are multiplied together in order to arrive at the combined usage factor for each service (WLR = 1.0, MPF = 1.10 and SMPF = 0.17).[106]

While Ofcom has proposed to use these usage factors, it has suggested[107] that, should it not satisfactorily resolve its concerns as to the integrity of BT's fault rate data, then it may be appropriate to equalise the usage factors such that MPF is the same as WLR+SMPF e.g. 1.10 or 1.17.

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103 Paragraph3.124 of the Consultation

104 Paragraph 5.23, of the Consultation

105 The cost components that pick up these repair costs are 'D-side copper current', 'E-side copper current', 'PSTN Drop wire Maintenance' and 'Local Exchange General Frames Current'. Source: footnote 317 of the Consultation.

106 Table A13.7 of the Consultation.

107 Paragraph 5.31 of the Consultation.

10.43 Sky is concerned that known trends and the latest data support a lower usage factor for MPF. To equalise usage factors may, therefore, unfairly disadvantage MPF operators and would result in MPF rental prices not reflecting their costs:

- BT's 2011/12 RFS shows a lower usage factor for MPF (1.04) compared to WLR+SMPF (1.16) or, allowing for higher LLU care levels 1.10 vs. 1.17. We note Ofcom appears to place less weight on these data (as an indicator of relative fault rates) because BT has asserted that it may have misattributed faults to WLR that should have been allocated to SMPF. However, if this were the case, it would merely indicate that the respective usage factors of WLR and SMPF were inaccurate but would have no bearing on the combined WLR + SMPF usage factor (which would be the same).

- [CONFIDENTIAL].[108]

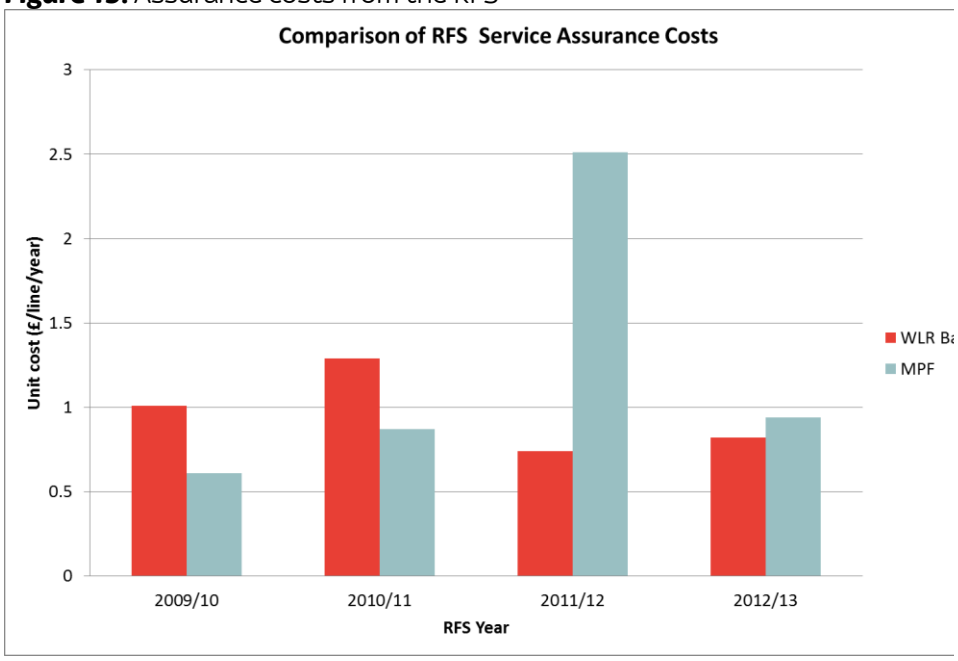
10.44 In light of this, we recommend that, as opposed to equalising fault rates, and in the absence of further reliable evidence, Ofcom should adopt for MPF the lower usage rates suggested by the data and as used by BT in its own RFS. Failure to recognise incremental cost differences between fixed access rental services will undermine Ofcom's broader policy objectives and, on the face of the limited evidence that is available, would unfairly disadvantage MPF operators.

Service Assurance

10.45 Service assurance costs mostly consist of those incurred in the supply by BT of call centre support to provisioning and repair. For Ofcom's base year cost calculations, it draws upon BT's reported service assurance costs within its 2011/12 RFS. However, as shown in the Frontier Report and reproduced below, it is clear that these data are significantly different to service assurance costs reported in either the RFS from the two preceding years or in the 2012/13 RFS.

[108] [CONFIDENTIAL]

Figure 19. Assurance costs from the RFS



Source: BT RFS 2010-2013

10.46 There appears to be no explanation from BT for such a spike in MPF service assurance costs. We note that in the two years preceding the spike, WLR service assurance costs per line were considerably higher than for MPF and, for 2012/13, costs are broadly similar.

10.47 It is evident, therefore, that the 2011/12 data is an outlier that should not be relied upon as a gauge of the relative service assurance cost differences between WLR and MPF. Further, no evidence has been put forward that could explain why MPF assurance costs were so high in that year while WLR service assurance costs fell.

10.48 In fact, if anything, rejecting the 2011/12 data and looking only at the data from the other years would lead Ofcom to the conclusion that, at the very least, service assurance costs per line should be equalised but that, more appropriately, MPF service assurance costs per line are likely to be lower than for WLR.

10.49 Given that the 2011/12 RFS data appears to be a clear outlier and absent reasoned justification, Sky considers that Ofcom should at the very least equalise the service assurance cost allocation between MPF and WLR. Better still, it may be appropriate to reduce the per line unit cost of service assurance to the average of those presented in the 2009/10, 2010/11 and 2012/13 RFS as these unit costs appear more stable. If Ofcom proceeded on that basis, it would conclude that MPF unit costs for service assurance would be up to c£0.50 lower than those for WLR.

Cumulo Rates

10.50 The allocation of cumulo rates costs to WLR and MPF does not properly reflect cost causation and, hence, Ofcom's estimates of the incremental cost differences between the services are incorrect. Ofcom's base year cumulo allocations per WLR and MPF line are broadly similar at just over £3.[109] These unit costs are subsequently forecast to decline in accordance with Ofcom's assumptions of efficiency improvements, volume effects and inflation over the course of the charge control period.

10.51 However, Sky remains of the view that a relatively equal unit cost per line between MPF and WLR does not adequately reflect the relationship between the volumes of these services and Openreach's overall cumulo rates cost.

10.52 It is widely acknowledged that the migration of lines from WLR to MPF causes BT's rateable value ("RV") and, hence, its cumulo costs to reduce (often in the form of rebates to BT). In the past, both BT and Ofcom have argued that this reduction in RV related only to a reduction in BT's downstream PSTN[110] profits (e.g. lower profits generated from wholesale calls services). As a result, they argued, there was no reduction in the RV of its copper access business and, as such, lower cumulo costs (for example, in the form of rebates) do not and should not flow through to Openreach services (and, in particular, to MPF).

10.53 Sky (with TalkTalk Group) appealed Ofcom's approach to allocating cumulo costs to MPF and WLR at the last charge control by putting forward an alternative method to the Profit Weighted Net Replacement Cost ("PWNRC") method favoured by BT in its accounts and accepted by Ofcom.

10.54 While the CC did not find that Sky and TalkTalk's method was demonstrably better than the PWNRC, during the course of the proceedings BT and, subsequently, Ofcom made crucial admissions that some of the reduction in BT's RV as a result of the migration from WLR to MPF does indeed relate to a reduction in the RV of Openreach's copper access business and is not solely attributable to reduced downstream profits of its PSTN business.

10.55 Specifically, Ofcom states:

> *"After making what it describes as a correction, BT said that "a proportion of rebates arising <u>from an increase in the number of MPF lines</u> would flow through to Openreach services."* [Emphasis added][111]

10.56 So, clearly, because the RV of Openreach's copper access business reduces as WLR lines migrate to MPF then MPF lines must have a lower RV than WLR and, as such, should attract a lower allocation of cumulo costs. The CC, in its final determination, acknowledged that:

> *"we no longer consider that Sky/TalkTalk's argument for allocating a greater share of cumulo rates to WLR than to MPF appears inconsistent with Ofcom's approach of only allocating Openreach's portion of the cumulo rates bill to WLR and MPF."*[112]

10.57 However, despite this conclusion, Ofcom still considers that the allocation of cumulo costs between MPF and WLR should be similar. It gives two reasons:

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109 Paragraph A14.48 of the Consultation.
110 Public Switched Telephone Network.
111 Paragraph A14.37 of the Consultation.
112 Paragraph 11.109 of the CC Determinations.

(i) there are only minimal differences in the usage of rateable assets by WLR and MPF; and

(ii) it would be consistent with Ofcom's approach to price differentials and incremental cost differentials which is aimed at incentivising communications providers to make efficient choices between MPF and WLR that minimise overall costs.

10.58 Sky does not consider these reasons to be a sound basis for supporting similar allocations of cumulo costs to each of WLR and MPF because:

- any differences between MPF and WLR in the usage of rateable assets have no bearing on BT's cumulo costs;
- it would in fact be inconsistent with Ofcom's approach to price differentials because there is an objective incremental cost difference between MPF and WLR in that more MPF lines lower Openreach's cumulo costs whereas more WLR lines raise them; and
- given the above, equalising cumulo costs per line between MPF and WLR will result in communications providers making inefficient choices that do not minimise (cumulo) costs. Put simply, migration from WLR to MPF lines minimises BTs cumulo rates bill (and Openreach's share). Communications providers will make cost minimising choices. Therefore the implied lower RV for MPF should be reflected in a lower relative cumulo cost allocation compared to WLR.

10.59 Sky considers that it is a relatively straightforward exercise for Ofcom to estimate the appropriate cumulo allocations to lines.

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