OFCOM CHARGE CONTROL REVIEW FOR LLU AND WLR SERVICES – CONSULTATION ISSUED 31 MARCH 2011

RESPONSE BY EVERYTHING EVERYWHERE LIMITED

A. INTRODUCTION

Everything Everywhere Limited (**EE**) welcomes the opportunity to respond to Ofcom's important consultation on the next charge control review for local loop unbundling (**LLU**) and wholesale line rental (**WLR**) services, issued on 31 March 2011 (the **Consultation**).

This Consultation is of key commercial and competitive significance for the success of EE's Orange Home fixed voice and broadband business going forward. In this regard we note that, whilst during the course of 2011 we have been moving from a direct shared metallic path facility (**SMPF**) and WLR based mode of providing these retail services to providing our retail services through a wholesale arrangement with BT, [✂][✂].

The comments in this response represent the views of EE. It should be noted that the views of EE's shareholders and those of the holding companies and ultimate parent companies may vary from these views.

Those parts of this response marked with [✂] and highlighted in blue are confidential to EE.

B. EXECUTIVE SUMMARY

EE's experience of LLU regulation and market conditions in the UK as an SMPF based service provider has been a telling one. Most notably, following the initial successes of Ofcom LLU policy in stimulating SMPF based retail broadband competition, progressive changes to regulatory investment ladder have resulted in us witnessing over the last five years the market exit of a very large proportion of the SMPF "early adopters" (e.g. Tiscali, AOL, Pipex, Bulldog). In May 2011, we have also seen the total number of unbundled lines in the UK falling rather than growing for the first time in several years, from 7.62 million lines in April 2011 to 7.56 million lines in May 2011[1].

We believe that it is no coincidence that, at the same time, in 2011 we are seeing the cost of retail broadband services in the UK rising for the first time in five years.[2] Furthermore, there is a clear and growing consumer preference for voice and broadband bundles in the UK, which has also had a material impact on both retail pricing and the declining ability of pure broadband SMPF based operators to offer compelling consumer offers. Our internal price analysis of the price increases of Orange Home's main retail bundle competitors over the past year is as set out in Figure 1 below:

[1] http://www.offta.org.uk/updates/otaupdate20110607.htm
[2] Broadband.co.uk, "Cost of Broadband Rises for First Time in Five Years", 25 May 2011

Figure 1: Retail Price Comparisons

		Line Rental (monthly)		Call connection fee (per chargeable call)		Daytime UK Land Lines (per minute)	
		From	To	From	To	From	To
BT	April-11	£13.60	£13.90	11.5ppc	12.5ppc	7.0ppm	7.6ppm
	Jan-11	£13.29	£13.60	10.9ppc	11.5ppc	6.4ppm	7.0ppm
	Oct-10	£12.79	£13.29	9.9ppc	10.9ppc	5.9ppm	6.4ppm
TalkTalk	May-11	£12.30	£12.60	11.14ppc	12.5ppc	7.0ppm	7.6ppm
	Jan-11	£12.04	£12.30	10.9ppc	11.14ppc	6.4ppm	7.0ppm
	Oct-10	£11.49	£12.04	9.25ppc	10.9ppc	5.9ppm	6.4ppm
Sky	Jul-11	£11.25	£12.25	10.11ppc	12.5ppc	6.03ppm	7.6ppm
	Jan-11	£11.00	£11.25	9.9ppc	10.11ppc	5.9ppm	6.03ppm

everything everywhere

Whilst much of the current regulatory framework carefully put in place by Ofcom is sound, we attribute the difficulties currently being faced by WLR+SMPF based service providers to five key regulatory hurdles, four of which are within the scope of the current Consultation:

1. The current asymmetric switching process that applies, depending on whether the gaining service provider is SMPF based or Metallic Path Facility (**MPF**) based (within the scope of Ofcom's Strategic Review of Consumer Switching);

2. The current asymmetric switching costs that are faced by the gaining provider, depending on whether they are SMPF based or MPF based (within the scope of this Consultation);

3. The non-price controlled charges for calling and network features payable by SMPF based providers, which can be avoided by MPF based providers (within the scope of this Consultation);

4. The costs of WLR+SMPF rental that exceed the equivalent costs of MPF rental by both more than the LRIC differential of providing these services and the additional up-front infrastructure investment costs, appropriately spread over time, required to be made by MPF based providers (within the scope of this Consultation);

5. The extent to which Openreach is still permitted to charge prices for the supply of LLU and WLR services which exceed the efficient costs of so doing (within the scope of this Consultation).

We address each of these issues briefly in turn, with our detailed submissions provided in Section C of this response in answer to the Consultation questions and summarised in the Annex to this response.

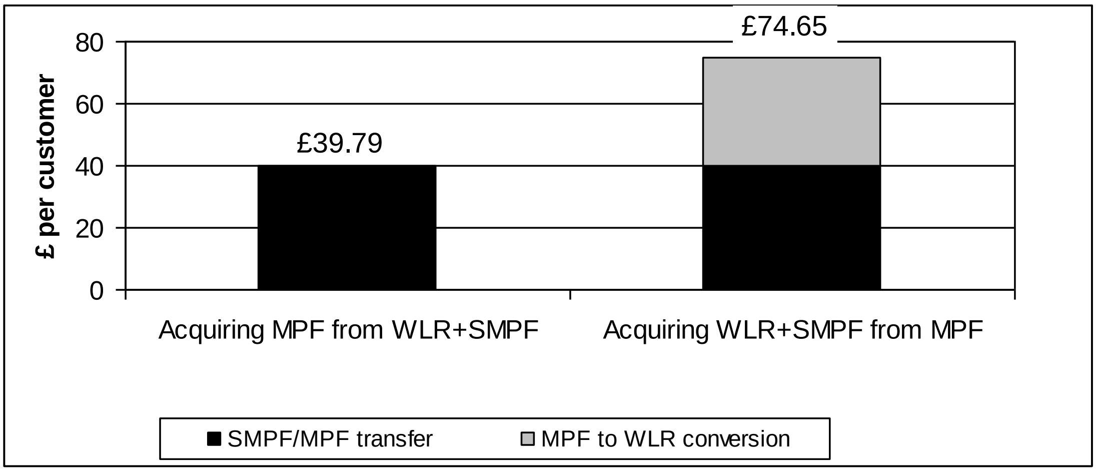
1. Asymmetric switching process

As Ofcom will be aware, switching a customer from SMPF to MPF does not require a Migration Authorisation Code (**MAC**), whereas switching a customer from SMPF to SMPF does require a MAC. Although not addressed by this particular Ofcom Consultation, this regulatory asymmetry currently confers a key unfair competitive advantage on MPF based providers seeking to acquire customers from SMPF based providers and must be something that Ofcom keeps front of mind when considering its overall policy objectives and legal obligations to achieve sustainable and vigorous retail broadband competition through LLU. We very much look forward to further progress in this regard later this year.

2. Asymmetric switching costs

As noted above, increasing UK trends towards bundled voice and broadband offers are making it increasingly important for SMPF based operators to be able to offer both voice and broadband services, through a combined WLR+SMPF based offering. Currently, it costs £34.86 more to migrate a customer from MPF to WLR+SMPF than it does to migrate a customer from WLR+SMPF to MPF, notwithstanding that the process involved is largely the same (indeed, seems to be cheaper to migrate to WLR+SMPF). On a standard 12 month contract term, this £34.86 switching cost disadvantage faced by WLR+SMPF based providers means that their offer to a migrating MPF based customer either has to be £2.91 per month more expensive than the offer an MPF based provider can make to a migrating WLR+SMPF based customer, or the WLR+SMPF based provider has to suffer £2.91 per month less margin to serve the customer (based on an average of the most recent monthly line rental prices in Figure 1, this represents 22-23% - or nearly a quarter - of the monthly charge).

Figure 2: Migration Costs[3]



Accordingly, it is simply not generally financially viable for WLR+SMPF providers to compete for MPF based customers when faced with this regulatory cost disadvantage. Urgently remedying this severe adverse competitive anomaly is a key outcome that we seek from the upcoming charge control (see further our response to Consultation Questions 4.11 and 5.6).

3. Non-price controlled calling and network features

Ofcom does not currently impose price controls on any of BT's calling or network features and is proposing to continue this stance in the Consultation. We believe that it is very important for Ofcom to charge control at least two such features – namely caller display and voicemail. The information available to us suggests that BT is currently extracting monopoly profits from the supply of these features. Given the current consumer preferences for and prevalence of voice and broadband bundled offerings in the UK market, these prices are causing serious competitive harm to WLR+SMPF based voice and broadband bundle providers such as EE, who have no effective choice but to buy these services from BT.

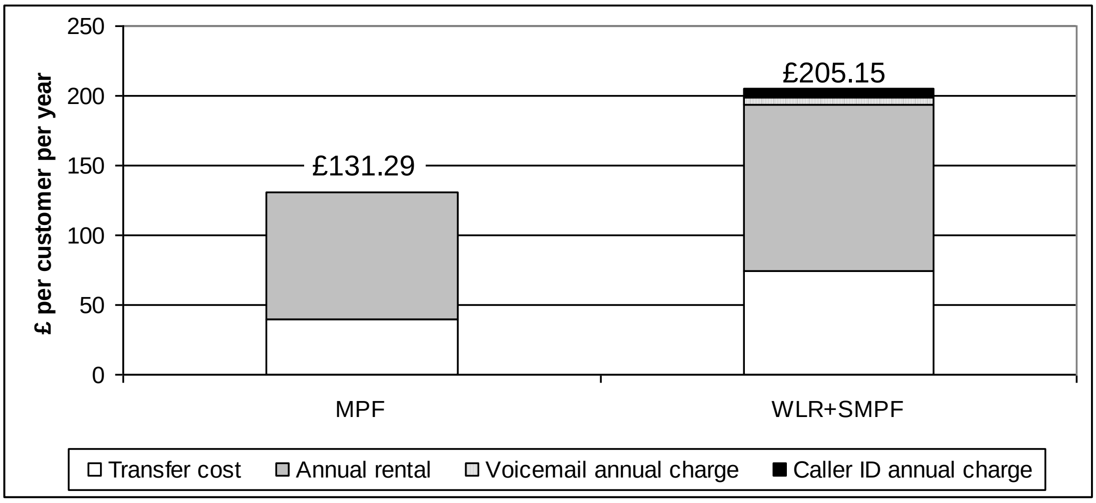
[3] Based on current Openreach charges.

We would accordingly find it very surprising if these charges were compliant with BT's significant market power (**SMP**) obligations – in particular Condition AAAA3 - Basis of Charges.[4] As these charges have been and continue to cause serious competitive detriment to WLR + SPMPF based competitive broadband providers, we urge Ofcom to regulate these charges by way of a price cap effecting an immediate one-off adjustment to bring these charges in line with cost (see further our response to Consultation Question 5.8 below).

4. WLR+SMPF vs. MPF rental differential

EE believes that the current differential between MPF vs WLR+SMPF rental costs (which is well above the LRIC differential in the cost of providing these services) is excessive, and is inefficiently distorting competition in favour of MPF based service provision. In terms of EE's current regulatory cost base, the total cost imbalance we face when competing with MPF based providers is substantial, and highly competitively significant:

Figure 3: 12 Month Subscriber Costs[5]



In contrast, Ofcom's own figures of the LRIC differential between MPF and WLR + SMPF show that MPF operators' total costs are significantly lower than those competing using the SMPF product. The LRIC differential of £8 - £15 (see Figures 8.1 and 8.12 of the Consultation) can be considered as the level of cost which the MPF operators have to self provide, but which SMPF based operators are renting from BT. This is significantly less than the differential in proposed charges which *averages* at £25 over the charge control period. [✂][✂]

This distortion arising from regulated prices is an outcome that the Competition Commission has decided firmly against.[6] It is also something that Ofcom is legally obliged to avoid, under its obligations under the European Union's Common Regulatory Framework (**CRF**) to ensure that, so far as is practicable, retail broadband providers using MPF as an input to their services are not favoured over those who use WLR and SMPF input products, or vice versa.[7]

Yet, in this Consultation Ofcom appears to have given no detailed consideration to the issue. We believe that this is a serious legal deficiency in Ofcom's analysis. We further believe that scrutiny of the outcomes of Ofcom's proposed charge control through this lens would and

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[4] This SMP condition requires BT to ensure that its charges for "*each and every charge offered, payable or proposed for Network Access covered by Condition AAAA1(a) is reasonably derived from the costs of provision based on a forward looking long-run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed*."

[5] Based on current published BT charges.

[6] *Carphone Warehouse Group plc v Office of Communications*, Case 1149/3/3/09, Determination, 31 August 2010, (the **CC WLR Determination**)

[7] *Communications Act* 2003 s 4(6).

should result in Ofcom making a number of adjustments to the charge control to redress this imbalance – in particular in the areas where the cost allocation decisions made by Ofcom mean that WLR+SMPF based operators are continuing to subsidize MPF based operators and where forecasts appear to unduly favour MPF based service provision (see further our response to Consultation Questions 7.1, 7.3, 7.8, 7.9, 7.11 and 8.1 below)

5. Level of Openreach's charges

EE is broadly supportive of the approach that Ofcom is proposing to take in relation to the valuation of BT's duct network. However, we believe that there are some further important adjustments required to be made to the proposed charge controls, in particular regarding indexation and efficiency adjustments, to ensure that Openreach recovers no more than its efficient costs of supply (see, in particular our response to Consultation Questions 3.9, 7.3, 7.4, 7.5 and 7.6 below).

For all of the reasons set out above, we are concerned that Ofcom may not fully comply with its legal obligations if it proceeds to set the proposed charge controls as per the Consultation, by:

- Failing to have due regard to the overall impact of the charge controls on the competitive viability of broadband service provision using WLR + SMPF by providers other than BT (cf its obligations under, inter alia, s 88 of the *Communications Act* 2003 (**Act**)) ;

- Failing to pay due recognition to the current competitive contribution and ongoing potential to provide competition in the retail broadband market made by service providers other than BT who use WLR+SMPF rather than MPF as input products (cf its obligations under, inter alia, ss 4(3)(a) and 4(8) of the Act); and

- Accordingly inappropriately favouring the provision of broadband services using MPF rather than using WLR and SMPF, to the detriment of WLR and SMPF based competitors, current and future UK retail broadband competition and UK consumers (cf its obligations under, inter alia, s 4(6) of the Act).

Clearly, the consequences of this charge control are serious. As noted above, we believe that damage to retail broadband competition being caused by the current regulatory approach is already apparent. Going forward into a next generation access (**NGA**) environment, consequences can be expected to become even more severe and to have a further detrimental impact in reducing overall incentives on operators to migrate to NGA. MPF operators will have greater costs in migrating to fibre based products than SMPF operators (who can rely on continuing use of WLR in the interim and will be better placed to migrate to the new network architecture of NGA in the longer term). Therefore the artificial preferment of MPF operators will dampen incentives overall for operators other than BT to migrate to fibre products. This risks leading to handing a dominant position in NGA to BT (at least in non cabled areas).

We believe that the price cap arrangements which are considered in the Consultation need to take into account this wider context, and should be set in a way which urgently redresses the balance such that competition and future investment incentives are less distorted in future. We firmly believe that this is vital to ensure a sustainable platform for fixed broadband competition during the period of the charge control, and into the future. We therefore respectfully request Ofcom to take into detailed consideration our response to the Consultation questions as set out in Section C of this response, and as summarised in the Annex to this response.

C. RESPONSE TO CONSULTATION QUESTIONS

Section 3 – Approach to setting the Charge Controls

Question 3.1: Do you agree with Ofcom's proposal to set synchronised charge controls for LLU and WLR?

Yes, we support the proposal for synchronisation. We strongly agree that consistency in the setting of WLR and LLU charges is vital to create a level playing field between MPF and WLR+SMPF / SMPF based broadband providers (i.e. to comply with Ofcom's legal obligations not to favour one means of providing broadband services over another)[8].

Question 3.2: Do you agree with Ofcom's proposal to set charge controls for LLU and WLR to expire on 31 March 2014?

Yes.

Question 3.3: Do you agree with Ofcom's proposal to proposal to use a CCA FAC methodology to establish the cost base for the next LLU and WLR charge controls? Please give reasons for your answer. (Note that respondents are also invited to comment on contribution of the RAV approach in Question 3.5 below)

The cost standard to use in setting these charge controls needs to be based on the underlying objectives of the charge control itself. That is, a suitable cost standard should create incentives which promote Ofcom's statutory duties and ensure that the charge control is effective. The key aims of a wholesale charge control of this type, where the products in question are a key input to both BT and its downstream competitors, need to be ensuring that BT is not able to charge excessive prices, is incentivised to improve efficiency and that competition is not distorted. In economic terms a cost standard is required which creates an appropriate balance between allocative, productive and dynamic efficiency. EE considers that Ofcom should regulate consistently across different segments of the telecommunications industry and therefore considers that the default approach to price regulation should be based on some form of long run incremental cost (**LRIC**) standard. Mobile Call Termination, for example, is regulated by reference to such a cost standard.

Allocative efficiency suggests that costs should be allocated such that each service bears the costs which it directly causes, that BT is able to recover its efficiently incurred costs and that common costs are allocated in a sensible way which least distorts competition and output. Productive efficiency requires that BT is incentivised to reduce costs and make appropriate efficiency gains. Dynamic efficiency needs to ensure both that BT's incentives to invest are not undermined as well as ensuring that competitive providers are also incentivised to make efficient investments. Importantly, this also requires some form of technology neutrality and ensuring that competition between different types of providers is not distorted by the charge controls.

EE expects that there is more than one cost standard which, appropriately applied, could provide a reasonable balance between all of these different objectives. However, there are significant benefits from regulatory consistency and continuing use of the same basic cost standard for the setting of charge controls. Investments and decisions around entry into specific market segments are longer lasting than individual charge controls. Therefore, changing the fundamental regulatory approach to setting a charge control needs to be done carefully and only where there is a clear and quantifiable benefit from so doing. Otherwise, the regulatory regime risks adversely impacting on competition and investment which will be to the ultimate detriment of consumers. In the case of these specific charge controls, the Current Cost Accounting (**CCA**) Fully Allocated Cost (**FAC**) approach has also relatively recently been considered and accepted by the Competition Commission.

[8] See *Communications Act* 2003 s 4(6).

For all of these reasons, EE is not expressing a strong view on the use of a CCA FAC standard (as opposed to LRIC) and understand the benefits of continuing to base these charge controls on a broadly CCA FAC basis. However, EE notes that this in itself introduces an inconsistency in Ofcom regulation (as between different segments of the telecoms industry). As the Consultation recognises in paragraphs 3.18 to 3.19, regulating in this way needs to be done in a way which ensures that it is not introducing further distortions which could be avoided by regulating on a consistent LRIC basis.

An appropriately assessed FAC standard is able to be used to set a charge control which ensures that BT does not charge excessively, that there are incentives to improve efficiency and which promotes allocative efficiency. EE strongly believes that it is fundamentally important to ensure that the method of allocation is such that individual charges are set in a way which does not distort competition or investment incentives between different types of competitors. Similarly, the way in which costs are assessed on a "current" basis needs to ensure that competition is not distorted and that, overall, BT is not able to reap any windfall gains.

In this regard, we agree with Ofcom that certain adjustments to the overall level of FAC costs are required (for example, in the treatment of pre-1997 duct assets as discussed in the answer to Question 3.5 below). Further, EE believes that this means it is crucial that the allocations arising should be sense checked against alternative measures to ensure that they do not lead to competitive distortions between different types of providers as explained in response to Question 8.1 below.

Finally, the fact that these charges are based on BT's actual costs (albeit on a current cost basis) means that it is important that robust and challenging efficiency savings are applied to these costs (see further our response to Question 7.3 below, where EE sets out its view that Ofcom has chosen too low an efficiency adjustment given the available evidence). These costs estimates are based on actually incurred accounting costs, rather than a hypothetical efficient operator (using bottom-up cost estimates such as a LRIC approach). This should be taken into account when considering potential efficiency savings.

Question 3.4: Do respondents agree with our proposal to proposal to apply anchor product pricing as a guiding principle in setting the charge controls, whilst including economies of scope which result from the allocation of costs in Ofcom's financial modelling? Please give reasons for your answer.

All else being equal, it is reasonable to expect that the introduction of a new technology should not lead to increases in long run prices (appropriately adjusted for quality). In order to ensure that competition is not disrupted, there are circumstances where it can therefore make sense to ensure that short run prices do not rise through the introduction of such new technologies. To the extent that this is what the "anchor pricing principle" is saying, EE considers that this is an appropriate cross check to consider in setting these charge controls.

However, we do not consider that this is a "guiding principle" so much as one potentially important additional factor to take into account when considering the impact of a particular set of charge controls. It will not always be appropriate to apply this principle rigidly and its use needs to be rooted in the particular circumstances of the case under consideration. Such a principle should not be used as a way of keeping new technology prices higher than necessary and should also not be applied in a way which hinders future investment.

As set out in our response to Question 3.3 above, any charge control needs to strike an appropriate balance between different forms of efficiency and ensure suitable incentives for investment, innovation, efficiency and competition. These should be the "guiding principles" and anchor pricing is simply – in certain circumstances – one tool to apply in achieving these ultimate aims. Further, while the general principle can be clearly stated, the practical implementation (and where it should be applied) is often far from simple. Interpreted in one way, the anchor pricing principle suggests that migration between different technologies should not lead to individual technologies having to pay more. If this is a guiding principle, it seems to have been selectively applied given the advantages given to MPF operators compared to those competing using WLR+SMPF. While these are not different technologies, a key impact on the allocated costs arises from the assumptions concerning migration between these different ways of providing current generation broadband. WLR+SMPF has clearly not been insulated from the impact of these migrations.

Any use of anchor pricing principles needs to be done with care and this is not the only important cross check principle which needs to be applied. Given that the anchor pricing principle, in practice and in the circumstances of this particular charge control, does not appear to have a significant impact on the particular levels of the WLR and LLU charge controlled prices, EE does not have any further comment on its use here.

Question 3.5: Do you agree with our assessment that the decision on the treatment of pre-1997 duct assets set out in the 2005 Valuing BT's Copper Network remains appropriate for this set of charge controls? If not, why do you consider that the basis of valuing pre-1997 assets should change and what valuation basis should be used?

EE agrees with Ofcom's conclusion that the treatment of pre-1997 duct assets should not change. We believe that the reasoning which Ofcom used in 2005 to justify the current treatment remains valid, that BT's arguments about why the situation has changed do not stand up to rigorous appraisal and that Ofcom's reasoning in the Consultation for retaining the current approach is sound.

Duct assets are long lived and any further development of competition in the provision of such assets in the coming years seems remote. Virgin Media as a cable operator is the only other communications provider (**CP**) which also has significant relevant duct assets and the cable industry has not built out any additional such assets significantly in recent years. At least for the period being considered for this charge control, it seems highly unlikely that there will be significant additional investment in additional duct assets (at least from any CP other than BT). Indeed, this is why Ofcom has found it necessary to introduce the remedy of physical infrastructure access (**PIA**).

As Ofcom notes, BT is able to recover efficiently incurred costs under either an Historic Cost Accounting (**HCA**) or a CCA approach to valuing the duct network – the only difference is timing. A switch from one method to another creates a risk of BT being able to over recover costs. Ofcom explains this in detail (which is simply a mathematical fact) in Annex 5 to the Consultation, with which EE agrees. Therefore extremely good reasons are required to switch the regulatory approach for these historic assets and, for reasons of regulatory certainty, Ofcom would need to be certain that the costs and risks of any change in the approach were fully justified by the benefits. EE believes that the costs and risks are real, immediate and significant. Any benefits are speculative and highly uncertain.

The costs of switching to a CCA valuation of pre-1997 assets arise from:

- the regulatory uncertainty created (as identified by Ofcom in paragraph 3.44) which would impede future investment and competition;

- the risks that BT will be able to over-recover, or earn more than a reasonable return, on these assets (a proportion of which we expect were created with public money prior to privatisation) which would also harm the investment incentives of other CPs and competition more generally; and

- the fact that this would generally lead to adverse effects on the current level of competition by increasing costs for current infrastructure competitors (but for BT would simply shift profits between different divisions of BT).

The benefits identified by BT are that CCA valuation of these older duct assets would improve investment incentives. However, these benefits are to a large extent speculative, depending on:

- BT actually investing the windfall it gains in this way rather than simply taking this as increased profit (in circumstances where there would seem to be currently, and for the duration of the proposed charge control, little competitive pressure in relation to ducts themselves on BT to actually invest more);

- there being a significant need for additional duct investment (where it is significant that Ofcom has found that the current duct network seems broadly adequate for current requirements, as discussed in paragraph A5.34 of the Consultation); and

- pre-1997 duct valuations actually having a significant impact on investment incentives: as Ofcom discusses, these costs are largely sunk and therefore irrelevant to <u>future</u> investment incentives; BT is able to make a reasonable return on these assets over their whole lifetime under Ofcom's approach and it is unclear why they need to make a greater return on older sunk assets in order to have an incentive to invest in <u>new</u> duct assets (which will be treated differently as not being pre-1997 assets by definition).

Ofcom also reports BT as arguing that competition is now established which reduces the need for retaining the HCA valuation of these assets (where the establishment of infrastructure competition was one of Ofcom's key justifications for switching back to HCA valuation in 2005). This argument is flawed on two grounds. First, BT appears to be equating all infrastructure competition which is not appropriate. Ofcom was concerned in 2005 with establishing LLU based infrastructure competition. It is logically not appropriate to equate this with duct based infrastructure competition and suggest, as BT is effectively doing, that because LLU based competition is established it is no longer necessary to value these assets on the basis that there is no duct based infrastructure competition. Second, Ofcom is concerned with promoting *sustainable* competition. Increasing LLU charges, on the basis of an increased pre-1997 asset valuation, would harm the on-going sustainability of LLU competition. It would obviously be highly inappropriate to impact adversely LLU competition solely because it had been established by increasing prices yet further upstream where there is still limited competition.

For all of these reasons, EE agrees with Ofcom that changing again the approach to valuing these pre-1997 assets is not justified and believes that such a change would have a net negative impact on competition and investment in the wider sector.

Question 3.6: We note that we would expect that the difference between the charges for MPF and PIA should be at least as great as the difference in their respective incremental costs. Thus, if we maintain the RAV adjustment in copper based access services, we would expect that any assessment that we make of duct access charges would reflect a consistent approach to asset valuation, recognising the RAV adjustment. In reaching this view we have taken utmost account of the European Commission's recommendation on NGA. Do you agree with this assessment of the need to recognise the RAV adjustment in the setting of duct access charges? If not, please give your reasoning.

This question appears to ask for views on the appropriate level at which Ofcom should set charges for the PIA remedy that BT is obliged to provide (i.e. charges for duct access). Whilst we would welcome a separate Ofcom consultation on the issue of PIA pricing, we do not currently have any views on the matter.

However, in relation to the issue of whether the asset valuations are affected by PIA, EE agrees with Ofcom (as argued in paragraph 3.46) that the key issue here is ensuring that the relative charges between different products are appropriate and it is this which will ensure efficient investment incentives. Many of the points made above in relation to the asset valuations would apply to PIA as much to LLU based competition (in that duct is still an uncompetitive input to the PIA product). The key regulatory objective should therefore be to ensure that the choice between LLU based competition and PIA based competition is not unduly distorted by the regulatory regime. This is inherently an issue to do with the relativity between their respective prices.

We also note that, for the purposes of setting the current proposed WLR and LLU charges, Ofcom has not attempted to allocate any costs to the provision of PIA by BT (§7.23). We do appreciate that there is currently some uncertainty around the exact likely scale and impact of PIA within the next three years. However, forecasting is never an exact science, and it may similarly be said that there is currently some uncertainty as to the exact likely scale of WLR, SMPF and MPF usage over the same period.

As we understand that field trials of PIA have taken / are taking place and that service launch for duct sharing was scheduled for June 2011, we would be very surprised if BT has not by now formulated some indicative forecasts for likely take-up of PIA over the next 3 years. Given the significance of duct costs as an element in the WLR and MPF cost stacks, we believe that it is important for Ofcom to take due account of any other products across which BT is likely to be able to share these costs during the life of the WLR and LLU charge controls. We therefore believe that Ofcom should make a conservative usage allocation to PIA in respect of BT's duct costs. In contrast, we believe that Ofcom's current proposal of no allocation to PIA will either inappropriately allow BT to over-recover these costs (through the WLR and LLU charges and then again through its PIA charges) or risk a competitive distortion in favour of PIA based service providers over LLU and WLR based service providers (by not charging them for duct costs which have already been paid for by LLU and WLR based service providers).

Question 3.7: Do you agree that it remains appropriate to value post-1997 assets on a replacement/CCA basis? If not, please give your reasoning.

EE does not have strong views on the principle of continuing to value post-1997 duct assets on a replacement or current cost basis. There are definite benefits, in terms of regulatory certainty, from not changing the basis on which these assets are valued without good reason. EE does not consider that there has been a material and relevant change in circumstances which would warrant such a change at this stage. The lack of any likely competition in the provision of ducts and the likely introduction of a PIA product means there is a strong case for continuing to apply the same principle going during the next charge control period. EE notes that Ofcom plans to review this approach during the next round of market reviews and charge controls.

Given the lack of any likely competition in the provision of physical ducts, the key regulatory concerns here should be to ensure that BT receives a reasonable return on its assets and that those returns are also not excessive (which would imply high prices which would harm competition in downstream markets). By the same token any change in regulatory approach which led to windfall gains must be avoided both in this and future charge controls.

Question 3.8: as BT's recent valuation of post-1997 assets is not consistent with alternative estimates of replacement values it does not form a appropriate basis for setting charges

For the various reasons which Ofcom identifies in the Consultation, EE agrees that the proposed BT valuation is not consistent with previous approaches and is therefore an inappropriate basis for valuing post-1997 assets.

BT's approach, leading to a replacement cost for post-1997 duct of £2.9 billion, cannot be sensibly or robustly reconciled to the accumulated actual spend (identified by Ofcom as being £2.4 billion over the 1997-2010 period). EE agrees that a change of this magnitude could only be justified on the basis of robust and convincing evidence of a real cost increase, which BT appears not to have provided. EE further agrees that the most likely reason for the greater value being attributed to these assets relates to the methodology which BT has used. A change in methodology which would have such a significant change in the wholesale charges (and hence impact on competition) would require a significant justification and clearly establishing why the alternative valuation approaches are materially deficient. Ofcom's approach, based on actual spends and relatively objective measures such as relevant inflation measures, is not only not so deficient, but provides a reasonable and reconcilable value.

Further, BT's approach is based on assessing the replacement cost of its duct assets as a whole and then allocating an element of these costs to post-1997 assets (paragraph 3.75). Given that a different approach is being used for pre-1997 assets, a method which is dependent on valuing all assets is clearly not fit for purpose as any approach used for valuation should ensure that the relevant costs are appropriately recovered over the time period under consideration (in this case the period from 1997). Any approach which requires an assessment to be made of asset valuations prior to 1997 therefore risks allowing over or under recovery in an arbitrary way.

EE therefore agrees that BT's approach is not a robust or suitable basis on which to base a charge control. On this basis, EE has no further comment on Ofcom's basic approach of valuing these assets on the basis of actual spend in the relevant period, minus accumulated depreciation and then indexed.

Question 3.9: Do you agree with our proposal to include a valuation of duct in the charge controls based on indexation of post 1997 expenditure? If so, should this indexation be based on RPI; GCSI or GCSI adjusted for either productivity, scale economies or both (the detailed examination of thee indices is set out in Annex 4)? Please give reasons for your answer.

The Consultation is not clear on Ofcom's approach to indexation of post 1997 duct assets and the exact indexation figures used for calculating the base case.

- Paragraphs 3.84 to 3.86 suggest that the base case is derived from picking the mid point of a range derived from applying the General Building Cost Index (GBCI) (which leads to a post 1997 duct value of £2.2bn) and the GBCI -1% (which leads to a post 1997 duct value of £2.0bn), giving "the base case for our charge control model" as a value of £2.1 billion for the post -1997 duct;

- Figure 3.2 appears to suggest that indexing on the basis of RPI gives a post 1997 duct value of £2.0bn, i.e. the same as GBCI-1% in the above;

- Annex 5 (at paragraphs A5.164 to A5.181) discusses these issues in more detail and also refers to a range based on GBCI and GBCI-1% (with the BT "national discount" applied to these) and paragraph A5.181 states "We have used a valuation of £2.1billion in our modelling for this consultation";[9]

- Paragraphs 7.61 to 7.62 suggest that RPI has been used to index the CCA value of post-1997 duct assets to create a "sensible base case" (which the Consultation suggests is similar to GBCI-2% at this point), which is reiterated at §7.77; and

- The model which Ofcom released with the Consultation appears to use RPI for this purpose (the relevant figures being in row 126 of the sheet Duct_CCA_Piper in the work book "RAV for publish3.xlsx"), which gives a post 1997 duct value of £2.1bn in 2009/10 (cell N62).

Ofcom's approach and preference is therefore not clear, but EE has assumed that Ofcom is proposing to use the GBCI index (potentially adjusted) as is clearly suggested in section 3 and annex 5 of the Consultation. EE disagrees with this approach. As is noted in Annex 5 to the Consultation, general regulatory practice is to use a general (RPI) price index as the Analysys Mason report for Ofcom found (§A5.171). The reasons stated for diverging from this approach are not sufficient or appropriate. The most detailed justification in the Consultation for rejecting RPI is given at §A5.172:

> "*We have reviewed the appropriate index for use in our estimate. Clearly, given its use in other elements of our charge control we considered whether Retail Prices Index ("RPI") was appropriate. It is a widely used and well understood price index.*

[9] While the consultation question refers to Annex 4, we assume that this is referring to this discussion.

> *However, as illustrated in the Analysys Mason report industry price indices have tended to run significantly above RPI. We therefore do not consider that RPI provides an appropriate basis in this case*."

This seems to boil down to an argument that a construction index has run above RPI, duct is construction and therefore the construction index is more appropriate. This turns on whether it is appropriate to index the post 1997 ducts on the basis of a construction cost index. EE does not consider that Ofcom has made any case of why this should be the case. First, assets which are indexed in other regulated industries are just as likely to be based on construction costs or other input costs which move differently to general inflation. The fact that duct costs are construction is therefore no reason to disregard regulatory precedent (both in other industries and Ofcom's own previous practice).

Second, the reason for indexation needs to be considered. This is to put the costs incurred over a number of years into current prices. A general inflation index is a superior measure of the movement in the value of money over time. This is what is relevant here as the aim should be to ensure that the current cost of the assets is not out of line with the opportunity cost to BT of building those assets. This is the approach which ensures that BT does not earn excessive returns and competition downstream is not distorted. Ofcom has taken the replacement cost principle too literally here despite the fact that the concept of a competing provider building the same of amount of ducts today is completely hypothetical. Ofcom should rather, therefore, focus on the value in today's money of the assets which BT has built (and this provides BT with fair remuneration) rather than the cost which BT would need to incur to recreate those assets today (which is hypothetical and not even physically possible in a short time frame).

EE therefore believes that a general inflation index is more appropriate. Further, EE is concerned that Ofcom has not even considered alternative general inflation indices in this context, but appears to have constrained its consideration to the all items RPI. As set out above, the relevant question is which general inflation index appropriately reflects the movements in the value of money over time. UK regulators have consistently used RPI measures. This provides a good reason for continuing to do so, without strong reasons for use of an alternative index, to provide regulatory certainty and continuity. However, EE considers that the RPIY index (which excludes the impact of mortgage interest payments and indirect taxation) would better reflect the movement of the value of money to BT and better reflect its opportunity cost from having made these investments. In applying inflation (presumably to other costs) as discussed in paragraph 7.58 of the Consultation, Ofcom has effectively used a forecast of RPIY. EE also notes that Ofcom has used the RPIY index to rebase charge control levels between periods in the mobile sector. The use of this index would therefore also be consistent with Ofcom practice both in other charge controls and in other parts of this charge control.

EE therefore considers that the most appropriate way to index post 1997 duct assets is by using the RPIY measure of inflation which excludes mortgage interest payments and indirect taxation. This would also be consistent with Ofcom's approach to other categories of costs. Given the figures which Ofcom has provided in its model and the Consultation, use of the RPIY index to rebase the post 1997 duct assets would lead to a figure below £2.0bn.

Question 3.10: Do you agree with our proposal to discount the indexed valued by an estimate of a national roll out of duct? If so, do you consider BT's estimate of 14.5% to be appropriate? If you disagree with our approach please give your reasons.

We are not able to provide any views on the level of economy of scale national roll-out discount that BT would or would not be able to obtain were it to replace its network.

Question 3.11: Our range for the duct value is defined by the degree to which BT is able to establish contracts with cost below the national average. Do you consider that it is reasonable to expect BT to achieve below national costs on average?

We are not able to provide any views on the level of economy of scale national roll-out discount that BT would or would not be able to obtain were it to replace its network.

Question 3.12: Do respondents agree with our preferred approach to use glide paths to align charges with costs except in the circumstances where one-off adjustments may be preferable? Please give reasons for your response.

EE has no comment on Ofcom's broad approach with respect to setting glide paths for prices over the course of the charge control period, but has the following comments on the implementation in this proposed charge control.

In relation to the potential for one off cuts, EE considers that there is a strong case for the effect of previous misallocations, which are impacting on competition between WLR+SMPF and MPF operators, to be rectified at the start of the charge control period. In particular, in this context, EE considers that the allocation of phone book costs only and all to WLR+SMPF operators is not justified and has never been justified (see our answer to Question 7.10 below). As such, any adjustments made to remove this distortion should be applied immediately and WLR charges reduced accordingly by the full amount of this adjustment in the first year of the charge control. The same arguments apply to re-allocation of TAMs costs (by an ex post adjustment) back to the MPF services which use these assets, and away from SMPF services, which do not (see answer to Question 7.11).

EE also considers that the assumed future RPI values which Ofcom's approach uses to set the X's in the RPI-X calculation are over optimistic. In relation to these charge controls, Ofcom has taken a relatively simple approach of effectively adding in expected inflation to create an X value which leads to the required real reduction. The problem with Ofcom's approach in the Consultation is that the level of the X becomes fixed for the charge control period, even if out turn RPI is in fact higher than was assumed when the X values were set. This gives a gain to BT and means that charges are higher for competing operators. Although the same assumed values of inflation have been used for setting BT''s costs, any nominal undervaluation of these assets which results can be corrected in the next charge control round when assets are set on current cost basis at that time. However, competing operators will never have the opportunity to recover the higher charges which they will pay as a result in this charge control period. Ofcom's assumed future inflation of 3% is significantly below the level at which RPI is currently running and does not appear to have been based on any actual forecasts or forecasting approach. EE therefore considers that Ofcom needs to revisit this aspect of its approach to setting the X for the glide paths.

Question 3.13: Do you agree with Ofcom's proposal to impose the arrangements for charge control compliance and requirements for provision of data set out in Annex 13? Please give reasons for your answer.

We do not have any views on this Question.

Question 3.14: Do you agree with Ofcom's proposal to use the RPI as the appropriate measure of inflation for indexation? Do you agree that change in RPI for the year to 31 October preceding the start of each Relevant Year should be used? Please give reasons for your answer.

EE has no comment on the proposal to continue to use the all items RPI for the purposes of setting the RPI-X price control formulae and notes that is consistent with long held UK regulatory precedent both in telecoms and other regulated industries.

Question 3.15: Do you agree with Ofcom's proposal to retain provisions for "Carry Over" in the new controls? Please give reasons for your answer.

We do not currently have any views on this Question.

Question 3.16: Do you agree with Ofcom's proposal that charge changes made under the new controls prior to April 2012 should be made with a minimum 28 days notice? Please give reasons for your answer.

On balance, EE agrees that it would be beneficial for the new charges in the first charge control year to be introduced with a reduced notice period. It is unlikely that retail prices could be changed this quickly in response to any change in the wholesale cost base, which creates a risk that some operators would be disadvantaged through having an increased wholesale cost base for a period when their corresponding retail prices are locked in. However, this potential cost is likely outweighed by the benefits of ensuring that the new charge controls come into effect relatively quickly, given that they will be introduced significantly into the current charge control year (and indeed the charge control period overall).

Any benefits of the new charge controls compared to the interim charges should be available to wholesale customers as soon as possible, especially given Ofcom's proposal to set the charge ceilings for key services for the first period of the new controls (which in any event reduces BT's flexibility to charge anything else).

EE takes this view on the basis that the charges which Ofcom is proposing in the Consultation are adjusted in the ways which EE proposes or, at the very least, some of the differential between different types of charges is significantly reduced (see in particular our answer to Question 8.1 below).

Question 3.17: Do you agree with Ofcom's proposal that charge for key services should be set for the 1st period of the new controls – i.e. the period between the first day of the new controls and 31 March 2012? Please give reasons for your answer.

While the ultimate effect should be the same whether a controlling percentage is set or an explicit ceiling (as the relevant RPI figure will be known with certainty at the time the controls are set), EE agrees that there would be some benefit in terms of increased certainty with the approach Ofcom proposes. However, continuing this logic, EE considers that it is important that, given that the charge controls will start significantly into the first year of the new charge controls, the benefits of such certainty apply to all charges. Where charges are not being set subject to an individual control, EE therefore considers it would be useful to require any changes to such charges to be notified at the same time as individually set charges will become set.

Section 4 – LLU Charge Control Structure

Question 4.1: Do you agree that we should set separate line rental charge controls for (i) MPF rental and (ii) SMPF rental?

We agree with Ofcom's proposal that MPF and SMPF line rentals should be set such that the price of MPF and SMPF line rentals will each separately be equal to their forecast CCA FAC costs (§4.14).

However, for the reasons set out in response to Question 4.12 below, we do not agree that these rental costs should, on the basis of the costing information currently before Ofcom, include any charges for cease activities (§4.15).

Question 4.2: Do you agree that separate baskets for MPF ancillary services, SMPF ancillary services and co-mingling ancillary services is appropriate and proportionate to mitigate the opportunity for gaming while providing Openreach some flexibility to efficiently adjust prices?

EE objects to Ofcom's analysis at §4.24 that "*BT Wholesale is the biggest buyer of SMPF products and its major competitors (such as Sky and TTG) tend to buy MPF products*".

As per BT's reported financial results, in Q1 of financial year 2010/2011, BT reported providing more external SMPF lines than it provided MPF lines (3,519,000 SPMF and 3,387,000 MPF lines).[10] In spite of the regulatory disadvantages that competitive SMPF providers have suffered, as at Q4 of financial year 2010/2011, there remained 3,342,000 external SMPF lines, as compared with 4,268,000 MPF lines.[11] That is to say, as at 31 March 2011, 43% of the LLU lines over which competitive broadband services to those provided by BT Retail are provided remain SMPF lines. Furthermore, other vigorous retail broadband competitors to BT (with EE's retail broadband services being a key case in point), now use the SMPF lines internally consumed by BT to provide competitive retail broadband services that are based on managed services acquired from BT Wholesale.

Therefore, whilst it is true that BT Wholesale is also a large buyer of SMPF products, it would be a serious mistake for Ofcom (indeed, one likely to violate Ofcom's obligations under section 4(6) of the Act) to discount the very important competitive contribution to the retail broadband market in the UK that is made by SMPF based competitors to BT; MPF based competitors and non-BT network based competitors.

Accordingly, whilst we do not object to the setting of separate baskets and separate basket controls for MPF and SMPF ancillary services per se, we believe that it is vital for Ofcom to ensure not only that MPF based competitors can compete against BT, but also that non-BT SMPF based competitors can compete with MPF based competitors (as well as against non-BT network based competitors and BT).

In this respect, we do not believe that Ofcom has taken adequate account of the fact that Openreach is not only able to potentially favour its downstream operations by trading off increases in the MPF basket against decreases in the SMPF basket (§4.27), but also is able to do the same thing *within* the SMPF basket. In particular, we consider that there are certain services within the SMPF basket that more likely to be consumed by SMPF based competitors to BT, rather than by BT's downstream retail operations. For example, as BT has started with a large incumbent base of retail customers, its downstream retail operations are more likely to be concerned with keeping that base intact and/or growing that base organically, than in acquiring new customers through churn from other operators. In contrast, in our experience, the transfer costs to gain customers from other operators (both SMPF based and MPF based) are critical to new entrant WLR+SMPF based operators as they try to build scale (see further our response to Question 5.6 below).

Question 4.3: Do you agree that we should set basket specific controls as opposed to a single control which is applied to all baskets?

We agree with Ofcom's decision to take into account the determinations made by the Competition Commission in the appeals brought by the CarPhone Warehouse Group (now TalkTalk) on this point.

However, as a point of principle, we note that it is important for Ofcom to keep in mind that, in each of the appeals, the determinations made by the Competition Commission responded only to the case as framed by TalkTalk, which was framed predominantly in its interests as an MPF provider. In setting the current charge controls, Ofcom has a much wider policy remit and we would note in particular that, in ensuring that Ofcom complies with its legal obligations not to favour one means of providing electronic communications services over another,

[10] http://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q411KPIs.pdf
[11] http://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q411KPIs.pdf

Ofcom has a duty to ensure that it protects the interests of competitive SMPF based broadband providers and WLR+SMPF based broadband and voice bundle providers as much as it protects the interests of competitive MPF based broadband and broadband and voice bundle providers.

Question 4.4: Do you agree that measuring compliance of basket controls against prior year volumes (as opposed to current year volumes) is an appropriate and proportionate approach to charge controlling ancillary services?

EE notes that this approach to calculating the relevant volume weights for basket controls is one which Ofcom has used in a number of previous charge controls. In setting basket controls, EE considers that the key objective for Ofcom should be to ensure that BT does not have the opportunity to set charges in a way which distorts competition (for example by favouring its own downstream operations). Given the practicalities involved in setting ancillary charges, EE agrees that it is unlikely that the additional complexity and uncertainty resulting from using current year weights would significantly affect the ability of BT to manipulate charges in this way to its own advantage.

Question 4.5: Do you agree that the inertia clauses applied to the ancillary services baskets should be tightened from their current level of 10%? Please give views on the appropriate level of inertia clauses in the range of 2% to 7.5%.

Ancillary charges can be material for WLR+SMPF competitive operators as additional charges to the core rental charges. Where BT has some flexibility to vary these individual charges, there is therefore a danger that price rises are focused on particular charges where there is no alternative to purchasing from BT and where competing WLR+SMPF operators are captive customers. Cumulatively, this could have a detrimental effect on competition. This is in addition to the slightly different (but related) potential concern set out in the Consultation concerning BT's ability to focus price rises on those products whose volumes will allow BT to over-recover its costs. An inertia clause also provides a degree of protection to purchasers of ancillary services that price changes over time will not lead to price volatility in input prices. Such volatility would make planning investments harder for competing providers. As such, EE agrees with Ofcom that there are benefits to retaining and tightening the inertia clauses. For the same reasons EE considers that the tightening should be towards the lower end of the range which Ofcom has specified reducing BT's ability to vary the balance between these charges year on year.

Question 4.6: Do you agree that we should not align or intervene to narrow the differential in charges for MPF and SMPF expedite?

We do not currently have any views on this Question.

Question 4.7: Do you agree that we should align the price jumper removals?

Ofcom has stated that it "*would be concerned if customers provisioned using SMPF services faced higher barriers to switching (**which do not relate to the underlying costs of the service**) than customers of its competitors*." (§4.90) However, in this case, Figure 4.5 appears to identify an additional activity required for SMPF jumper removal, which is not required for MPF jumper removal. Accordingly, from a cost causation perspective, it would seem that some difference in price is objectively justified. We are therefore concerned that, if Ofcom arbitrarily aligns the prices for SMPF and MPF jumper removal, Ofcom may thereby distort efficient competition by sending incorrect investment signals (i.e. encouraging inefficient switching from SMPF providers to MPF providers). We further do not believe that such alignment is necessary from a price transparency perspective (cf §4.78), as in each case, an operator's termination charges will vary according to its own relevant costs of doing business – whether or not jumper charge removal charges are aligned as proposed by Ofcom.

Question 4.8: Do you agree that we should use the weighted average of current prices to estimate the 2010 price of the service for jumper removals?

See our response to Question 4.7 above.

Question 4.9: Do you agree that option 1, that is ensuring alignment of similar charges at the beginning of the charge control period but not imposing any further obligation on Openreach to keep charges aligned, is the most appropriate and proportionate way to avoid competitive distortion caused by misalignment of prices?

We assume that the services Ofcom considers to be "similar" or "equivalent" for the purposes of this Question are those services listed in Figure 4.2 of the Consultation.

Our comments on alignment of expedited connections and jumper removals are provided in response to Question 4.7 above. Our comments on connections and transfers are provided in response to Questions 4.10 and 4.11 below.

In relation to the remaining services listed in Figure 4.2, where there are no relevant differences in the activities when these services are provided within the SMPF or MPF baskets, we have no objection to Ofcom's proposal to align the charges where they are not already aligned (e.g. for tie pair modifications). It is not clear from Figure 4.2 whether or not this is the case for bulk migrations – hence we offer no views on Ofcom's proposals in this regard.

We do not otherwise have any views in response to this Question.

Question 4.10: Do you agree that option 1, that a charge control in the range of RPI-9.9% - RPI-12.9% (base case RPI -11.4%) should be imposed on MPF new provide to bring the charge into line with CCA FAC by the end of the charge control period?

In order to avoid competitive distortion between MPF and SMPF/WLR+SMPF based providers, we agree that Ofcom should take a similar approach to setting the price for MPF new provides as it does for setting the price for WLR New Connections. On the basis that Ofcom is proposing for the current above cost WLR New Connection price to be aligned with FAC by the end of the charge control period, then we consider that it is appropriate that Ofcom adopts the same approach for MPF new provides.

Question 4.11: Do you agree that charge controls in the range RPI-7.7% - RPI-10.7% (base case RPI-9.2%) should be imposed on MPF transfer and SMPF connection to bring the charges into line with CCA FAC by the end of the charge control period?

We agree with Ofcom that "*where charges are levied on end users when they terminate a service, or switch providers where charges at the wholesale level can be passed on to retail users and create or raise a barrier to switching*", Ofcom's objective should be to ensure that these charges "*do not result in distortion to downstream markets*" (§4.102).

However, we are quite concerned that Ofcom's proposals would appear to be very likely to create just the kind of distortion in downstream markets that Ofcom claims it is seeking to avoid. In particular, we note in this regard that it has been found in the CC WLR Determination that:

> *"… a differential between charges for MPF and WLR+SMPF that is greater than cost could result in* ***inefficient investment in MPF****. In other words, it could lead to CPs making investment in MPF services that* ***would not be justified by the underlying costs of delivering services using MPF*** *rather than WLR+SMPF* ***or the ability to offer consumers new or better services***." (emphasis added) [12]

[12] CC WLR Determination §3.245.

We understand that Openreach's current charges for MPF, SMPF and WLR connections and transfers (singleton migrations) are as follows:[13]

a) MPF Connection Charge – new provide standard: £52.79

b) Transfer from WLR or SMPF to MPF (MPF Connection charge – Transfer from WLR/SMPF: £39.79

c) Transfer from MPF to MPF (MPF Connection charge – Change of CP migrations): £39.79

d) SMPF Connection charge: £39.79, covering:

   - Basic provide on existing WLR
   - Simultaneous provide with WLR
   - Transfer from SMPF to SMPF
   - Transfer from MPF to SMPF
   - Transfer from WLR

e) WLR basic line connection: £48.22; and

f) Transfer MPF to WLR: £34.86.

In this context, we understand that where in Figure 4.8 Ofcom refers to "MPF transfer/connection", it is referring to the Openreach charges listed in (b) and (c) above, and that where Ofcom refers to "SMPF Connection (New Provide and Single Migration)", it is referring to the charges listed in (d) above.

We accordingly conclude from the FAC cost estimates set out in Figure 4.8 that:

- It is <u>significantly more expensive</u> for BT to effect a transfer between MPF providers or from WLR/SMPF to MPF (a **Transfer to MPF**) than it is for BT to effect a transfer between SMPF providers or from MPF to SMPF (a **Transfer to SMPF**), with the charge for a Transfer to MPF estimated at £37.03 in 2013/14 but the charge for a Transfer to SMPF only estimated at £30.24 in 2013/14; and

- The current uniform Openreach charge of £39.79 for both a Transfer to MPF and a Transfer to SMPF is in both cases above Ofcom's estimated FAC, but is only slightly higher in respect of the charge for a Transfer to MPF (£2.76 or 7.5%), whereas it is significantly higher in respect of the charge for a Transfer to SMPF (£9.55 or 31.6%).

On the basis of the above, we believe that Ofcom's reasoning that the charges for these services should be aligned "*because their underlying costs are similar*" (§4.102) is fundamentally flawed. On Ofcom's proposal, by aligning the charges based on a weighted average of the forecast FAC cost stacks to a single charge of £32.35, the charge for a Transfer to SMPF will remain well above its actual forecast FAC by the end of the charge control period (by 7.8%) yet the charge for a Transfer to MPF will be set below its forecast FAC by 12.6%.

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[13] http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=totid5BwFmkf9vLcBITRyZF9loRxWIbIKK6V7YWmlYAlMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AIlSgtIFAKw%3D%3D; http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=LI%2BLzfp8sh2Y2DndjiRMoqOJDXc5GerAOSBb9tNt8RglMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AIlSgtIFAKw%3D%3D; http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPrices.do?data=63iUyYbpRV%2Fdw36mtxo4r1nqs1m6OcKz301sgolk8P2FdiaKKPEfrCsJCb3sZkzJ

We believe that there is a very clear risk that the setting of such aligned charges would, as condemned by the Competition Commission, lead to CPs making an investment in transfers to MPF services that is not justified by the underling costs of delivering services using MPF rather than WLR+SMPF. Specifically, we believe that this will create a situation that Ofcom itself has previously warned against, i.e. one where:

> *"... This could be inefficient if consumers were only persuaded to switch to an MPF-based CP because that CP was able to offer a lower price because it used a wholesale input that had an artificially low price relative to the wholesale inputs used by other CPs… in theory, CPs using MPF might be able to undercut rivals even though they had higher internal costs or were offering a worse service. This might mean that CPs using WLR+SMPF would be incentivized to switch to using MPF. Alternatively, as not all CPs maybe equally well placed to use MPF, distorted wholesale prices could distort competition to favour CPs that were better placed to take advantage of MPF."*[14]

This competitive distortion is currently further exacerbated by the gross asymmetry in the much higher non-price controlled Openreach MPF to WLR+SMPF conversion charges as compared to the regulated Openreach WLR+SMPF to MPF conversion charges (see further our response to Question 5.6 below).

We therefore strongly recommend that the charges for Transfer to MPF and Transfer to SMPF are <u>not</u> aligned. Rather, we recommend that each charge is separately brought into line with its own CCA FAC by the end of the charge control period – with an up-front one-off adjustment being made to the charge for Transfer to SMPF, given the significantly high level (31.6%) at which the current Openreach charges are above the forecast CCA FAC cost for these services.

Question 4.12: Do you agree that the charge for MPF and SMPF cease should be zero and costs recovered from rental charges?

If we understand the position correctly, Ofcom believes that the forecast cease cost information provided to it by BT and listed in Figure 4.9 "*seems unlikely to reflect the true underlying costs of the service*" (§4.113). Unless and until Ofcom is satisfied that it has received reliable cost information in this regard from BT, then we do not see how Ofcom can objectively justify setting any form of regulated charge for the supply of these services - whether in the form of a separate cease charge, an increase to the rental charges for SMPF or MPF or otherwise. Quite simply, we believe that, in the absence of Ofcom being so satisfied, any such charge would patently fail the legal tests as set out in section 47(2) of the Act requiring the charges to be objectively justifiable, non-discriminatory, and proportionate to what the relevant SMP charge control condition is intended to achieve.

We therefore do not believe that BT should be able to recover any costs for MPF or SMPF flexi-ceases until it has provided reliable cost information to Ofcom in this regard. If and when Ofcom receives this information, then we believe that Ofcom should re-consult on any proposed inclusion of these costs in the charge control (whether in the form of a separate cease charge, an increase to the rental charges for SMPF or MPF or otherwise).

Question 4.13: Do you agree that the 70 low volume products in the co-mingling basket should continue to be charge controlled within the co-mingling basket?

We do not currently have any views on this Question.

Question 4.14: Do you agree that time related charges should remain out of the scope of the charge control and subject to general remedies applied in the WLA market review?

[14] CC WLR Determination, §3.234

We support Ofcom's proposed further consideration of this issue in its review of cost orientation guidance, which we understand is scheduled for 2011. We do not otherwise currently have any views on this Question.

Question 4.15: Do you agree that special fault investigations should remain out of the scope of the charge control and subject to general remedies applied in the WLA market review?

We support Ofcom's proposed further consideration of this issue in its review of cost orientation guidance, which we understand is scheduled for 2011. We do not otherwise currently have any views on this Question.

Question 4.16: Do you agree that charges for special fault investigations should remain aligned between MPF and SMPF?

At all times when considering regulated charges for the purposes of this charge control review, we believe that it is important for Ofcom to keep in mind that competitive distortions can arise not only "*as a result of differential charges*" (§4.130), but also as a result of uniform charges imposed when there is a relevant differential in costs. On this basis, we are concerned that Ofcom may not be able to establish that it has met each of the criteria set out in section 47 of the Act for imposing this new SMP condition (i.e. that the new condition is objectively justifiable, non-discriminatory and proportionate), without further examination of the costs of providing the relevant SMPF and MPF special fault investigation services, so as to ensure that these are also aligned.

Question 4.17: Do you agree that electricity charges should remain out of the scope of the charge control but subject general remedies set in the WLA market review?

We support Ofcom's proposed further consideration of this issue in its review of cost orientation guidance, which we understand is scheduled for 2011. We do not otherwise currently have any views on this Question.

Question 4.18: Do you agree that both MPF and SMPF expedited connections should be charge controlled within the MPF and SMPF ancillary services baskets?

We do not currently have any views on this Question.

Question 4.19: Please indicate which of the Options 1-4 you think would be the most effective method of regulation of LLU enhanced care services. Please indicate whether you think Option 4 (removal of the cost orientation requirement and creation of a new requirement that the charges for LLU enhanced care should not be misaligned from those for equivalent WLR enhanced care services) would be an effective remedy.

We do not currently have any views on this Question.

Question 4.20: Do you agree that new services which partially or fully replace existing services should be included in the charge controls?

We agree with Ofcom that Openreach should not be allowed to deliberately or inadvertently revise its service structure in such a way as to reduce the scope of services covered by the Ofcom regulated baskets and introduce the new elements in a less regulated manner (§4.166). We further agree with Ofcom's proposals to address this concern as set out at §§4.166-4.170 of the Consultation.

Section 5 – WLR Charge Control Structure

Question 5.1: Do you agree that the core rental should be subject to a charge control which sets the price of the WLR core rental on a glide path to ensure it recovers CCA FAC costs by the end of the charge control period?

EE agrees with Ofcom's proposal to retain a separate charge control for WLR core rental. Without a strong and compelling reason for changing the current approach in this regard, there is benefit in continuing with a framework which has worked in the past. This promotes regulatory certainty which is beneficial in and of itself. As the Consultation notes, "*the current framework has worked well, and no stakeholders have lobbied for changes*" (§5.12). EE does not consider that the potential benefits identified by Ofcom for a change to a basket approach (set out in paragraph 5.11 of the Consultation) are significant and, in fact, the greater flexibility in setting these charges could lead to adverse distortions. Ofcom suggests that such distortions could occur as between WLR and LLU products. EE considers there would also be a danger of distortions arising which would harm competition (and in particular the ability of competing WLR+SMPF based operators to switch customers to their service) between WLR products.

In relation to the end point of the proposed charge control – i.e. the proposal that WLR core rental services recover CCA FAC costs by the end of the charge control period – EE has no further comments to those made elsewhere in this response. However, EE notes that this means that these core rental charges will be <u>above</u> an allocated cost base (i.e. costs derived from BT's own actually incurred costs assessed on a forward looking basis) for most of the charge control period. EE considers that this needs to be taken into account when other judgements are being made about issues such as the efficiency assumptions made, cost indexation approaches and when considering the competitive impact of cost differences. On the final point, the fact that all of the actual charges will be above CCA FAC as assessed is likely to exacerbate the difference between costs based on this measure and LRIC estimates (see our answer to Question 8.1 below).

Question 5.2: Do you agree that WLR transfer should be subject to a separate charge control? Please give reasons for your answer.

Yes. The WLR to WLR transfer service is a vital bottleneck switching service that any WLR or WLR+SMPF based competing operator must acquire from Openreach in order to gain an existing WLR or WLR+SMPF based customer from BT Retail or any other WLR or WLR+SMPF based provider. With the increasing prevalence of voice and broadband packages in the UK retail broadband market, the cost of the WLR to WLR transfer service is thus a critical input cost to enabling both voice and broadband retail competition in the UK. For as long as BT retains SMP in the Wholesale Fixed Analogue Exchange Line (**WFAEL**) market, we therefore firmly believe that the price of this service should be subject to a separate charge control to prevent Openreach from imposing excessive price rises, and increasing switching costs, that could distort or prevent competition in downstream markets.

Question 5.3: Do you think that Ofcom should adopt Option 1 or 2 above as its approach to the pricing of WLR transfer during the next charge control? Please give reasons for your answer.

Ofcom notes that WLR to WLR transfers charges are currently set significantly below cost and that these additional costs have been recovered from WLR rentals historically. This leads to an additional £2.37 being added to base cost allocation for WLR rentals (based on a continuation of the current approach).

In this regard, EE agrees with Ofcom that, given the degree of difference in the WLR transfer cost and charge, full rebalancing to CCA FAC over the course of the next charge control period (i.e. to £16.30 by 2013/14) would be highly disruptive and liable to distort retail competition unduly (§5.24).

For the same reasons, we are also concerned that full rebalancing to DLRIC (circa £11.00 by 2013/14) within the next charge control period (i.e. Option 2) would also, as Ofcom observes "*require very significant increases in each year of the control*" (§5.25) and therefore not be appropriate or justifiable.

On the basis of currently available information, EE therefore agrees with continuing the status quo (Option 1).

However, although EE cannot fully replicate the calculation which leads to the £2.37 uplift on WLR rentals and thus cannot comment definitively on the merits of such an approach, we also consider that there could be some value in Ofcom exploring a third alternative approach which lies somewhere between Options 1 and 2 – i.e. a modest increase in the WLR transfer charge which moves it further towards but not necessarily all the way to the DLRIC cost by the end of the charge control period. Given the historic position there would seem to be no particular reason why any rebalancing has to be achieved in one charge control period (whose duration is to a great extent arbitrary, or at least set with reference to completely different considerations). We would be happy to participate in any further consultation on such a proposal.

Question 5.4: Do you think that the cost orientation obligation should be removed from WLR transfer services? Please give reasons for your answer.

Subject to our comments in response to Questions 5.2 to 5.3 above, we do not currently have any views on this Question.

Question 5.5: Do you agree that the price for WLR new provide should be subject to a separate control which ensures that the price is aligned with FAC by the end of the charge control period?

On the basis of the reasoning provided in §§5.28 to 5.30 of the Consultation, we agree that Ofcom's proposal seems reasonable.

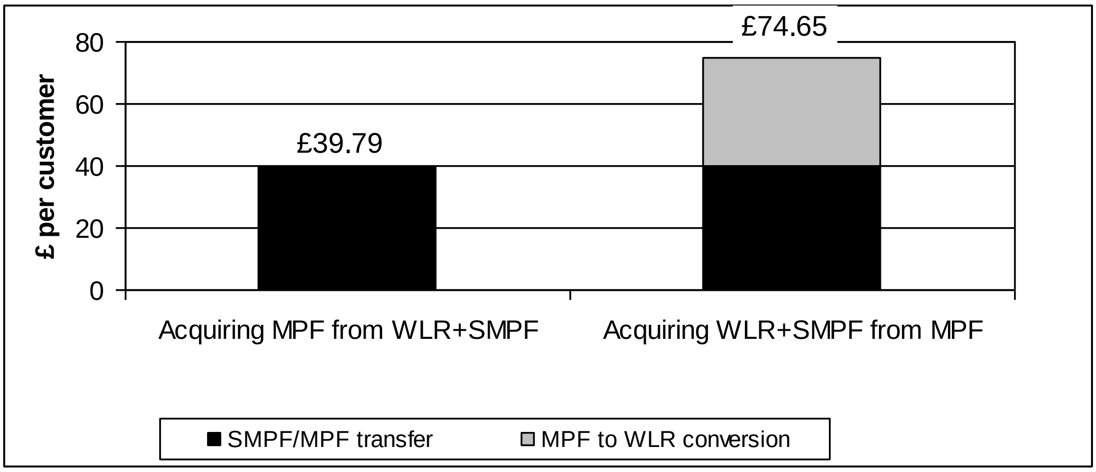
Question 5.6: Do you agree that a charge control would not be practical for MPF to WLR conversion given the low volume of services?

We strongly disagree with Ofcom's proposal to leave BT's charges for MPF to WLR non-charge controlled, thus continuing to expose WLR+SMPF based broadband providers to a highly competitively significant £34.86 cost disadvantage when they want to acquire a customer from an MPF based provider, as compared to when an MPF based provider wishes to acquire an SMPF or WLR based provider.

From EE's perspective [✂] [✂], this asymmetry in migration charges is one of the most important regulatory hindrances to our ability to compete effectively and actively for MPF based retail broadband customers.

As set out in diagram form below, the financials are quite simple and quite clear. MPF based providers compete directly with WLR+SMPF based providers in the supply of retail broadband and voice packages to customers. The overall costs of these packages to customers therefore need to be competitive and comparable. Yet, on a standard 12 month contract term, the £34.86 switching cost disadvantage faced by WLR+SMPF based providers means that their offer to a migrating MPF based customer either has to be £2.91 per month more expensive than the offer an MPF based provider can make to a migrating WLR+SMPF based customer, or the WLR+SMPF based provider has to suffer £2.91 per month less margin to serve the customer (representing circa 22-23% of current monthly retail line rental costs).

Figure 2: Migration Costs



In this regulatory context, it is hardly surprising that there is a relatively low volume of MPF to WLR conversions (§5.37) – as it is simply not generally financially viable for WLR+SMPF providers to compete for MPF based customers when faced with this cost disadvantage arising directly from the (non) regulated charges. Accordingly, in direct contradiction to Ofcom's conclusions in the Consultation, we believe that these low numbers of conversions do not indicate a lack of competitive distortion, but rather provide direct evidence of the competitive distortion and harm being caused by Ofcom's failure to regulate to align MPF to WLR+SMPF migration costs with WLR+SMPF to MPF migration costs.

In considering the competitive impact of Ofcom's current and proposed continued lack of regulatory intervention on this important issue, we again urge Ofcom to keep in mind that, as at 31 March 2001, there remained 3,342,000 external SMPF lines (43% of all external LLU lines).[15] Accordingly, any disadvantages suffered by SMPF based providers relative to MPF providers due to regulatory distortions are not simply faced by BT Retail – they are also faced by a very significant proportion of competitive retail broadband providers in the UK.

Indeed, in looking at the issue of migration charges in particular, we consider that it is far more likely that the current high MPF to WLR+SMPF transfer charges will have a much greater negative impact on external SMPF customers than on BT Retail – as BT Retail has a much larger incumbent base of customers than new entrants, and is therefore much less affected by high migration costs from other operators than new entrants, who must try to gain customers from other operators (both SMPF and MPF based) in order to build scale.

Given that Ofcom has further concluded that the MPF to WLR conversion service and the WLR to MPF conversion service involve similar engineering inputs which Ofcom believes should result in similar prices (§5.33), we therefore urge Ofcom to intervene to effect an immediate charge control on the price for MPF to WLR transfers so as to ensure that the price that is required to be paid to Openreach to migrate a voice and broadband retail customer from MPF to WLR+SMPF is no more than the price to migrate a voice and broadband retail customer from WLR+SMPF to MPF (i.e. currently £39.79).

Question 5.7: Do you agree that charges for MPF to WLR conversion should not be aligned precisely to the charge for WLR to MPF?

We disagree in the strongest terms with Ofcom's conclusions in this regard. See further our response to Question 5.6 above.

Question 5.8: Do you agree that charges for calling and network features should not be charge controlled? Please give reasons for your answers.

[15] http://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q411KPIs.pdf

EE (though its Orange Home business) is a provider of retail analogue line rental and voice calling services that are competitive with those provided by BT Retail. We do not provide these services on a stand-alone basis, but rather as part of our broadband bundles – "broadband and off-peak calls", and "broadband and anytime calls". These voice and data bundles complement our broadband only "simply broadband" offering.

As a result of growing customer preferences for voice and broadband bundles and their increasing prevalence in the UK market, it has become critical to the success of our retail broadband business that we can provide bundled analogue line rental and voice calling services that are competitive with those offered by BT Retail and by MPF and non-BT network based providers – both in terms of price and the features offered.

We note in this regard that:

- Ofcom's latest Communications Market Report[16] has observed that, as at Q1 2010, 50% of UK households were taking up some form of bundled communications offering, with 39% of households either taking up a fixed voice and broadband bundle, or a fixed voice, broadband and multi-channel TV bundle (Figure 1.40). 52% of these households cited "value for money" as their main reason for subscribing to such bundles, with a further 19% of households citing "convenience of one supplier" as their main reason (Figure 1.44).

- Recent market bundled voice and broadband offerings include:

    - BT's Plusnet offer launched on 20 June 2011 of half price broadband for 9 months for customers signing up to Plusnet Value broadband and fixed voice bundle[17]; and

    - Sky's offer launched on 8 June 2011 of a 6 month half-price broadband promotion for new sign-ups subscribing to bundles of voice and broadband packages including phone line rental, without taking Pay-TV[18]

- [✂][✂].

In this respect, although Ofcom notes in the Consultation that there are around 50 network features and 30 call features that BT currently charges for, we consider that there is a very much smaller subset of these features that are generally regarded as "must have standard features" by consumers, and thus which are competitively critical [✂][✂], which are as follows:

- Caller display – currently provided by BT through Openreach, and charged at £1.50 per end-user per quarter (£6.00 per annum)[19]; and

- Voicemail – currently provided by BT through BT Wholesale's 1571 service, charged on a monthly basis at £11.28 per end-user per annum (£0.94 per month) for wholesale customers who spend £21,249.99 per month or less on the service, with staggered discounts applicable of up to 48.5% on this price once the customer's monthly spend on the service reaches more than £127,500[20].

Current market retail offerings in relation to these features include the following:

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[16] http://stakeholders.ofcom.org.uk/market-data-research/market-data/communications-market-reports/cmr10/
[17] http://www.plus.net/packages/half9/?utm_campaign=half9
[18] http://www.sky.com/shop/broadband-talk/broadband-options/
[19] http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=EwnpVKiM8jvUpuFwx0E%2FdRXQI8%2Bm%2BTHtnjVNUjalCHwlMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AlISgtIFAKw%3D%3D
[20] https://www.btwholesale.com/pages/downloads/pricing/sppl/section_36/part6_wholesale_calling_network_features/SECTION_36_PART_6.2.doc

- Free voicemail (1571), and free caller display for customers who sign up to BT Privacy at Home from BT Retail[21];
- Free standard voicemail and free caller display from Sky on its Sky Talk package[22] and
- Free standard voicemail service and free caller display privacy pack from TalkTalk on its Talk UK Evening & Weekend package[23] and Talk UK Anytime package[24].

In Ofcom's Statement on the Fixed Narrowband Services Wholesale Market Review[25], Ofcom obliged BT to provide "network features that comprise the basic service" on the basis of a cost oriented charge control (§§13.7; 13.26). In relation to other, "additional features" Ofcom deferred its analysis to consideration in the context of the setting of the 2009 WLR charge control (§§13.27-13.28). Nevertheless, Ofcom did note that:

> *"For other, additional features, the price may be constrained to some extent by the market, since if they are priced higher than the perceived value of the service, demand will fall. This does not, necessarily, drive down demand for the basic WLR service.* ***However, where such a service is required, a CP has no choice but to purchase this from Openreach****. We said we were concerned that if these value-add features were included in the basis of charges obligation it may act to inhibit Openreach from providing additional services in the future* ***but that demand for new features may be inhibited if Openreach is able to set prices freely****."* (§13.8, emphasis added)

In Ofcom's consultation on the 2009 WLR charge control, Ofcom proposed not to regulate the charges for these "additional features", on the basis that "*given the significant reduction in prices implemented by Openreach, there did not seem to be a compelling reason for Ofcom to consider increasing regulation of these services by introducing a charge control*" [26].

In Ofcom's final statement on the 2009 WLR charge control[27], Ofcom maintained the view that it was appropriate not to regulate these charges. Ofcom reached this view notwithstanding that Openreach's price reductions once the possibility of price regulation was intimated by Ofcom suggested that its previous prices were in many cases at least 7 times the level actually required for Openreach to still be able to offer these services on a profitable basis (i.e. dropped from £1.50 per quarter to £0.24 per quarter). Furthermore, Ofcom reached this view notwithstanding that, for the main three features that actually proved to be popular with competing voice providers to BT Retail when the prices were reduced, BT made the classic decision of an anti-competitive monopolist to revert to not offering any price reduction whatsoever.[28]

Nevertheless, Ofcom did advise that "*We have and will continue to encourage Openreach to consider alternative pricing strategies to identify if there are options which would allow it to introduce sustainable price reductions*." [29]

In respect of caller display, BT has offered no such "sustainable price reductions" since reverting to their £6 per annum charge on 1 August 2009, and thus continues to enjoy what we believe to be essentially an additional £6 per year profit on top of the current regulated WLR rental charge on all lines for which competing retail providers such as EE consider it competitively essential for them to be able to offer this feature to customers.

[21] http://www.productsandservices.bt.com/consumerProducts/displayTopic.do?topicId=25504
[22] http://www.sky.com/shop/terms-conditions/talk/code-of-practice/call-features/
[23] https://sales.talktalk.co.uk/pricing/package/eveweekend
[24] https://sales.talktalk.co.uk/pricing/package/anytime
[25] http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr_statement_consultation/summary/main.pdf
[26] Ofcom, Charge controls for Wholesale Line Rental and related services, Statement, 26 October 2009 §6.63
[27] Ofcom, Charge controls for Wholesale Line Rental and related services, Statement, 26 October 2009.
[28] Ofcom, Charge controls for Wholesale Line Rental and related services, Statement, 26 October 2009 §§6.75-6.77
[29] Ofcom, Charge controls for Wholesale Line Rental and related services, Statement, 26 October 2009 §6.77

Similarly, BT, through BT Wholesale, has offered no discount on its 1571 voicemail services, the prices for which have been operative since 1 December 2008, yielding what we believe to be an additional £6.28 to £11.28 per annum profit on all lines in respect of which competing retail providers such as EE consider it competitively essential for them to be able to offer this feature to customers.

Combined, acquisition of these two features alone (which we consider to be competitively essential to a retail voice offering, and in relation to which we have no alternative than to acquire the service from BT), yield BT additional WLR related revenues of at least £12.28 per annum – more than 10% more than the current regulated WLR rental price of £103.70.

Presumably funded via cross-subsidisation, at the same time, BT Retail manages to offer these services to end-users as standard features of its voice service, free of charge, as do the MPF based providers Sky and TalkTalk – who do not face the same charges for these services as their WLR based competitors.

We consider that it is fundamentally inconsistent with Ofcom's objectives of setting SMP conditions to allow BT to continue to extract such monopoly profits from its legacy infrastructure to the detriment of WLR based competitive retail voice providers (both in their ability to compete with BT, and in their ability to compete with MPF based and non-BT infrastructure based service providers, who are not reliant on the acquisition of these wholesale inputs from BT). Clearly, neither the general remedies imposed in the last WLR charge control nor market pressures have operated to reduce these profit levels to acceptable levels.

We therefore consider that it is imperative that Ofcom puts an urgent stop to the competitive harm that has been caused and continues to be caused by its inaction in this area to date, by imposing LRIC based charge controls with one –off adjustments to take immediate effect. These charges should be set keeping in mind that BT has already enjoyed many years of monopoly rents to recover its initial capital expenditure to support the supply of these services; the lack of actual incremental activity required by BT to support the supply of these services; and the fact that BT Retail currently offers these services free of charge to end-users. On this basis, we can see no reason why these prices should not be set at a maximum level of no more than £0.96 per annum, thus aligning these prices with the level of discount that BT has successfully managed to sustain on many of its other similarly situated WLR analogue calling features[30].

Question 5.9: Do you agree with that pre-validation charges should not be charge controlled? Please give reasons for your answers.

We do not currently have any views on this Question.

Question 5.10: Do you agree with that ISDN to WLR conversion charge should be subject to a cost orientation obligation but should not be charge controlled? Please give reasons for your answers.

We do not currently have any views on this Question.

[30] For example, we note that Openreach currently offers call diversion and call barring at this price – (see http://www.openreach.co.uk/orpg/home/products/pricing/loadProductPriceDetails.do?data=EwnpVKiM8jvUpuFwx0E%2FdRXQI8%2Bm%2BTHtnjVNUjalCHwlMnGHsqdC0vzO163bJmh34D91D7M0q8u%2F%0AIlSgtIFAKw%3D%3D), and that these features are all software features which can be provided by the same telephony platform – such as the Sonus ASX server (see http://www.sonusnet.com/products/telephony-application-server/asx-telephony-application-server-.aspx). Unlike caller ID, provision of voicemail services may be said to involve incremental storage costs. However, in light of the scale of the volume discounts currently offered by BT Wholesale on its voicemail services and the many free standard voicemail services offered in the retail market by a range of different providers, we do not believe that these costs are likely to be material.

Question 5.11: Do you agree with that cancellation charges should not be charge controlled? Please give reasons for your answer.

We do not currently have any views on this Question.

Question 5.12: Do you agree that time related charges should remain out of the scope of the charge control and subject to general remedies applied in the WAEL market review?

We agree that Ofcom should take a consistent approach across both LLU and WLR services on this matter. We do not otherwise have any views on this Question.

Section 7 – Calculation of the Charge Controls

Question 7.1: Do you agree with our general approach to estimating costs?

EE does not have any further comments on the methodology which Ofcom is taking to estimating the appropriate costs beyond those made elsewhere in this response (in particular in response to Ofcom's Consultation Questions relating to Section 3 of the Consultation, the remainder of Section 7 of the Consultation, and Section 8 of the Consultation).

In relation to the general approach which Ofcom has taken to cost allocation, one key area (as identified in paragraph 7.40 of the Consultation) is the assumptions about the services which will be delivered, in particular the volume forecasts used for these services as set out in Annex 6 to the Consultation. EE has as number of comments on Ofcom's approach and assumptions to deriving these volume forecasts as set out in that Annex 6.

Forecast reduction in fixed lines (A6.8 - A6.20)

Ofcom has first assumed that the historical trend of the number of fixed lines overall declining will continue, leading to 1.1million less lines overall by 2013/14.

One of the key reasons which Ofcom has identified for this is that the number of mobile only households is, it believes, likely to increase. However, EE notes that the gap between the broadband speeds offered by mobile and fixed providers is widening. Therefore mobile-only internet is likely to become increasingly unattractive. Under the EE Orange brand, for example, we specifically position our mobile broadband services as being suitable for low bandwidth services, recommending fixed broadband for uses such as iPlayer. We also note that the growth in mobile broadband (in terms of sales of "dongles") has recently stalled. [✂][✂]. Given that provision of fixed broadband requires a customer to take a fixed telephony line, this puts a natural break on this trend which Ofcom does not appear to have taken into account. Broadband is becoming an increasingly important product, especially with increasing amounts of content being provided (such as video/TV content over the internet) which requires customers to have access to high speed broadband.[31]

[✂] [✂]

Ofcom has also not discussed in this section of Annex 6 the various counteracting influences which could tend to increase the number of fixed lines. For example, there are currently 8.7m people in the UK who have never used the Internet[32]. The Government's "Race Online 2012" program aims to get these people online, and this seems likely to increase fixed broadband penetration.

Increasing numbers of smartphones and other connected devices also use WiFi for data access while in reach of such networks. EE Considers that using WiFi as an alternative form of access for mobile devices will continue to be important for users and is likely to increase

[31] TV style services over the internet is a current growth area which is increasingly being used through services such as iPlayer and YouView.
[32] The Office of National Statistics 18 May 2011 news release (*www.statistics.gov.uk/pdfdir/ia0511.pdf*)

over time. In particular in the home, users will increasingly use WiFi when wanting to download significant amounts of content to devices. This provides alternative general access to internet services in the home for activities such as side-loading information to tablets. WiFi also provides indoor coverage in the home for customers in the short term. [✂][✂] Therefore, the desire of customers to have WiFi access over smartphones and other connected devices (such as tablets) will continue to drive fixed broadband demand. Cellular access will be complemented by WiFi access in the home (which requires fixed broadband) rather than supplanting it.

Continued migration from WLR to MPF (A6.21 - A6.24)

Ofcom's volume forecasts further include a substantial shift in demand from WLR to MPF. MPF volumes are forecast to rise from slightly less than 4 million in 2010/11 to slightly more than 6.5 million in 2013/14, which Ofcom notes is consistent with the forecasts it has received from communications providers. Those forecasts will, of course, be based on expectations around wholesale pricing amongst other factors. EE agrees that historically there has recently been an increase in MPF, at the expense of WLR+SMPF. However, this has largely been due, in our view, to the regulatory cost imbalance between the two services, making it significantly cheaper to offer an MPF based service rather than one using WLR +SMPF.

It is also simpler for MPF providers to acquire customers, due to the switching processes in place, in comparison to the MAC process that WLR + SMPF providers are required to use. The costs of switching a customer from WLR to MPF products is therefore lower (and has no potential for any save activity) compared to the costs of switching in the other direction. Forecasting this trend continuing is therefore to a great extent based on regulatory distortions and inequalities of treatment between MPF and WLR. EE strongly believes that these distortions should be removed and the fact that pricing differences are exacerbated by the regulatory regime assuming that the distortions will, in effect, continue (and therefore the trend towards MPF will continue) is both unreasonable and represents a regulatory distortion of competition.

Further, the introduction of NGA is likely to lead to a shift back towards wholesale services, and away from unbundling. Consistent with Ofcom's WLA research, EE agrees that, where BT has provided an NGA network, wholesale services are the most cost effective way to allow providers to access this network, rather than competing providers investing in parallel infrastructure.[33]

As a result, if ISPs are to wholesale NGA from BT, then the exchange-based MPF equipment that ISPs have invested in is now only providing voice services. This suggests that MPF providers are therefore likely to stop investment in MPF infrastructure, and may instead choose to provision NGA customers onto WLR in the short term (i.e. within the scope of this charge control).

Overall EE therefore would expect to see growth in the wholesale access market, at the expense of unbundling, up to 2014. At that point there will be significant changes (resulting from developments such as voice over NGA and local exchange closures). IDC puts this wholesale access growth at 1% CAGR, which EE considers reasonable. Ofcom's assumption of a trend of increasing MPF at the expense of WLR (which is resulting in lower MPF prices and higher WLR prices which simply reinforces this trend) is no reasonable, self-reinforcing and represents a regulatory distortion in itself.

Decrease in SMPF volumes (A6.25 - A6.26)

EE agrees that there may be a reduction in SMPF volumes over the relevant time period, but this will not be driven by a shift from WLR to MPF but rather will result from the conversion on customers to NGA and fibre based products.

EE would be happy to discuss appropriate forecasts further with Ofcom if this would assist

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[33] See http://stakeholders.ofcom.org.uk/consultations/wla/summary

Ofcom in reaching a final view on these issues.

Question 7.2: Do you consider the task times to be reasonable? If not, please provide your reasons and alternative view, together with supporting evidence where possible.

EE has no particular views to express on the proposed task times set out in the Consultation.

Question 7.3: Do you have any views on our proposed assumptions regarding Openreach's ability to reduce costs through efficiency gains.

Consistent with general regulatory practice, Ofcom's approach has been to establish a range of potential efficiency gains, derived from using a number of different pieces of evidence. Ofcom is proposing to apply a net efficiency assumption at the mid-point of this range (after allowing for redundancy costs), with a gross efficiency gain of 5% across all costs. EE agrees with this broad approach and that Ofcom should in general not be determining in detail where the efficiency gains should be required, but rather require overall reductions.

EE does not have any comment on the range of evidence which Ofcom has used and assessed in Annex 7. In determining the appropriate range to derive from these various sources, Ofcom has not provided any detailed reasoning. Paragraph A7.41, which provides Ofcom's reasons for choosing the range in full, states:

> "Based on this evidence we consider that a net efficiency target between 3.5% and 5.5% per annum (on all costs) would be reasonable. In reaching this proposed range, we have not relied on any one particular piece of evidence but have instead applied our judgement to the range of evidence available."

The weighting which Ofcom has given to different estimates is therefore opaque. EE considers that a reasonable judgment applied to these different pieces of evidence should lead to a higher overall range. First, it seems reasonable to consider that the efficiency savings which BT sources imply – in advance of a price control process – should be at the bottom of the range. Combined with the fact that this would imply efficiency savings at least as great as the CC determined previously and the lower end of the range of savings which have actually been historically achieved, this suggests that the bottom of Ofcom's range of 3.5% is too low. Rather, Figure 7.1 in Annex 7 suggests the bottom of the range should be 4%. Second, Ofcom has provided no reason to "discount" the upper end of the historical trends of savings in determining its range for consultation, suggesting that the upper end of the end should be 6%. Therefore, EE considers that the appropriate *range* to consider for potential efficiency savings is 4% to 6%.

Applying the same approach which Ofcom has used with its range, this would suggest a gross efficiency saving of 5.5% and a net saving (taking into account redundancy costs) of 5% in the middle of this range, as opposed to 4.5%.

Further, EE believes that Ofcom's cost allocation approach has led to MPF prices being too low relative to WLR and, especially, WLR+SMPF charges. Specific areas where EE considers that the cost allocations and adjustments to charges are incorrect have been identified elsewhere. Correcting these specific inappropriate allocations would not lead to the differential in charges being the same as the differential in the LRIC for each of these services (as discussed below in relation to Questions 8.1 and 8.2). Ofcom has identified that WLR is a declining service. Over time, starting in this forthcoming charge control period, WLR will start to be replaced by next generation services. In this context, EE considers that BT should be able to achieve greater efficiency savings with respect to WLR products over the course of this charge control period. There is already evidence that BT is finding ways of making WLR provision more efficient with the introduction of WLR 3, which replaced WLR2 from 30 June 2011. WLR 3 has a number of efficiencies compared to WLR 2, in particular:

- Average time to install is 4 hours quicker;
- It results in 12-18% fewer rejection;

- Repeat faults reduced by up to 50%;
- Better testing and diagnostics; and
- Fault handling improved by around 20%.

As such, while EE agrees that Ofcom should not be determining exactly how BT should be achieving efficiency savings or applying specific efficiency assumptions to individual items of cost, EE believes that Ofcom should apply a different higher level efficiency assumption to WLR compared to LLU products. This could be achieved either by assuming greater efficiency savings in relation to WLR specific costs as a whole or by assuming that of the overall efficiency savings a greater proportion of these benefit WLR costs. The latter ex post adjustment to the CCA FAC estimates would be feasible, simple to apply and in line with Ofcom's policy objectives for this charge control.

Question 7.4: Do you have any views on our proposed assumptions regarding the impact of inflation on Openreach's costs through efficiency gains.

EE agrees that in considering cost inflation, Ofcom should use a measure which excludes the impact of mortgage interest costs and indirect taxes. The basis on which Ofcom estimate that this difference is around 0.5% is not clear from the Consultation (or the exact method by which Ofcom forecast RPI inflation as being 3%). Based on the difference between average changes in RPI and average changes in RPIY (which excludes mortgage interest payments and indirect taxes) over recent years, 0.5% is a low figure (and 0.7% would be reasonable). See also our comments responding to Question 3.9.

Question 7.5: Do you have any comments on our proposed approach to dealing with changes in the cost of replacing the copper assets?

Ofcom's approach to the cost of copper assets effectively treats these assets as a liquid investment asset. BT is being able to realise a holding gain from changes in commodity prices. In relation to other assets Ofcom is not sticking to a strict current replacement cost (which is in any case a hypothetical construct as it would clearly not be feasible to replace the network in a short time frame based on current costs). While EE strongly supports regulatory consistency, in this case it appears to have led to BT being able to realise a windfall gain, resulting from movements in commodity prices, which in a competitive market it would never be able to realise. BT cannot realistically start removing and selling copper to realise this gain. Any increase in the commodity price of copper should therefore only apply to new copper assets and it would be reasonable to apply, for example, an RPIY increase to pre-existing copper assets to achieve a current cost value.

Question 7.6: Do you have any comments on Ofcom's approach to projecting costs relating to Openreach's assets.

See the answer to Question 7.4 above. EE does not understand why Ofcom has used a future inflation forecast to roll forward assets (RPI at 3%) compared to the rate excluding mortgage interest costs and indirect taxes (which Ofcom is forecasting as 2.5%, a rate which EE considers high given an RPI forecast of 3%).

Question 7.7: Do you have any comments on the proposed regulatory adjustments to be made in determining the recoverable costs?

We agree with the adjustment proposed to be made by Ofcom so that the costs incurred and revenues forgone by BT Retail in administering the Light User Scheme (**LUS**) should no longer be allocated to regulated products by Openreach (§7.91). We do not currently otherwise have any views on this Question.

Question 7.8: What issues should we consider when deciding whether to exclude costs relating to evoTAMs from the regulated cost stacks? If you consider that the costs

should be excluded, please provide your reasons. If you consider that they should be included, how should they be allocated across services?

Given that the evoTAMs is a new service, the details of which are not yet clear, EE considers that it is not appropriate to include the costs associated with this service in the regulated cost stacks. On Ofcom's cost causation principles, it is not yet clear who will be the beneficiaries of this service (and the extent to which it will be a product which principally provides utility to BT). Further, the charging arrangements and whether individual SMPF operators will have the ability to opt in (or out) of using this service are also not clear as intimated in the Consultation at paragraph 7.97. The geographic reach of evoTAMs during the coming charge control period is another area which is unclear and therefore the competitive impact of recovering this across all WLR/SMPF lines cannot be properly assessed.

If evoTAMs costs are included, EE also believes that their recovery should be consistent with Ofcom's treatment of other similar costs. In particular, the treatment of TAMs costs which benefit MPF operators only needs to be consistent with the recovery of these costs. That is, if TAMs costs are allocated across all LLU lines on the basis that they are a set up cost, then the evoTAMs service should be treated in the same way. Ofcom's current approach appears to be that the evoTAMs costs are only recovered from WLR/SMPF lines. This inconsistency, if retained, would lead to a competitive distortion and be inconsistent with Ofcom's six principles of cost recovery.

Question 7.9: With reference to Annex 12, do you have any comment on our approach to calculating Openreach's cost of capital.

EE has concerns with Ofcom's approach to setting the cost of capital across charge controls and, as Ofcom is aware, this is a key aspect of its appeal of Ofcom's decision relating to the charge control of mobile call termination wholesale charges (**MTRs**).[34] We also note the comments of the Competition Commission in relation to calculation of the WACC made their determination in Carphone Warehouse Group plc v Office of Communications of 31 August 2010 (the LLU determination).

In the context of this Consultation, EE does not have any more detailed comments at this stage given that many related issues will shortly be considered by the Competition Commission in respect of the MTR appeals.

Question 7.10: With reference to Annexes 8 and 9, do you have any comment on our approach to allocating costs

EE does not have any comments on Ofcom's overall approach to allocating costs between the different services, which are not covered in responses to other Consultation questions. EE is, however, concerned with some of the adjustments which have been made to these allocated costs (see our answer to Question 7.11 below). EE notes that many, if not most, of the "usage factors" between the different services (for each individual activity) are very similar or the same between WLR and MPF. The key difference between these services is the provision of a line card. Ofcom's cost allocation approach in this sense reinforces EE's views on the suitable differential between these services as discussed in more detail below (in this context, see especially our answer to Question 8.1 below).

In terms of the individual cost allocations, EE has specific comments on two items, as set out below.

<u>Directories</u>

Based upon the statements made by Ofcom in Annexes 8 and 9 to the Consultation (Figure 8.2; §§A9.50-A9.51), it is our understanding that BT Retail has charged its full costs of

[34] Everything Everywhere Limited v Office of Communications (Mobile Call Termination) Case 1181/3/3/11, registered on 16 May 2011.

producing and delivering phonebooks to all households and businesses in the UK to Openreach, which costs Ofcom has then allocated in their entirety to the WLR service.

These costs are significant, starting at an allocation ((before depreciation, ROCE and efficiency adjustments) of £1.80 per annum in 2009/2010 and ramping up to a cost allocation of £2.36 per annum in 2013/14 (Figure 9.20). They thus represent the eighth largest individual WLR basic cost stack activity in 2013/14 (Figure 9.4) and a key point of difference between the WLR and MPF cost stacks, with MPF providers not proposed to be charged anything for this activity.

For the reasons set out below, EE believes that Ofcom has made a serious and highly competitively detrimental error in allocating BT's costs of producing and delivering telephone directories to the WLR service. EE believes that it is imperative that Ofcom remedies this error by removing these costs in their entirety from the WLR cost stack.

We understand that BT produces and delivers its printed directory (the **Phone Book**) through BT Directories, which is an operating sub-division of BT currently generating 23% of revenues for BT's BT Enterprises division.[35] BT Enterprises is in turn a part of BT's BT Retail operating segment.[36]

Although BT does not appear to publicly report on the profitability of its business of producing and delivering the Phone Book, all of the publicly available information that we have been able to find on this business suggests that it is a profitable one, and that the costs of running the business are costs that BT Retail would choose to incur regardless of whether or not Openreach had any contractual obligations to provide the Phone Book to end-users of acquirers of BT's WLR service. In this respect, we note as follows:

- BT now includes a classified section in all of the Phone Books that it produces and delivers.[37] BT decided to re-enter the classified directory services sector in 2002 as "*BT considered this to be an attractive opportunity and in particular saw the potential for it to become a vigorous competitor in the market for printed classified directories*".[38]

- BT publishes 171 Phone Books, each covering a different geographic area of the UK. BT aims to distribute a copy of the Phone Book free at point of delivery to every household and business in the relevant area. To do this, BT uses postal delivery point information from the Post Office address file (PAF).[39]

- A comprehensive distribution strategy for the Phone Book, which does not limit distribution only to end-users of other BT services, is in BT's view key to the competitive success of its classified advertising business, with BT publicly stating that:

    - "*The value of the classified advertisement to the advertiser – and hence the advertiser's willingness to purchase – is linked to the likelihood of the advert generating customer leads, which is inherently linked to the number and profile of end users of the directory. The value of the directory to end users is linked to its content (listings and advertisements) and comprehensiveness. In other words, usage drives content and advertising content drives usage – the "network effect*"".[40]

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[35] http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf (p 28)
[36] http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf (p 105)
[37] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008, §3.28
[38] http://www.competitioncommission.org.uk/inquiries/ref2005/classdirec/main_party_submissions.htm (BT initial sub)
[39] http://www.competitioncommission.org.uk/inquiries/ref2005/classdirec/main_party_submissions.htm (BT initial sub)
[40] http://www.competitioncommission.org.uk/inquiries/ref2005/classdirec/main_party_submissions.htm (BT initial sub)

  - "*Classified advertising customers in general focus on "cost per lead" – i.e. the price of the advertising divided by the number of business leads or opportunities it is likely to generate, with associated revenue potential*".[41]

  - The "*essential characteristics*" of advertising in printed directories include that "*they are: readily available to end users;…targeted at a local area and widely distributed in that area free of charge to end users (**not those purchasing another product**); and are standard references in that the directory is stored in the home and the advertisements can be repeatedly referred to throughout the duration of a directory cycle (usually a year)*" (emphasis added).[42]

- The success of BT's printed classified advertising business is in a material way connected to BT's ability to leverage off the UK wide well known "brand" of the BT Phone Book, with BT noting that "*A strong recognisable brand is very important in entering classified directory advertising. This is needed to accelerate the build up of product awareness and usage amongst end-users, which is the single most important factor leading to advertiser acquisition*".[43]

- Delivering the Phone Book to all households and businesses in the UK without regard to the nature of the telecommunications services used at those premises simplifies the delivery process for BT Retail from a practical perspective[44]

- There are likely to be benefits to BT Retail from increased classified advertising revenue that are obtained from providing near-universal geographical coverage. Some businesses, such as insurance companies, seek national coverage for their advertisements.[45]

- BT Retail is contractually bound to its classified customers to deliver to at least 95% of all households in any given Phone Book district.[46].

- Ofcom concluded in 2008 that "*Given the need to compete for advertisers with the universal coverage of Yellow Pages and Thomson, it seems highly unlikely BT would move back to subscriber only delivery*."[47]

Accordingly, for all of the above reasons, it is our understanding that BT Retail makes a commercial judgement not to deliver the Phone Book only to its own customers and to end-users of customers of Openreach's WLR service, but rather to all households and businesses in the UK (excluding in Hull).[48] As a result "*The Phonebook is in almost all cases provided to all end-user customers of other Communications Providers*", as well as to BT Retail customers.[49]

In terms of the profitability of BT Retail's Phone Book business, we note that, as a whole, BT Enterprises generated a net operating profit of £1,341m pounds in 2010/2011, increased from its profits in 2009/2010 and again from those in 2009/2008.[50]

While these figures do not disclose the profitability of Phone Book production and distribution on a stand-alone basis, we note that in 2008, confidential information provided by BT to Ofcom regarding its business of producing and delivering the Phone Book lead Ofcom to conclude that:

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[41] http://www.competitioncommission.org.uk/inquiries/ref2005/classdirec/main_party_submissions.htm (BT initial sub)
[42] http://www.competitioncommission.org.uk/inquiries/ref2005/classdirec/main_party_submissions.htm (BT initial sub)
[43] http://www.competitioncommission.org.uk/inquiries/ref2005/classdirec/main_party_submissions.htm (BT initial sub)
[44] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §2.10
[45] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §3.33
[46] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §3.34
[47] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §3.34
[48] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §2.10
[49] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §2.10
[50] http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf (p 28)

> *"It is clear that the Phone Book **is currently profitable and likely to remain so for the foreseeable future**. This is consistent with the report by the Competition Commission in December 2006…[which said that]… **BT is becoming a more significant operator in the classified advertisement market**, and its market share had grown rapidly since 2002*.
>
> *It is possible that if the requirement to publish the A-Z directory listing were removed, BT may choose to publish only the classified advertising section of the Phone Book. However, we consider that there are a number of commercial reasons why BT would not. Firstly, BT obtains revenue from … selling advertising in the A-Z section (e.g. bold/super bold listings, separate page listings etc). Secondly, the bundling of the A-Z part of the Phone Book and the classified advertisements is likely in part to increase classified advertisements revenues as it is the main unique selling point of the Phone Book as a vehicle to place advertising in. The A-Z sections of the Phone Book may help to give the Phone Book as a whole greater prominence and make it more attractive for businesses to advertise in the classified section."* (emphasis added) [51]
>
> *"BT has supplied Ofcom with information on the delivery costs of the Phone Book for different areas, and these vary significantly between different areas. However, **even for the areas with the highest delivery costs, these costs are significantly less than the average profit per directory**."* (emphasis added) [52]

Although it is not clear whether this position has changed since 2008, this seems to us unlikely. As per Figure 8.3, BT Retail's costs of producing and distributing the Phone Book are forecast to be relatively stable from 2009/10 to 2013/14, with a slight decrease in total costs forecast overall. Indeed, we note in fact that BT's costs of producing and delivering the Phone Book may have recently further decreased, with BT announcing that in 2010/2011 it has released the compact Phone Book, reducing its size by 15% to fit into letter boxes, and saving 2,000 tonnes of paper each year. [53]

Of course, an element of the profitability of BT Retail's printed directories business relates to the fact that Ofcom currently permits BT Retail to pass on its costs of production and delivery (and perhaps even a profit element on these costs) to Openreach, who in turn passes these costs on to acquirers of the WLR service.[54] Clearly, this gives BT Retail a cost advantage over competing suppliers of printed classified directory services such as Yell and Thomson, who must each bear their own costs of production and distribution, rather than being able to pass them on to third parties by means of an Ofcom sanctioned regulatory charge. In this regard, we have serious doubts as to whether Ofcom's endorsement of this practice complies with Ofcom's statutory objective to "*promote competition…in relation to the supply of directories capable of being used in connection with the use of electronic communications networks or electronic communications services*" as per section 4(3)(c) of the Act, to which Ofcom claims to have had regard in the current Consultation (§§ 2.33; 2.37; 9.63-9.65; 9.108-9.110).

In addition to potentially distorting competition in the market for the supply of printed classified directories, on the information available to us, there seems to be no other conclusion than that the allocation of BT Retail's costs of producing and delivering the Phone Book to the WLR cost stack provides a highly unfair cost advantage to MPF based communications providers and non-BT network based communications providers – who, unlike WLR and SMPF based[55]

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[51] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §§3.30-3.31

[52] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §3.33

[53] http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf (p 28). In this respect, we find it somewhat surprising that the cost allocation for directories is forecast to increase by more than 30% from 2009/2010 to 2013/14 (from £1.80 to £2.36) (Figure 9.4). Given that total Phone Book costs appear to be forecast as relatively static (Figure 8.3), we understand that the increase is attributable to the fact that this stable pool of total BT Retail costs is being recovered from a forecast decreasing base of WLR lines (§A9.52) – further reinforcing the inappropriateness of allocating these costs exclusively to WLR.

[54] Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §3.31

[55] As SMPF is not available on a standalone basis without the end-user also being served via an underlying WLR service (from the same or another provider), this discrepancy affects all SMPF providers, whether or not they provide

communications providers, receive but do not pay for delivery to their end-users of the Phone Book by BT Retail.

In the competitive retail markets for the supply of voice and broadband services (both on an individual and bundled basis), a difference in costs of supply reaching £2.36 per annum per end-user by 2013/14 (before depreciation, ROCE and efficiency adjustments) (Figure 9.20) is significant. At the same time, we can see no objective justification as to why the BT Phone Book would be delivered free of charge to the supplier for end-users of MPF and non-BT network based voice and broadband suppliers, but on a charged basis to the supplier for end-users of SMPF and WLR based voice and broadband services. Accordingly, we believe that this discrepancy is liable to distort competitive outcomes in the concerned markets, to the detriment of WLR and SMPF based voice and broadband services providers.

We therefore do not believe that this cost allocation decision by Ofcom is consistent with Ofcom's statutory duties to promote competition in relation to the provision of electronic communications networks and electronic communications services under section 4(3)(a) of the Act, in spite of Ofcom's claims to have regard to this objective in the Consultation (§§ 2.33; 2.37; 9.63-9.65; 9.108-9.110). We further do not believe that this cost allocation decision by Ofcom is consistent with Ofcom's statutory duty to only impose SMP conditions which do not unduly discriminate against particular persons or descriptions of persons as per section 47 of the Act, in spite of Ofcom's claims that the charge controls do meet this requirement and "*are set to ensure a fair return and price level for all customer groups*" (§9.59; §9.104).

By allocating the BT Retail costs of producing and distributing the Phone Book that are currently charged to Openreach fairly amongst the WLR and MPF costs stacks as opposed to exclusively allocating them to the WLR cost stack, Ofcom would be able to at least remedy the competitive distortion and discrimination against WLR and SMPF based suppliers and their end-users as compared with MPF based suppliers and their end-users. However, this would still not address the cost advantage enjoyed by non-BT network based voice and broadband suppliers – such as Virgin. It would also not address the cost advantage that BT Retail appears to enjoy over its competitors in the printed classified directories market.

Furthermore, simply making this change would not address the fact that allowing BT Retail to charge Openreach for any of its costs of producing and distributing the BT Phonebook is fundamentally inconsistent with the six principles of pricing and cost recovery developed by Oftel and subsequently used and endorsed by Ofcom on numerous subsequent occasions, including in setting charges in previous WLR charge setting exercise[56] The six principles of pricing and cost recovery are:

- i) Cost causation: costs should be recovered from those whose actions cause the costs to be incurred;
- ii) Cost minimisation: the mechanism for cost recovery should ensure that there are strong incentives to minimise costs;
- iii) Effective competition: the mechanism for cost recovery should not undermine or weaken the pressures for effective competition;
- iv) Reciprocity: where services are provided reciprocally, charges should also be reciprocal;
- v) Distribution of benefits: costs should be recovered from the beneficiaries especially where there are externalities; and
- vi) Practicability: the mechanism for cost recovery needs to be practicable and relatively easy to implement.

voice services in addition to broadband – as the BT Retail Phone Book costs will always form part of the cost-structure that the customer must ultimately pay for in order to receive the SMPF based broadband services. We further note in this regard the Competition Commission's findings that currently over half of BT's 21 million WLR lines are used in conjunction with SMPF services to provide voice and broadband services either by the same or different providers – *The Carphone Warehouse Group plc v Office of Communications* Case 1149/3/3/09, Determination 31 August 2010, §3.193(b)

[56] *Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services*, http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

Most notably in this regard, it is clear that, whilst Openreach does have a notional contractual obligation[57] to provide a Phone Book to end-users of acquirers of the WLR service, this is not the cause of the costs BT Retail incurs in producing and distributing the Phone Book. Rather, it is clear that BT Retail chooses to incur these costs in order to generate revenues and profits from both the classified and non-classified sections of the Phone Book, which revenues and profits are maximised when BT Retail distributes the Phone Book on a comprehensive national basis, to all homes and businesses in the UK, irrespective of the types of communications services consumed at those premises.

Furthermore, it is clear that the primary beneficiary of the BT Retail's decision to incur these costs is BT Retail itself, through the advertising revenue generation possibilities thereby created. Of course, the inhabitants of the residential and business premises to which the Phone Book is distributed by BT Retail also benefit, as well as the persons and businesses listed in the Phone Book; the communications providers who supply the numbers listed in the Phone Book; and the communications providers whose numbers that the persons to whom the Phone Book is distributed choose to call. Clearly, on any view, it is not merely acquirers of the Openreach WLR service who benefit.

Finally, although this did not appear to be Ofcom's finding in its 2008 consultation on the matter[58], it may be said that BT Retail incurs costs in producing and distributing the Phone Book not by choice, but rather only due to BT's universal services obligations. In this regard, we consider that the position should be no different to the costs incurred and revenues forgone by BT Retail in administering the LUS, which Ofcom has proposed in the Consultation should no longer be allocated to regulated products by Openreach (§7.91).

In conclusion therefore, for all of the above reasons, we believe that the directories costs should be removed in their entirety from the WLR cost stack.

Corporate Overheads

As per Figure 8.2, 43% of BT's corporate overheads appear to have been allocated to Openreach. Given that Openreach only employs 30% of BT staff (§A8.10), we consider that this figure seems a priori too high. We would therefore request Ofcom to investigate this allocation in more detail to ensure that it is valid.

Question 7.11: Do you agree with the proposed adjustments to the cost stacks for pricing purposes?

EE has concerns with the high level adjustments, which Ofcom is making to the outcome of its complex and detailed cost allocation calculations. In particular, EE does not agree that it remains (if it ever was) appropriate for TAMs costs to be spread across all LLU lines when they are used exclusively by MPF operators (see below).

[57] We note that in the last WLR consultation, significant thought was given as to whether WLR 3 should include the option to take a business directory listing rather than a residential directory listing, with it ultimately being decided that this should be included (http://stakeholders.ofcom.org.uk/binaries/consultations/wlr/statement/wlr_statement.pdf). To the extent that MPF providers and voice providers who do not use BT's network pay BT separately for listings in the BT Phone Book, whereas users of BT's WLR service do not, then we accept that the costs incurred only in providing these free of charge WLR listings are appropriate to be included in the WLR cost stack.

[58] See Ofcom Consultation on Telephone Directory Information Obligations and Regulations, issued 10 March 2008 §§3.39, where Ofcom concludes that commercial market conditions are sufficient to ensure the continued free provision and maintenance of printed directories without the need for any universal service conditions mandating the same.

Reallocation of TAMs costs from MPF to SMPF

We have reservations as to whether it was ever appropriate for Ofcom to ignore the principle of cost causation and to take a contrary "policy decision" to reallocate a large portion of BT's costs of TAMs, which are used exclusively in the supply of MPF services, to SMPF services.

However, even if it is accepted that this was an appropriate decision to have been taken in 2004[59], we believe that changes in circumstances since then and the application of Ofcom's principles of pricing and cost recovery in these changed circumstances mean that this is no longer a policy decision that is "*objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates*", as required by Section 47(2)(a) of the Act.

In this regard Ofcom is relying on its previous assessment that "set up" costs (into which TAMs costs were lumped) should be allocated across all LLU lines, and has not revisited this analysis. We believe that reassessing TAMs costs in the context of Ofcom's six principles of cost recovery in 2011 provides serious reason to question the validity of continuing this treatment in the current charge control:

i) Cost causation: It is clear that TAMs costs are caused by providing MPF products only, and not by any regulatory obligations imposed on BT to provide, or demand from competitors for, WLR or SMPF products. Ofcom has made it clear in the current Consultation that, from a cost causality perspective, TAMs costs should be allocated exclusively to MPF (see e.g. Figure 7.7 and §7.124). ;

ii) Cost minimisation: spreading these costs over all LLU lines provides no greater incentive to BT to minimise costs, and further could reduce incentives on MPF operators to seek lower cost or more efficient alternatives in future (as their cost of usage is effectively being subsidized by acquirers of SMPF services). In particular it is clear that there is absolutely no benefit whatsoever to be derived from a cost minimisation perspective in allocating TAMs costs to the very significant number of external SMPF lines that are consumed by competitors to BT – which competitors do not make any decision to acquire these services or not (as they do not use them) and who have absolutely no control over nor ability to reduce the cost of these services, which they neither supply nor use;

iii) Effective competition: viewed in the context of the current levels of competition between MPF based and SMPF based broadband providers and the current levels of charges for MPF vs. SMPF and WLR+SMPF charges, we believe that increasing the costs of competing SMPF and WLR + SMPF operators above the costs of actual supply of SMPF services to these operators actively distorts competition and reduces effective competition. In particular, we note that in 2004 there may have been a valid concern that allocating TAMs costs exclusively to MPF providers could have given them a higher cost base than BT and SMPF based providers and thus undermined the then emerging levels of LLU competition (see §8.15 of the 2004 Decision). However, in contrast in 2011, it is clear that levels of MPF based competition are strong and continuing to grow, and that the differential between MPF vs. WLR+SMPF charges is significantly higher than the differentials in the LRIC costs of providing these services. In this context, we do not believe that the allocation of TAMs costs exclusively to MPF lines would cause any harm to effective competition. Rather, we believe that this adjustment will actively assist effective competition by enabling SMPF based LLU providers to compete more effectively and without subsidizing MPF providers.;

iv) Reciprocity: this principle is not relevant here;

v) Distribution of benefits: the 2004 Decision suggests that these set up costs should be recovered across all lines on the basis that all customers would benefit from the competition thus engendered, but this logic no longer applies as continuing competition is now harmed by this reallocation; and

[59] "Review of the wholesale local access market: Identification and analysis of markets, determination of market power and setting of SMP conditions." Explanatory statement and notification. 16 December 2004 (the **2004 Decision**).

vi) Practicability: clearly recovering TAMs costs exclusively from MPF operators is practical and Ofcom's base cost allocations provide the relevant figures which have been adjusted after this allocation.

It is also worth noting that in the consultation preceding the 2004 Decision[60] (§ 9.48) Ofcom suggested that to allocate TAMs costs across all lines would lead to shared access lines effectively paying for the same service twice (with the testing for SMPF lines done with the line cards paid for through the charges for the WLR service). Neither the 2004 Decision, nor the current Consultation, explain why Ofcom has not taken this into account. Finally, we note that Ofcom never suggested that its decision taken in 2004 should stand for all time, but rather expressly envisaged that it may need to revise its approach to the allocation of TAMs charges in the future (see § 9.85 of the 2004 Decision).

In light of these significant concerns, we do not believe that Ofcom's decision to simply continue on with its 2004 Decision to allocate TAMs costs across both MPF and SMPF lines(see §§7.125-127) is objectively justifiable, non-discriminatory and proportionate as required by section 47 of the Act for Ofcom. Indeed, given the adverse effects of regulation on SMPF based operators (see our answer to Question 8.1 below), Ofcom's duty to promote competition would suggest that it is important that the approach is reversed and these costs recovered from the services which cause them, which are solely MPF products.

Inclusion of costs relating to (WLR to WLR) transfers

Please see our response to Question 5.3 above.[61]

Inclusion of costs relating to MPF and SMPF ceases

Please see our response to Question 4.12 above.

Question 7.12: Do you agree with our approach for deriving the glide paths?

EE has no further comments on Ofcom's broad approach to deriving the glide paths (and setting of X values in the RPI-X formulae) to those set out above in answer to Question 3.12.

However, EE questions the implementation of this approach in the context of this specific charge control. In relation to the RPI forecast assumptions used, Ofcom notes elsewhere in the Consultation, forecasting RPI is subject to significant uncertainties. Ofcom's assumption of 3% for the period beyond 2012/13 appears conservative given the current and recent level of RPI. This level of assumed RPI has not been justified in the Consultation with regard to any specific forecasts for RPI but is simply an assumption. As set out in our answer to Question 3.12 above, this is therefore likely to favour BT at the expense of competing operators.

EE is also concerned about the implications of using a 4.5% RPI increase figure for the first year of the charge control. This is based on the October 2010 RPI figures, but is essentially assuming that the charge control starts in April 2011. Clearly this will not be the case and therefore it is not clear that it remains appropriate to calculate the X on this basis. We understand that Ofcom is aiming to have the new charge controls on which it is consulting in place in October 2011. Thus, the new charge controls will not come into effect until some seven months after expiry of the last set of charge controls on 31 March 2011.

RPI has been above the 4.5% level since October 2010 (the average annual increase for each month since October 2010 is 5.1% and RPI inflation has been higher in every month since October 2010). This higher inflation in subsequent months before the charge control actually starts could be argued to provide BT with a windfall gain in that the X value would be

[60] "Review of wholesale access market" Consultation of 24 August 2004.
[61] We note that §7.129 refers to section 5 considering three options but there does not appear to be any third option discussed there.

higher if assessed on a later month. Sticking with the standard October value, which is predicated on the X becoming effective in the following March (or charges being reduced to a new level in that month), could therefore have adverse impacts on purchasers of BT's wholesale products. Another consequence of the charge control starting part way through the price control year is that BT appears to be gaining a "holiday" of around seven months from any required efficiency savings. We would therefore expect that an efficiency adjustment should be made to the start point of charges in the new charge controls, to reflect the efficiency savings that BT will have been making in the months between 31 March 2011 and the start of the new charge controls.

Without making such an adjustment, we do not believe that the new charge control will comply with Ofcom's obligations under section 88(1)(b)(i) of the Act to ensure that the charge control is appropriate for the purposes of promoting efficiency, that is to say, one which, in the language of the Competition Commission sets a "suitably demanding efficiency target for Openreach." (§2.231)

We note in particular in this regard the Competition Commission's comments in the 2010 Appeal in relation to the efficiency adjustments required to be made to the last charge control that:

"We disagreed with Ofcom's view that correcting for the inconsistency between the models was not a necessary part of our efficiency decision. Our efficiency determination required a 3.7 per cent efficiency to be applied to total costs in each year and Ofcom's modelling did not do this. We asked Ofcom to run its models in a way that ensured that the RAV model reflected the full output of our decision. Ofcom did this and provided revised cost stacks on 18 August." (§5.272)

This leads to a more general issue with Ofcom's calculation of the glide paths which is that they appear to be calculated on the assumption that charge reductions will start in March 2011 (based on charges in force at that time - §1.16). Given that charges will not, in fact, start being subject to the charge control before around October 2011, this will mean that the glide paths could lead to charges not being reduced to the level of Ofcom's cost estimates by the end of the charge control period. Whether this will, in fact, be the case is not clear from the Consultation as the exact method of calculation of the relevant first year charges in the proposed conditions (annex 13 of the Consultation) is not set out in the Consultation.

We understand the need for continuity and consistency in the modelling between the previous and the new controls (§2.60) and thus we understand why it may not be appropriate to use the bridging charges as the start point. Nonetheless the above issues need to be taken into account and, in setting the glide paths, Ofcom potentially needs to make two further adjustments. First an adjustment needs to be made to take account of the fact that charges will be above the level that they would otherwise have been under the charge control for the period between April 2011 and when the charge control takes effect later this year. Second, if Ofcom continues to take the view that the X is calculated as from March 2011, then this calculation of X needs to take account of the fact that the reductions will not in fact start until later in the charge control period and therefore reductions need to be steeper or the first year charge calculated in a way which takes this effect into account. Alternatively, and with equivalent effect, the X could be calculated on the basis that the charge controls start when they will <u>actually</u> start and reduce the charges from the level they are as at that time to the cost estimates (i.e. over a shorter time period).

As a result, while EE does not have any particular comments on the overall methodology used to set the glide paths, the implementation of that methodology in these circumstances means that Ofcom's proposed X values are too low (greater reductions are likely to be required).

Section 8 – Approach for setting WLR and LLU differentials

Question 8.1 Do you agree with Ofcom's proposal to base charges on CCA FAC provided that this results in differentials between the core rental charges that are not less than the likely differences in LRIC and not significantly greater than the likely differences in LRIC?

EE understands that the process of analysis carried out by Ofcom in Section 8 of the Consultation is essentially designed as a cross check on the results of the CCA FAC process, and that Ofcom is using the LRIC estimates as a way of ensuring that the outcomes from the cost allocation exercise both are reasonable and do not lead to material competitive distortions.

As such, we have significant concerns with the way in which Ofcom is interpreting this analysis. In particular, whilst Ofcom states at §8.14 that "*we do not think the differential should be significantly greater than LRIC*" and asks Consultation respondents whether they agree with this view, the focus of Ofcom's actual analysis appears to be exclusively concerned with ensuring that the differentials in core rental charges are *not less* than the likely differences in LRIC.[62]

EE agrees with Ofcom's assessment that it makes no sense to distort the results of a costing exercise to create (greater) artificial investment incentives in favour of MPF. As such, EE broadly agrees with the arguments that Ofcom makes in paragraphs 8.10 to 8.12 of the Consultation. However, we are very concerned that Ofcom does not appear to have undertaken any significant analysis on the extent to which the CCA FAC costs differentials are significantly greater than the likely differences in LRIC (or indeed even provided any indication of what Ofcom considers would constitute a "significantly greater" differential).

If this were the case, and EE believes that it is, then this will also have a significant detrimental effect on efficiency: distorting retail prices and hence allocative efficiency and harming dynamic efficiency (by distorting investment choices away from operators competing on the basis of WLR and SMPF products).[63] EE also notes that the adjustments which Ofcom has made to the underlying CCA FAC allocations *significantly worsen* the extent to which LRIC differentials are less than the proposed base charge differentials.

EE believes that the differences in the base charges are already significantly and adversely out of line with LRIC differentials, but Ofcom provides no explanation of why it considers that the base charges are within reasonable bounds given their LRIC cost analysis. As is shown in Figure 4 below, the difference in LRIC charges is significantly below the difference in the base charges between the different LLU products. This figure concentrates on the comparison between MPF and WLR+SMPF as being particularly important – as Ofcom recognises at §8.3 of the Consultation.[64] Figure 8.1 of the Consultation only makes this comparison for the final year of the charge control. The impact of this, as discussed in more detail below, is to create a regulatory distortion to competition.

[62] The CC WLR Determination (§3.237) noted the risk of charge differentials distorting competition between MPF and SMPF based operators. Further, at §3.270 of the CC WLR Determination, the CC notes that distorting incentives in favour of MPF could "result in inefficient investment in MPF resulting in higher, not lower, costs."
[63] Ofcom itself recognised this and is quoted in the CC WLR Determination making exactly this point (see §3.264 of the CC WLR Determination).
[64] The CC WLR Determination (§3.247) also recognised this as the appropriate comparison to make when comparing the differential between these two sets of charges.

Figure 4: Comparison of proposed charge and LRIC differentials

	2011/12	2012/13	2013/14	Average over period
Proposed difference in WLR+SMPF and MPF Charges	£27	£25	£23	£25
LRIC difference	£10	£10	£10	£10
LRIC Difference as percentage of Charge Difference	36%	40%	44%	40%

For the purposes of Figure 4, we have assumed the LRIC differential is at £10. This is conservatively within Ofcom's range of £8 to £15. [✄] [✄].

What Figure 4 shows is that, on Ofcom's own figures, relative charges of WLR+SMPF compared to MPF, are significantly out of line with the estimated LRIC differential. The situation is worse at the start of the charge control period and Ofcom's comparison based only on the final year therefore underestimates the potential competitive damage.

This demonstrates that MPF operators have a significant advantage compared to those relying on SMPF inputs. One way of viewing the difference between these types of LLU operators is that SMPF operators rent certain exchange based equipment from BT, which MPF operators purchase and have to amortise over a number of customers and a relevant payback period. The LRIC differentials provide one estimate of the difference in non BT network costs between these two approaches. Efficient MPF operators are therefore able to have a lower overall cost base compared to SMPF operators. This is distorting investment incentives (the make/buy decision) in an inefficient way and therefore distorting competition. EE's own estimates of what additional capex an MPF operator would need to incur on top of that which a WLR+SMPF competitor will need to spend are not dissimilar to (and at the lower end of) Ofcom's estimates of the LRIC differentials. The difference between the LRIC differential and the base charge differential therefore represent a direct subsidy to MPF based operators. EE can see no justification for continuing this situation which is detrimental to competition and therefore the interests of end consumers.

It will also have a further detrimental impact in reducing overall incentives on operators to migrate to next generation access. MPF operators will have greater costs in migrating to fibre based products than SMPF operators (who can rely on continuing use of WLR in the interim and will be better placed to migrate to the new network architecture of NGA in the longer term). Therefore the artificial preferment of MPF operators will dampen incentives overall for operators other than BT to migrate to fibre products. This risks leading to handing a dominant position in NGA to BT (at least in non cabled areas).

Survival and successful evolution of the precious and important degree of SMPF and WLR+SMPF based retail broadband competition that Ofcom has helped to build up since the introduction of LLU in the UK is critically dependent on Ofcom ensuring that the regulatory framework it lays down:

- First, respects and honours the infrastructure investment ladder regulatory signals given by Ofcom encouraging the take-up of SMPF (especially but not limited to in the early years of LLU); and

- Second, provides a level regulatory playing field for competition between two equally valid and viable infrastructure based means of providing retail broadband services (i.e. those using MPF input products from Openreach and those using, directly or indirectly, SMPF input products from Openreach).[65]

Currently, this is not the case. Fundamentally, we are concerned that there is a flawed assumption underlying Ofcom's willingness to allow this harmful situation to continue, that competition based on MPF will in some sense create greater competitive pressure, on the basis that MPF operators build greater amounts of network (as opposed to purchasing services from BT). However, there is no clear evidence that the relatively small level of greater up front expenditure made by MPF providers as compared with WLR+SMPF providers creates greater competition or benefits to consumers. Specifically:

- The difference in costs of providing the two Openreach services is not as significant as the difference in regulatory costs. The regulatory regime itself therefore negates the extent to which MPF based operators need to compete on network cost, as the regulatory regime insulates them from this competitive pressure. Obviously, it does not do this to the extent sought by TalkTalk in the CC WLR Determination. However, we still firmly believe that the risks that the Commission was concerned about in this regard have in fact materialised under the current regulatory framework and will persist under Ofcom's proposals – namely:

  > "*that there is a[n actualised] risk that a differential between charges for MPF and WLR+SMPF that is greater than cost could result in inefficient investment in MPF. In other words, it could lead to CPs making investment in MPF services that would not be justified by the underlying costs of delivering services using MPF rather than WLR+SMPF or the ability to offer consumers new or better services*."[66]; and

- To the extent that it is a valid proposition that MPF based providers currently provide a greater competitive constraint than SMPF based providers – then we would suggest that this has far less to do with the small additional upfront investment made by MPF based providers, and far more to do with the fact that the regulatory playing field is currently tilted firmly in favour of MPF based providers, to the detriment of SMPF based competition. As such, if regulation continues to favour MPF operators at the expense of WLR + SMPF operators, then it will in itself lead to a reduction in the level of competition to provide fixed broadband, leading to higher long run prices and less overall benefits to fixed broadband consumers.

In light of all of the above, EE believes that a proper analysis of LRIC differentials to ensure that Ofcom's regulatory price controls are not inappropriately distorting competition or unduly favouring MPF based service provision in compliance with Ofcom's obligations under the Act leads to a strengthening of the case for:

- assuming higher WLR specific cost savings;

- either treating directory costs as a retail cost (which is not recovered by Openreach) or, in the alternative, at least allocating directory costs more equitably across all lines which have a listing;

- removing the TAMS adjustments to the CCA FAC estimates which exacerbate the difference in the base charges in an unwarranted fashion;

- adjusting the volume forecasts (and in particular the balance between MPF and WLR lines represented in those forecasts) in a way which does not inappropriately lead to more costs being allocated to WLR compared to MPF; and

- removing any allocation of evoTAMs costs to WLR/WLR+SMPF.

[65] We note in particular in this regard the findings of the Commission in the CC WLR Determination at §§ 3.234-3.252

[66] CC WLR Determination §3.245.

EE has argued for all of these changes to Ofcom's proposals above.

Question 8.2: Do you agree with Ofcom's assessment of the likely differences in LRICs between MPF and WLR/WLR+SMPF?

EE does not have any detailed comments on Ofcom's broad brush estimates of the incremental costs of MPF, WLR and WLR + SMPF. At the level of detail at which Ofcom has undertaken this assessment these figures appear broadly in line with EE's expectation of the differences in the costs of providing these different services. It is important to note that these are also an indication of the differences in the non-BT network costs which different types of provider will incur (which EE considers would be at or just below the bottom end of Ofcom's range). As set out above, EE is more concerned with the use which Ofcom has made of these estimates.

ANNEX: SUMMARY OF KEY CHANGES PROPOSED TO CHARGE CONTROL

As set out in the body of this response, there are several key areas in which we believe that the proposed charge controls contain significant flaws which should be corrected. In summary, our key areas of concern are as follows:

- **Switching costs:**
  - We urge Ofcom to intervene to effect an immediate charge control on the price for MPF to WLR transfers so as to ensure that the price that is required to be paid to Openreach to migrate a voice and broadband retail customer from MPF to WLR+SMPF is no more than the price to migrate a voice and broadband retail customer from WLR+SMPF to MPF (i.e. currently £39.79) (see response to Question 5.6)
  - We strongly recommend that the charges for MPF transfer and SMPF connection are <u>not</u> aligned. Rather, we recommend that each charge is separately brought into line with its own CCA FAC by the end of the charge control period – with an up-front one-off adjustment being made to the charge for SMPF connection, given the significantly high level (31.6%) at which the current Openreach charges are above the forecast CCA FAC cost for this service (see response to Question 4.11);
  - Until Ofcom is satisfied that it has received reliable MPF and SMPF cease cost information from BT, we do not believe that BT should be able to recover any amount for the provision of these services (whether from a separate cease charge, rental charges, or otherwise) (see response to Question 4.12);
- **Calling and Network Features:** We believe that there are certain BT charges for calling and network features, in particular for caller display and voicemail, which should be charged controlled as BT is currently extracting monopoly profits from their supply. As these charges have been and continue to cause serious competitive detriment to WLR + SPMPF based competitive broadband providers, we urge Ofcom to regulate these charges by way of a price cap effecting an immediate one-off adjustment to bring these charges in line with cost (see response to Question 5.8);
- **Directories:** We believe that, on an appropriate application of the principles of cost causation and distribution of benefits, the costs incurred by BT Retail to produce and deliver telephone directories throughout the UK are a retail cost, which should not be re-charged at all to Openreach. If Ofcom does not agree on this point then, at a minimum, we still believe that these costs should be allocated across all communications providers whose numbers are listed in the BT directories and to whose customers BT delivers directories – and not simply exclusively allocated to acquirers of BT's WLR service (see response to Question 7.9);
- **TAMs**: We believe that it is no longer appropriate for Ofcom to ignore the principle of cost causation and to take a contrary policy decision to reallocate to SMPF services a large portion of BT's costs of Test Access Matrixes (**TAMs**), which are used exclusively in the supply of MPF services (see response to Question 7.11);
- **evoTAMs:** Ofcom's current proposed model appears to include evoTAMs in the regulated cost stacks for WLR and SMPF (§8.20; §§9.41-9.43). Given that the evoTAMs are still being rolled out and it is not yet clear on what terms they will be offered or by whom they are most likely to be purchased, as well as the fact that they will only be available for use in conjunction with a limited sub-set of WLR and SMPF lines, EE considers that it is *not* appropriate to include the costs associated with this service in the regulated cost stacks. Certainly, if Ofcom does include evoTAMs in BT's regulatory cost base, then we consider that it is imperative that Ofcom takes a consistent approach on cost causality for evoTAMs as that taken for TAMs – i.e. if TAM costs are to continued to be allocated across all LLU lines in spite of their use

exclusively by MPF lines, then evoTAM costs should be allocated across all LLU lines as well (see response to Question 7.8);

- **LRIC differential:** We are concerned that Ofcom's use of its LRIC estimates, as a cross check on the CCA FAC estimates, has effectively ignored competitive impacts on competitive broadband providers using WLR+SMPF: the differentials between CCA FAC estimates for WLR+SMPF are significantly higher than the equivalent LRIC differentials which implies a competitive detriment to operators competing with BT who are reliant on these wholesale inputs (see response to Question 8.1);

- **Duct indexation:** Ofcom's approach to indexing post-1997 duct assets is not clear, with various alternatives discussed in different parts of the Consultation. We consider that the most appropriate approach is to index these assets by the RPIY index (which is an alternative Ofcom does not raise in the Consultation, but which would be consistent with its approach to inflating other costs) (see response to Question 3.9);

- **Glide paths:** EE considers that the assumed future RPI values which Ofcom's approach uses to set the X's in the RPI-X calculation are over optimistic. We consider that Ofcom needs to revisit this aspect of its approach to setting the X for the glide paths (see response to Question 3.12). We also believe that Ofcom's approach to setting the glide paths, given that the charge controls are not starting in March 2011, may not appropriately adjust for the actual likely start date (see response to Question 7.12)

- **Efficiency savings:** EE considers that Ofcom has selected a range of potential efficiency savings which is too low. From the different pieces of evidence which Ofcom has cited, a reasonable range for potential savings would be 4%-6%. Further, while we agree that it makes sense to have a high level efficiency requirement (rather than apply different savings to different assets or classes of cost), EE considers that there is a case for a higher efficiency assumption to be applied to WLR costs, as WLR is now a robust and established service (see response to Question 7.3);

- **Mode of excluding mortgage interest and indirect tax in RPI cost forecast:** While Ofcom's exact approach to forecasting inflation is unclear, we consider that the level of RPI excluding mortgage interest payments and indirect taxation is too high based on the average difference between the RPI and RPIY indices (see response to Questions 7.4 and 7.6);

- **Cost of copper:** We disagree with Ofcom's approach to establishing the current cost of BT's copper assets which implicitly assumes copper is a liquid asset for BT (see response to Question 7.5);

- **PIA duct usage:** We believe that Ofcom should make a conservative usage allocation to PIA in respect of BT's duct costs. We believe that Ofcom's current proposal of no allocation to PIA will either inappropriately allow BT to over-recover these costs or risk a competitive distortion in favour of PIA based service providers over LLU and WLR based service providers (see response to Question 3.6);

- **Alignment of ancillary charges:** We do not believe that it is appropriate for Ofcom to align the price of jumper removals (see response to Question 4.7). We do not believe that SFI prices should be aligned without further examination of the relevant costs of supplying these services (see response to Question 4.16);

- **Volume forecasts:** EE has concerns with the volume forecasts used in Annex 6 to the Consultation, to which the charge controls are highly sensitive (see response to Question 7.1); and

- **Corporate overheads:** The figure of 43% seems a priori too high and we therefore request Ofcom to investigate this allocation in more detail to ensure that it is valid.