Charge control review for LLU and WLR services

Openreach response to the Ofcom consultation
dated 31 March 2011

July 2011

NON-CONFIDENTIAL VERSION

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This response is provided on behalf of British Telecommunications plc ("BT") by Openreach, a line of business within BT. References to Openreach should also be read as being to BT, where appropriate.

1 Executive Summary

1. The United Kingdom has one of the most competitive and dynamic markets in the world for the provision of fixed line data and voice services. Competition in these markets is underpinned by the provision of regulated wholesale inputs by Openreach in the form of Wholesale Line Rental ("WLR") and Local Loop Unbundling ("LLU") services. There are over 23 million LLU and WLR lines currently provided to end-users in the UK.

2. In resetting the LLU and WLR charge controls, it is important that Ofcom reaches the right decision since this will affect all areas of investment in current and future network technology and shape competition for fixed line data and voice services for the next few years. It is vital that Ofcom comes to the right conclusion and discharges its statutory duties appropriately.

3. These charge controls must provide a reasonable opportunity for Openreach to fully recover its forward looking efficiently-incurred costs, including permissible regulatory returns on capital across the key copper access products throughout the charge control period. The controls should also provide the appropriate incentives and pricing flexibility to allow Openreach to respond to market demand and the needs of its customers.

Ofcom's overall approach

4. Ofcom's approach to the cost modelling and allocations that underpins its current charge control proposals was largely endorsed by the Competition Commission ("CC") and the Competition Appeal Tribunal ("CAT") in the LLU Appeal.[1] Openreach therefore agrees that Ofcom's overall approach is appropriate, however, Openreach disagrees with a number of the assumptions and parameters used by Ofcom:

   - the Weighted Average Cost of Capital ("WACC") estimate is too low
   - pay inflation estimate is too low
   - efficiency target is too high
   - corporate overhead costs are understated
   - Physical Infrastructure Access ("PIA") should not be part of this current consultation
   - certain Sub Loop Unbundling ("SLU") costs must be recovered from WLR and LLU.

5. In addition, the baskets proposed by Ofcom for Ancillary services are overly restrictive and do not provide adequate or appropriate flexibility to fully recover costs and to efficiently price the services.

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[1] The Carphone Warehouse Group plc v Ofcom (Local Loop Unbundling), Case 1111/3/3/2009 ("LLU Appeal") and The Carphone Warehouse Group plc v Ofcom (Wholesale Line Rental), Case 1149/3/3/2009 ("WLR Appeal"), Competition Commission Final Determinations of 31 August 2010 and Competition Appeal Tribunal Rulings of 11 October 2010.

6. There are also two key Ofcom positions, not considered by the CC, that Openreach fundamentally disagrees with:

   - continuing to apply the Regulatory Asset Value ("RAV") Adjustment
   - continuing to exclude the pensions deficit repair contributions.

Regulatory Asset Value

7. Ofcom proposes to continue to value duct assets installed prior to 1997 on a HCA basis which results in a significantly lower valuation than on a replacement cost basis (the "RAV Adjustment").

8. Ofcom committed to reviewing the appropriateness of the RAV Adjustment in 2005,[2] but has not evidenced here that the adjustment is still appropriate. Its primary reason for continuing the RAV Adjustment is the supposed 'windfall' gain for BT shareholders but as we show this gain is completely illusory and in fact, the RAV Adjustment perpetuates continued under-recovery of costs.

9. Continuing with the RAV Adjustment will distort competition and investment decisions, the very impacts which Ofcom seeks to avoid. Removing the RAV Adjustment would improve productive efficiency and would have no adverse impact on downstream competition.

10. Notwithstanding our disagreement with the continued application of the RAV Adjustment, Ofcom must correct two errors in its CCA valuation of access network assets installed after 1997 which uses an indexation methodology:

    - the industry specific index should not be reduced by as much as 1% per annum; an appropriate adjustment should be no greater than 0.5% per annum
    - the application of the national discount results in an under-recovery of efficiently-incurred costs which Ofcom must rectify either by correcting the methodology or not applying the discount.

Pensions deficit repair contributions

11. Pensions deficit repair contributions made by BT are efficiently incurred costs and Ofcom has erred by failing to take them into account.

WACC

12. Ofcom has consulted separately on WACC in the context of the Wholesale Broadband Access consultation. We submitted our detailed response, together with an independent report by Oxera, to that consultation which provided extensive arguments, evidence and analysis to support the view that Ofcom's proposed reduction in BT's WACC is excessive and disproportionate. We reserve the right to make further comments on the appropriateness of Ofcom's WACC statement to the WLR and LLU charge controls once the statement has been published.

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2 Ofcom, *Valuing Copper Access*, 18 August 2005, paragraph 5.22.

Pay Inflation

13. Published national statistics and recent regulatory determinations support a pay inflation rate of 1% per annum above the assumed RPI. Ofcom's proposal assumes a rate of pay inflation equal to RPI, which should be adjusted upwards by 1% per annum.

Efficiency

14. Ofcom's analysis is flawed and does not support a conclusion that 4.5% is an appropriate target for efficiency. The evidence below supports an appropriate efficiency target of no greater than 3.5% per annum:

- the CC Determination[3] stated that 3.7% per annum was the appropriate efficiency target for Openreach for the period to 2012/13 i.e. covering two-thirds of the duration of these controls. One would not expect, and Ofcom does not evidence the case for, a deviation from these recent findings

- Ofcom commissioned KPMG to update the independent report that underpinned the CC Determination, and KPMG has recommended an efficiency target between 2.3% and 2.6% per annum

- Ofcom has incorrectly interpreted the industry benchmarking information; the industry 'Best in Class' is an inappropriate measure of efficiency and should be excluded. Ernst & Young has properly interpreted the industry average report for Openreach and identified a target range for efficiency between 1.9% and 2.6% per annum

- Ofcom's low-case historic estimate and forecast estimate of Openreach's efficiency are both approximately 4% per annum.

Cost Allocation

15. Openreach believes that Ofcom has erred in its analysis and that it should make the following corrections:

- **corporate overheads**: Ofcom has been inconsistent in its application of the efficiency factor to corporate overheads, which results in a greater-than-intended level of efficiency being applied to Openreach's total cash costs. Ofcom must be consistent and remove this anomaly

- **repair costs:** Ofcom allocates the same repair costs to LLU and WLR even though LLU is guaranteed to be repaired a day faster than WLR. LLU repair therefore requires a higher resource commitment and so its costs are higher than for WLR and Ofcom should reflect this in the cost stacks.

Physical Infrastructure Access

16. Ofcom should not include questions about PIA (which is subject to a cost orientation obligation) in a charge control consultation that relates to different products i.e. LLU and WLR.

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3 CC Determination, paragraph 2.239.

Sub Loop Unbundling

17. Ofcom's recent SLU determination finds that certain costs are not permissible to be recovered from SLU costs stacks although they are costs legitimately incurred by Openreach. Ofcom must therefore consider in this consultation how these costs can be recovered across WLR and LLU services.

Ancillary Services

18. Openreach considers that the broad approach that Ofcom has taken to the treatment of ancillary services is appropriate, as it has taken into account most of the points raised by the CC. We believe, however, that in a certain areas, Ofcom needs to make further changes to its proposals, key amongst which are:

    - the removal of the inertia clauses since the ancillary baskets are already tightly controlled

    - the removal of cost orientation obligations from value-added services, including Expedite

    - the removal of any proposed regulation of Special Fault Investigation since these fall outside the WLA market

    - ensuring services that are common to more than one market, for example co-mingling services, are regulated consistently and on exactly the same terms. We propose the simplest approach is to regulate the services in only one market.

2 Market Context

2.1 Introduction

19. Ofcom published its consultation regarding charge controls for Local Loop Unbundling ("LLU") and analogue Wholesale Line Rental ("WLR") services entitled "Charge control review for LLU and WLR services" ("the Ofcom consultation") on 31 March 2011, and updated it on 18 May 2011 to correct for a small number of errors. The proposed controls are for the period until March 2014. Ofcom proposes that the controls will come into effect 28 days after it issues the final statement, which is expected in autumn 2011.

20. The previous set of LLU and WLR charge controls expired on 31 March 2011.[4] Ofcom delayed resetting the controls as a consequence of the LLU Appeal not concluding until October 2010 and the need for the outcome of the appeals to be reflected in the next set of controls.[5]

21. Ofcom has taken into account the outcome from the Competition Appeal Tribunal's ("CAT") rulings disposing of the LLU and WLR Appeals against Ofcom's previous charge control statements.[6] The CAT rulings were published on 11 October 2010, and endorsed the findings of the Competition Commission's ("CC") Determinations dated 31 August 2010.

22. As a result, for the period from 1 April 2011 until Ofcom concludes this consultation, or 31 March 2012 (whichever occurs sooner), Openreach has voluntarily committed to a range of interim charge ceilings for key WLR and LLU services. These ceilings are in line with the CC Determination and provide fair and reasonable charges to Communications Providers ("CPs"). They provide pricing certainty for LLU and WLR services in the absence of formal charge controls.

2.2 Market developments

23. In order to meet its objectives, Ofcom seeks to promote WLR-based competition alongside Metallic Path Facilities ("MPF") and WLR+Shared MPF ("SMPF") based competition. This continues to result in positive outcomes in terms of narrowband and broadband competition.

24. WLR continues to stimulate effective retail narrowband competition, as evidenced by Ofcom's removal of BT's obligations at a retail level for the provision of lines and calls for the first time since privatisation in 1984.[7] There are around 400 CPs using WLR as the input into their end-user offerings, and the WLR product volumes purchased by CPs (other than BT) continue to be significant, as shown in the figure below.

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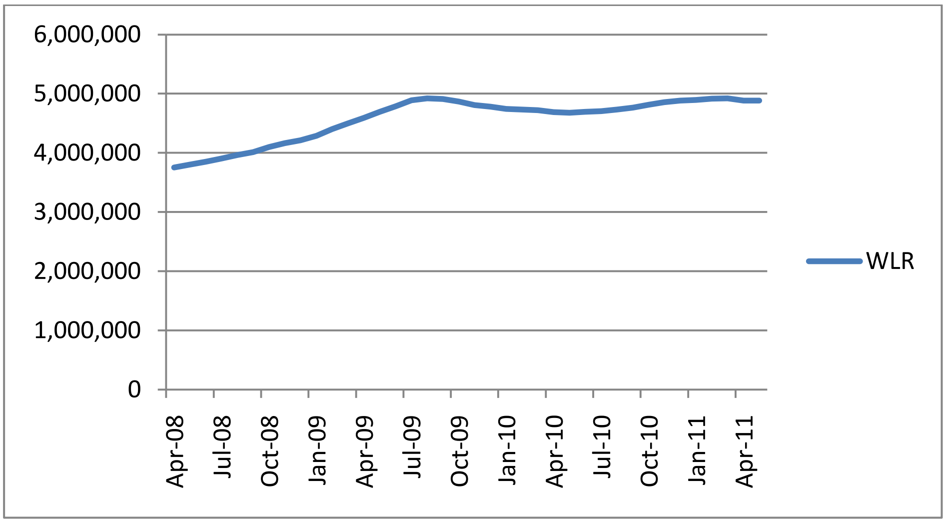
4 Refer: Ofcom, *A new pricing framework for Openreach*, 22 May 2009 ("2009 LLU Statement") and Ofcom, *Charge controls for Wholesale Line Rental and related services*, 26 October 2009 ("2009 WLR Statement").

5 Ofcom consultation, paragraph 1.14.

6 The *Carphone Warehouse Group plc v Ofcom (Local Loop Unbundling)*, Case 1111/3/3/2009 ("LLU Appeal") and *The Carphone Warehouse Group plc v Ofcom (Wholesale Line Rental)*, Case 1149/3/3/2009 ("WLR Appeal"), Competition Commission Final Determinations of 31 August 2010 and Competition Appeal Tribunal Rulings of 11 October 2010.

7 Ofcom. *Ofcom deregulated retail telecoms market: Move could trigger more choice and lower prices for consumers*, news release, 15 September 2009.

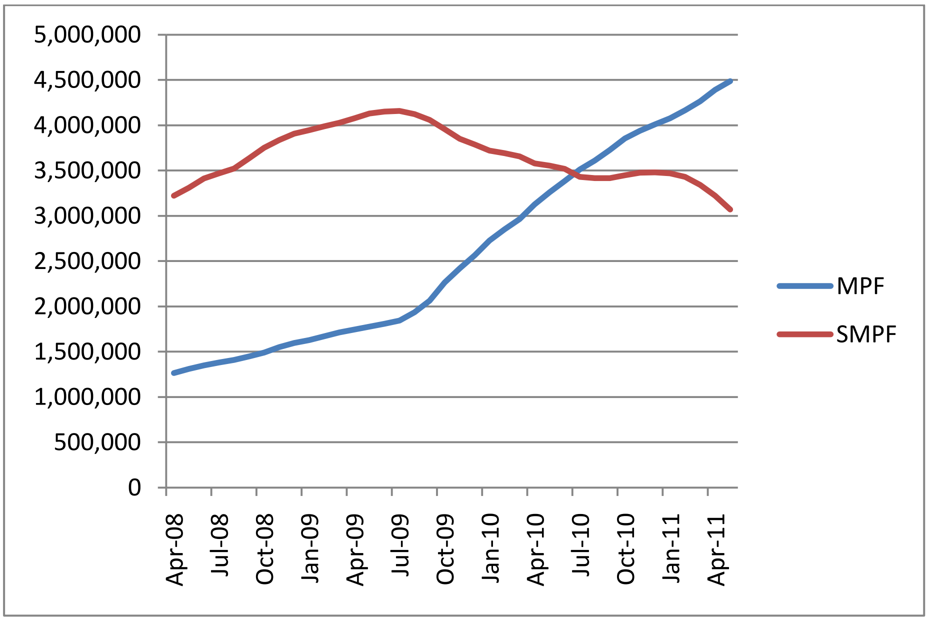
Figure 1 Growth of WLR rental volumes by non-BT CPs



25. The growth in broadband competition in the UK has been reliant on the availability of SMPF (which is used to provide broadband-only services, with WLR used to provide voice services), as well as MPF (which is used to provide broadband and voice services).

26. UK consumers have a range of choices about how they consume fixed line data and voice services – separate broadband and narrowband providers, separate lines and calls providers, full bundle, etc. Of the total LLU lines supplied by Openreach, 71% are used to supply SMPF services. It is likely that over half of end-users taking broadband service from SMPF providers take their narrowband service from another supplier. In contrast, MPF-based provision does not allow consumers to split their service in such a way or have this degree of choice, as the MPF-based provider uses the line to provide both narrowband and broadband services to the same consumer. The growth in MPF and SMPF based competition from non-BT CPs is shown below.

Figure 2 Growth of MPF and SMPF rental volumes by non-BT CPs



27. The recent growth of MPF is primarily due to TalkTalk Telecom Group PLC ("TalkTalk"), and more recently British Sky Broadcasting Limited ("Sky"), migrating from WLR+SMPF to MPF. The decline in WLR and SMPF volumes is particularly visible from July 2009 onwards, with a concurrent acceleration in MPF growth. Given TalkTalk's announcement in November 2010 to further extend its unbundled network to 2,700 exchanges, serving 93% of the UK customers,[8] and Sky's continued roll-out, Openreach expects MPF volumes to continue to increase over the charge control period. However, WLR and WLR+SMPF will continue to be an important part of the market over the period of this control, delivering additional choice and other benefits to end-users.

2.3 Increasing infrastructure level competition

28. While WLR, MPF and WLR+SMPF based competition plays a significant role in providing fixed narrowband and broadband services to end-users, the broader telecommunications market continues to evolve with an increasing range of infrastructure choices available to end-users and a plethora of wholesale access options becoming available to CPs.

29. End-users have a choice of networks to obtain their voice and broadband services:

- around 5 million access lines to end-users are provided over cable networks[9]
- mobile networks are increasingly being used as the sole supplier of voice and/or data services to households; the number of mobile-only households continues to increase (currently 14% of households[10] up from 12% in 2009[11]) and is likely to continue to increase as the service to end-users improves e.g. an average download speed of 1.5Mbit/s has been achieved when using dongles and datacards[12]
- over 400 CPs supply services utilising the Openreach copper network.

30. The remedies imposed through the recent Wholesale Local Access market review[13] ("2010 WLA Market Review") and WLR market review[14] ("2010 WLR Market Review") provide a number of wholesale access options for CPs, including:

a) WLR

b) MPF & SMPF

8 TalkTalk, *Interim Results for the 6 months to 30 September 2010*, 16 November 2010, available from: http://m0.ttxm.co.uk/sites/www.talktalkgroup.com/pdf/corporate/1H-11_RNS_v_FinalDR.pdf.

9 Ofcom, *Telecommunications market data tables Q4 2010*, April 2011, Table 2, page 5.

10 Ofcom, *Communications Market Report*, 19 August 2010, page 90.

11 Ofcom, *Communications Market Report*, August 2009, page 248.

12 Ofcom, *Measuring Mobile Broadband in the UK: performance delivered to PCs via dongles/datacards*, September to December 2010, May 2011, page 7.

13 Ofcom, *Review of wholesale local access market, Statement on market definition, market power determinations and remedies — Statement*, 7 October 2010, ("2010 WLA Market Review").

14 Ofcom, *Review of the wholesale fixed analogue exchange lines markets*, Statement, 20 December 2010, ("2010 WLR Market Review").

c) Sub-Loop Unbundling ("SLU")

d) Virtual Unbundled Local Access ("VULA")

e) Physical Infrastructure Access ("PIA"); duct sharing and/or pole sharing (both currently in trial stage).

31. The access service a CP chooses to consume reflects the investment model they pursue, ultimately allowing them to invest in their own networks to complement (and potentially compete with) the Openreach network. The various wholesale access options will be used to provide the next generation of services to end-users. These services are being increasingly provided not only by BT's retail divisions, but by a range of CPs giving end-users a greater range of choice, speed and quality of services.

2.4 Investment in Next Generation Access ("NGA")

32. The UK Government aims to have the best superfast broadband network in Europe by 2015, as it recognises the importance to the economy of remaining at the forefront of communications technology.

33. Openreach is investing £2.5 billion to deploy NGA services to two-thirds of UK premises by 2015. This is a significant investment in an industry that continues to evolve at pace, and given the critical stage that the market is at now, it is imperative that Ofcom ensures that these charge controls provide the right incentives for BT shareholders to continue to invest.

34. Openreach's NGA programme is the largest single commercial investment in fibre-based broadband infrastructure ever undertaken in the UK, and is one of the biggest civil engineering projects running in the country at this time. Over the course of its NGA programme Openreach will be installing 30,000 cabinets (which are mini-exchanges within their own right), connecting 200,000 distribution points, enabling over 1,000 exchanges and laying over 50,000km of fibre. The rollout of the network is occurring at a rapid pace, being 40% faster than the Deutsche Telekom roll-out and equivalent to a whole "Singapore" of deployment footprint every quarter.

35. With the growing importance of investment in fibre-based services, it is clearly important for Ofcom to ensure that Openreach is able to recover its efficiently incurred costs in the LLU and WLR charge controls and so support the continuing major investment by Openreach in communications infrastructure.

3 Approach to charge control

36. This section outlines Openreach's view on the approach taken by Ofcom to the LLU and WLR charge controls. We note that:

- the CAT ruling provided a solid basis and appropriate methodology for the charge controls, and Openreach would not expect deviation from it without compelling reasons being evidenced by Ofcom
- the approach to interim prices are considered reasonable by Ofcom
- transparency is important and we believe that stakeholders have been provided with sufficient information through the consultation to enable informed responses – Openreach considers that any further disclosure is inappropriate.

3.1 Competition Appeal Tribunal Ruling

37. Openreach notes that Ofcom's approach to setting the charge controls for LLU and WLR has been informed by the CAT's ruling (based on the CC Determination) following CPW's 2009 LLU and WLR Appeals. In that process, the CC assessed whether Ofcom had made any errors in conducting the previous charge control review.

38. In relation to WLR, Ofcom's decision was upheld. Thus the CC rejected an argument that there should be a greater price differential between MPF and WLR and between MPF and WLR+SMPF. The same argument was also rejected in relation to the LLU Appeal.

39. In relation to the LLU charge control, the CC concluded that Ofcom had made some errors. With respect to the cost stacks for MPF, SMPF and LLU Rentals, the CC's Determination can be characterised as follows:

a) Ofcom's efficiency target was increased to 3.7% (net of implementation costs)

b) Ofcom did not err in setting the Weighted Average Cost of Capital ("WACC") at 10.1%

c) Ofcom did not err in its allocation of costs from BT Group to Openreach

d) Ofcom's approach to inflation was broadly upheld, apart from an error in the model for energy inflation, and it not take full account of the Openreach pay freeze when considering wage inflation

e) the challenge to the setting of the glide-path was rejected.

40. With respect to LLU Ancillary Services (a range of services that are consumed with the main LLU products, and which include connection, migration and cease products, as well as space and power in BT exchanges and LLU tie cables), the CC found that Ofcom should not have set a single charge control applicable to the three LLU Ancillary Services baskets. In this context, the CC concluded that MPF New Provide should be charge controlled separately. The CC also found that an additional constraint was required on the Co-Mingling basket which could be addressed by a ruling that

there should be no upward price changes on services in this basket for the remainder of the charge control.

41. Openreach believes that the LLU and WLR Appeals provide clarifications and explanations as to the appropriate methodology that Ofcom should adopt on these issues in the context of these charge controls. While some of the underlying data may have changed in the intervening period, Openreach would not expect major changes to the framework and methodology for estimating costs in Ofcom's cost modelling process unless there was a compelling rationale, consistent with the CAT's ruling, for such variations. For example, Openreach would expect that Ofcom's methodology used to calculate the efficiency targets and WACC, and Openreach's allocation of BT Group costs, are likely to be broadly similar to those validated by the CAT.

3.2 Interim prices

42. In late 2010, Openreach and Ofcom recognised that the introduction of the next set of charge controls would be delayed beyond the expiry of the previous control. In the absence of a new charge control being set, LLU and WLR services are subject only to the general cost orientation obligations. Openreach recognised that this would create pricing uncertainty for its customers. As a result, Openreach provided a voluntary commitment to Ofcom regarding the prices that it would charge for the period 1 April 2011 until 31 March 2012 (or until a new Ofcom charge control is set, whichever occurs sooner).

43. In December 2010, Openreach announced that it had voluntarily agreed with Ofcom that key LLU and WLR charges from 1 April 2011 would be no higher than ceilings based upon the cost modelling that was used by Ofcom to calculate the charge controls in 2008/09 and adjusted to reflect the CAT Ruling in the LLU and WLR Appeals, as shown in Table 1 below. As Ofcom acknowledged at the time, the way the voluntary charge ceilings were set was "*a reasonable approach to take*".[15]

Table 1 Interim pricing arrangements

	Service	**01/04/10-14/10/10 (i.e. year 2 of the glide path in the original 2009 LLU and WLR Statements)**	**15/10/10-31/03/11 (i.e. adjusted to reflect the outcome of the LLU and WLR Appeals set out in the CAT rulings)**	**Price ceiling from 01/04/11 (voluntary interim price ceilings)**
a	MPF Rental	£90.46	£89.10	£91.50
b	SMPF Rental	£15.63	£15.04	£14.70
c	WLR Basic rental	£103.68	£103.68	£103.68
d	MPF New Provide	£75.01	£62.11	£52.79
e	WLR New Provide	£55.74	£55.74	£48.22
f	WLR Transfer	£3.09	£3.09	£3.09
	LLU Ancillary Services			No increase of more than 3%

15 Ofcom, *Charges for LLU and WLR services from 1 April 2011*, 1 December 2010, available from http://stakeholders.ofcom.org.uk/binaries/consultations/openreachframework/statement/charges.

3.3 Ofcom's cost model

44. Ofcom has published three cost models as part of its consultation for these charge controls (collectively, "the Ofcom Model"):

- Cost Forecast model
- RAV model
- Cost Allocation model.

45. The Cost Forecast model utilises forecasts for volumes of Openreach products to calculate the total number of manhours and costs required in a particular year to undertake the various activities needed to deliver and maintain services to CPs. Such a calculation draws upon detailed and sensitive operational data, including supplier contracts and labour rates agreed with unions and agencies. The Cost Forecast model also contains projections of non-labour driven costs such as "Internal Costs of Sales" which include linecards and electronics costs, and BT Group transfer charges, including accommodation, Cumulo rates and corporate overheads among others. The outputs of the Cost Forecast model are then fed into the Cost Allocation model.

46. The RAV model is used to generate indexed valuations of the pre-1997 duct and copper assets and the CCA valuation of the post-1997 assets. The model projects the asset and depreciation costs using HCA feeds from the Cost Forecast model and the CCA adjustments required. The model outputs, namely the RAV adjusted duct and copper asset base, associated depreciation charges and holding gains/losses, are then input to the Cost Allocation model.

47. The Cost Allocation model allocates the cost inputs from the Cost Forecast and RAV models. The allocation is first of all to activities, and secondly, to products according to a set of allocation rules and usage factors, to provide a consistent outcome with the Regulatory Finance Statements ("RFS").

48. The information used in the Cost Forecast model is actual Openreach management information for financial years 2009/10 and 2010/11 (actual and forecast). This is used by Ofcom to project forward its expectations for the Openreach business based on various assumptions including volume, inflation and efficiency. The Cost Allocation model is a simplified version of the RFS designed to achieve a similar unit cost outcome to the RFS, but using fewer and less complex allocation bases. The key point is that the base year of the Cost Allocation model is anchored to the RFS for individual products and at a total cost level via a full and detailed reconciliation of the adjustments that Ofcom makes to regulatory cost stacks for pricing purposes, e.g. RAV.

49. The benefit of the Ofcom model is that it provides a view of Openreach's entire business — it is not a "silo" view of the world where changes to one product have no impact on another. Indeed, the Ofcom model shows volumes and costs moving as volumes rise and fall for particular products, ensuring costs are appropriately allocated across products and that there is no double recovery of costs across the portfolio.

50. Openreach has agreed with Ofcom that Openreach business information contained in the Cost Allocation and Cost Forecast models could be made available by Ofcom to

interested stakeholders, with disclosure occurring in a way which ensures that confidential business secrets of Openreach (and its customers) are protected. In total, five models have been available to stakeholders as follows:

i) The Cost Allocation and Cost Forecast models are provided in their entirety, however the cells contain "dummy" data which enables stakeholders to understand the structure and mechanics of the models

ii) The Cost Allocation and Cost Forecast models have also been provided in a "frozen" format which contains real data but provided at a higher level of aggregation

iii) The RAV model has been provided in its entirety.

3.4 Transparency

51. Openreach recognises Ofcom's need to act transparently and fairly during its consultation process to ensure that sufficient information is provided to interested stakeholders, to give those consulted a meaningful opportunity to comment on Ofcom's proposed charge controls on LLU and WLR. However, a consultation process is not intended to enable stakeholders to exactly replicate Ofcom's analysis but rather, to understand Ofcom's approach and provide their views on that approach and any resulting proposals. The nature of Ofcom's regulatory function necessarily means that it has access to information which it would not be appropriate to make fully available to all stakeholders.

52. The CAT has recognised that there is a strong public interest in the protection of the confidentiality of the model used by Ofcom to formulate the charge controls. The CAT ruled in *CPW v Ofcom*:[16]

> *"We are in no doubt that the model used by OFCOM to establish the price control contains confidential and commercially sensitive information <u>which must, prima facie, be protected from disclosure</u>.....The interest in protecting this information from disclosure is not simply the commercial interest of BT. <u>There is a wider public interest in the maintenance of the competitive process which requires that detailed information about the breakdown of a company's costs, the volumes supplied, its profit and loss forecasts and other forecasts for its business over coming years is not disclosed to its actual or potential competitors...</u>" (emphasis added)*

53. Ofcom's duty to consult, which stems from Article 6 of the Framework Directive,[17] requires consultation on the "*draft measure*" but expressly acknowledges that confidential information may be withheld from the published results of consultation. There is no suggestion that confidential underlying material must be the subject of public consultation. Moreover, the European Commission's guidelines on market analysis and the assessment of Significant Market Power ("SMP") make clear that

16 *CPW v Ofcom* [2009] CAT 37, paragraph 9.

17 Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services, as amended (the "Framework Directive").

consultation pursuant to Article 6 of the Framework Directive does not require the disclosure of confidential information. [18]

54. Ofcom's "*Framework for disclosure of charge control models"*[19] recognises that due to reasons of confidentiality, full disclosure of the model may not be appropriate and proportionate:

> *"Where Ofcom does not consider full disclosure to be appropriate and proportionate, for example, due to reasons of confidentiality, Ofcom will endeavour to give interested parties the fullest access to the model feasible. With this in mind, Ofcom will give serious and transparent consideration to the following options, and be willing to take the appropriate step(s) unless there are clear reasons not to do so:*
>
> – *provide full explanation and, where available, documentation of methods used within the model and sources of the parameters and assumptions used in the model, including describing the underlying relationships and assumptions;*
>
> – *disclose those parts of the model where there are no confidentiality concerns or where confidentiality concerns can be addressed, for example, by providing or identifying publicly available data;*
>
> – *challenge stakeholder confidentiality claims to ensure that they are valid;*
>
> – *address any confidentiality concerns by, for example, masking confidential data, by substituting data with randomised values or providing data at a higher level of aggregation where this is meaningful and protects confidentiality; and*
>
> – *in the event that disclosure cannot be satisfied through alternative means, consider options to provide confidence about the validity of information withheld, such as subjecting the model to audit by an independent third party or other such appropriate and proportionate approaches."*

55. It is therefore for Ofcom to balance the rights of a consultee on the one hand and:

- the public interest in the protection of the commercially sensitive and confidential information entrusted to Ofcom for its regulatory purposes
- the interest of the regulated undertaking in ensuring that the confidentiality of the information it provides to the regulator is preserved.

56. There is a clear risk that a disproportionate focus on ensuring that levels of transparency meet the standard demanded from stakeholders (as compared to a standard which is acceptable to enable meaningful and intelligent consideration of, and response to, Ofcom's proposals) will negatively affect the functioning of effective competition in the UK telecommunications market. That is particularly the case in light of the fact that

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[18] European Commission, Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services [2002] OJ C165/6, paragraph 134.

[19] Ofcom, *Framework for disclosure of charge control models*, undated, available from: http://stakeholders.ofcom.org.uk/binaries/consultations/784024/Charge_control.pdf.

Ofcom does not restrict, and is not in a position to restrict, what use stakeholders make of the information disclosed during a consultation.

3.4.1 Ofcom's approach to this consultation

57. Following extensive discussions between Openreach and Ofcom to address Openreach's legitimate confidentiality concerns, Ofcom has disclosed the Cost Allocation and Cost Forecast models in their entirety, in both (a) a "frozen" format which contains data provided at a higher level of aggregation, and (b) with the cells containing "dummy" data which enables stakeholders to understand the structure and mechanics of the models. The RAV model has been disclosed in its entirety. Moreover, Ernst & Young has undertaken an audit of the full version of the Cost Forecast model. This approach is therefore entirely consistent with Ofcom's Framework.

58. This approach is also consistent with and supported by CPW's proposals in the LLU Appeal and the resulting CAT's 2009 ruling on disclosure of information:[20]

> *"CPW made submissions concerning the changes that could be made to the information to overcome any concerns that BT had. The information in the CF Final spreadsheet, which CPW accepts for the purpose of this application is confidential, could be randomised by replacing the true figures with ones to which a random factor, within a specified range, was applied. This would remove any commercial value and yet still enable Mr Heaney to understand the structure and mechanics of the model. Certain information in the other spreadsheets could be aggregated without diminishing its value to Mr Heaney. CPW described these proposals as pragmatic and straightforward."* (emphasis added)

59. Openreach therefore considers that disclosure has been carried out in this consultation in a way which balances those interests at paragraph 55 above. However, Openreach believes that the balance struck by Ofcom for the purposes of this consultation marks the limit of the range of reasonable possible responses from Ofcom:

- any greater disclosure of information in the Cost Allocation and Cost Forecast models would fail to protect the public interest in keeping such information confidential and BT's interest in ensuring that the confidentiality of the information it provides to the regulator is preserved

- stakeholders have more than sufficient information contained within the Ofcom models disclosed to them to enable them to participate meaningfully in Ofcom's consultation exercise and to provide an informed response to the subsequent consultation. The level of disclosure already required by Ofcom is, as far as Openreach is aware, the deepest and most comprehensive in any regulated sector in the UK, and to Openreach's knowledge goes far beyond that undertaken in any other EU Member State.

60. Whilst therefore Openreach supports Ofcom's view that the information made available is sufficient to enable stakeholders to give intelligent consideration and an informed

[20] *CPW v Ofcom* [2009] CAT 37, paragraph 23.

response,[21] Openreach firmly believes that any application from stakeholders for further disclosure of information would be disproportionate, unnecessary and inappropriate.

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21 Ofcom consultation, paragraph 6.18.

4 Regulatory Asset Value and RAV Adjustment

61. Ofcom proposes to continue to value duct assets installed prior to 1997 on a HCA basis which results in a significantly lower valuation than on a replacement cost basis (the "RAV Adjustment").

62. Ofcom committed to reviewing the appropriateness of the RAV Adjustment in 2005,[22] but have not evidenced here that the adjustment is still appropriate. In fact, the evidence suggests that should Ofcom continue with the RAV Adjustment it will result in significant distortions. We demonstrate below that a return to a full CCA approach will send the correct economic signals and will not result in any distortions. Therefore Openreach proposes that Ofcom returns to a full CCA approach instead of applying the RAV Adjustment.

63. Ofcom's key reason for continuing the RAV Adjustment is not supported by the evidence and in particular the supposed 'windfall' gain for BT shareholders, claimed by Ofcom, is completely illusory; in fact, the evidence shows that the RAV Adjustment perpetuates continued under-recovery of costs.

64. Not only is Ofcom's 'windfall' rationale contrary to the evidence, but it is demonstrably the case that the resultant lower valuation from the continued application of the RAV Adjustment will distort competition and investment incentives, the very impacts Ofcom seeks to avoid. Moreover, removing the RAV Adjustment would improve productive efficiency and would not adversely impact LLU operators' business plans as the costs would be borne in equal measure by LLU operators and their competitors, including downstream BT businesses.

65. Notwithstanding our disagreement with the continued application of the RAV Adjustment, should Ofcom continue to apply it, Ofcom must correct two errors in its valuation of Openreach's access network assets:

   - the industry specific index (General Building Cost Index ("GBCI")) should not be reduced by as much as 1% per annum; an appropriate adjustment should be no greater than 0.5% per annum

   - the application of the national discount results in an under-recovery of efficiently-incurred costs which Ofcom must rectify either by correcting the methodology or not applying the discount.

4.1 Background and Context

66. In setting charge controls, a key factor is the valuation of the assets required to provide the regulated services. Ofcom proposes to maintain its current valuation methodology which distinguishes between those access assets that were in place as at 31 July 1997 ("pre-1997 assets") and those installed after this date ("post-1997 assets"):

   - in 1997, Ofcom moved from valuing regulatory assets in the Regulatory Financial Statement ("RFS") from Historic Cost Accounting ("HCA") to Current Cost Accounting ("CCA")

[22] Ofcom, *Valuing Copper Access*, 18 August 2005, paragraph 5.22.

- in 2005, Ofcom moved away from CCA to, in effect, HCA, in respect of the pre-1997 assets only ("the 2005 approach")
- post-1997 assets remain valued on a CCA basis.

67. The effect of the 2005 approach is to reduce the value of the network access assets below their replacement costs, principally because HCA does not reflect the effects of underlying inflation between the time the assets were installed and the present time. We refer to the difference between the CCA costs (whether pre or post 1997) and the value proposed by Ofcom as the "RAV Adjustment".

68. The RAV Adjustment was made on the basis that:

    - there was no imminent prospect of infrastructure-based competition emerging[23]
    - 'dynamic efficiency' is best served by having a stable regulatory regime so that industry players can make their investments against a stable background[24]
    - CCA valuation for pre-1997 assets generates an unfair "windfall gain" to BT[25]
    - the RAV Adjustment still allows BT's shareholders a reasonable return.[26]

    This rationale is not supported by the evidence.

69. A key focus for Ofcom should be on ensuring the recovery of efficiently incurred costs but we show below that the RAV Adjustment leaves a shortfall for BT's shareholders. We demonstrate that the RAV Adjustment does not allow a reasonable return and is not consistent with cost recovery. There is therefore no "windfall gain" to BT's shareholders from the application of CCA principles for the pre-1997 assets.

70. Moreover, nor is there an efficiency rationale to apply the RAV Adjustment as allocative, productive and dynamic efficiency are all served by a valuation based on CCA principles.

71. Openreach also comments in this section on the methodology proposed by Ofcom for valuation of post-1997 assets. In particular, the downward adjustment for assumed productivity gains to the index is too high and any national build discount should not be applied.

4.2 Appropriate methodology for valuing assets

4.2.1 CCA valuation of assets

72. Assets valued on a forward looking CCA basis provides appropriate price signals for both suppliers and consumers, as well as sending the correct investment signals to

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23 Ofcom consultation, paragraph A5.22.

24 Ofcom consultation, paragraphs A5.41-A5.45.

25 Ofcom consultation, paragraph A5.6.

26 Ofcom consultation, paragraph 3.45.

potential market entrants.[27] This is a very well-known attribute of CCA as set out, for example, in the Analysys Mason report,[28] which explains why replacement cost methodologies, such as CCA based approaches[29] send the right signals to allow market entrants to make efficient build/buy decisions.

73. The primary reason Ofcom gives for departing from CCA principles is because of its concerns that such an approach would lead to over-recovery of costs in relation to the pre-1997 assets over the life of those relevant assets. Furthermore, Ofcom seems to believe there are a number of factors which 'downgrade' the weight that might normally be attached to ensuring regulated charges incentivise competitive investment.

74. In this section we:

- demonstrate that the evidence shows that Ofcom's concerns about over-recovery of costs are groundless
- explain why deviating from CCA principles in the way that Ofcom proposes will inevitably create distortive effects.

4.2.2 Scope for competitive investment in access networks

75. A key part of Ofcom's overall logic is that new investment in the local access network is not considered likely over the period in question i.e. up to 2013/14.[30] This suggests that economic signalling can apparently be ignored in the specific situation of Openreach's duct assets, as Ofcom believes entry is unlikely anyway. In effect, this is arguing that there is no detriment to the pricing distortion in not using full CCA.

76. The RAV Adjustment has a built-in incentive for potential entrants to postpone investing. It is our view that it is perverse that regulation serves as a barrier to entry in a market where the regulator concludes that barriers to entry are already substantial. Ofcom needs to take a broader and longer term view of the scope for competitive investment in the access network and of the changed competitive environment since 2005.

77. Ofcom should distinguish between the duration of a charge control and the underlying substantive issue which the SMP condition and any eventual remedy seeks to address. Entry into access markets is not a short-term proposition, and cannot be made – or assessed – over a relatively short timescale. Regulatory intervention that is justified by reference to a relatively short-term view will impact on (and disincentivise) long term investment.

78. Even if large scale entry is unlikely to happen in a relatively short timescales, Ofcom is wrong to set charges below replacement costs as this can only discourage the beginnings of such investment and market entry which might, over time, occur to a material degree. Moreover, Ofcom should not limit its consideration of the impact of

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27 Ofcom consultation, paragraph. 3.48.

28 Analysys Mason, *Alternative methodologies for the valuation of BT's duct assets*, 2 March 2010, page 2, ("Analysys Mason Report").

29 Analysys Mason Report, page 23.

30 Ofcom consultation, paragraph 3.51.

price signalling to the fixed access markets, it should also include significant adjacent markets that influence the fixed access market. Ofcom should, for instance, take into account the investments that have been made (and will continue to be made) in wireless access networks; 7 per cent of UK households are using mobile broadband as their only means of internet access, up from 3 per cent in 2009.[31]

79. Ofcom's proposed approach of continuing to artificially constrain prices below their replacement cost, by undervaluing the network assets that are included within the Ofcom model, and thus setting a lower price in the charge control, also distorts competition and investment as between BT's network and other fixed and wireless alternatives. While the RAV Adjustment reduces the downstream price for both WLR and MPF for all downstream CPs (including BT), the real effect is two-fold:

- first, it reduces Openreach revenues overall (affecting incentives to invest)
- second, it makes it harder for alternative access networks to become more established because they must compete against a lower-priced alternative.

Openreach contends that Ofcom has failed to properly address these concerns when setting out its proposals.

80. Openreach strongly disagrees with Ofcom's view that longer term considerations are addressed by access charges rising to replacement cost levels over time.[32] First, the process will not be completed until 2037 – so proper, market-based incentives are actually only being very gradually restored. Second, the very fact that incentives are slowly being restored may have the very consequence that investment in competing infrastructures will be postponed until such time when they have largely been restored.

81. Holding prices below their replacement costs will discourage market entry. This, in turn, means that Openreach's SMP is likely to be prolonged for longer than it would otherwise exist. Regulation therefore risks becoming self-fulfilling i.e. Ofcom finds that Openreach has SMP and then imposes charge constraints which will only serve to prolong the very SMP on which the need for regulation is justified.

82. Ofcom gives no substantive reconsideration to changes in market conditions other than to note that it has maintained its view that Openreach has SMP and that "*the competitive landscape has not changed significantly since 2005*".[33]

83. A key distinction is between upstream and downstream competition. While there are new wholesale access options open to CPs that were not available in 2005, it must be recognised that a key consideration in 2005 was Ofcom's desire to stimulate competition in downstream markets by encouraging CPs to compete against BT on the

31 In Ofcom's recent research regarding mobile broadband (see footnote 12), Ofcom recognised that mobile broadband is already proving to be an adequate substitute for fixed broadband despite the fact that mobile broadband performs at levels lower than those typically delivered by fixed broadband services. Services often have different characteristics, but this does not mean they cannot be substitutes, and thus compete against each other. For some customers, the lower performance levels are offset by cost savings and the fact that mobile services can be accessed when on the move.

32 See, for example, "The approach Ofcom is taking will, in the longer term, restore the asset base to its CCA value in line with Ofcom's previously stated view on the appropriateness of CCA as a basis for encouraging infrastructure investment.", Ofcom, *Valuing Copper Access*, 18 August 2005, paragraph. 4.28:

33 Ofcom consultation, paragraph 3.43.

basis of MPF and/or WLR.[34] The policy to stimulate such competition clearly influenced the design and introduction of the RAV Adjustment, as opposed to using a full CCA valuation. There has, however, been no proper recognition as to the success of this policy in this consultation and thus about the specific need to continue with the RAV Adjustment.

84. The regulatory controls flowing from the 2005 *Valuing Copper Access* statement have met these objectives – the growth of third party competition is supported by Ofcom's findings in the 2010 WLA Market Review:

> *"…at the wholesale level, the main development has been an expansion in the take up by [non-BT CPs] of wholesale products used to supply broadband, in particular LLU…take-up has increased rapidly, from around one million lines in November 2006 to over seven million homes today. The demand for LLU inputs has come from multiple network operators, three of which now have UK coverage for their LLU-based services exceeding 60 per cent. This has led to the creation of a highly competition retail market for broadband…"*[35]

85. The issue now is whether there is any need to maintain the low regulated prices which succeeded in establishing LLU and WLR-based competition. There is no reason why an increase in MPF and WLR charges from 2011 would undermine the success of this policy, in particular because the increase would apply to all competitors using Openreach's access network (including BT's downstream business itself).

4.2.3 Costs of sunk investments should be fully recovered in access charges

86. Openreach considers that there remain strong economic efficiency reasons to ensure costs of sunk investments are fully recovered in access charges and Openreach objects to Ofcom suggesting in this case that it can be appropriate to dismiss sunk costs.

87. When there are large fixed (capital) costs, it is not efficient to price on the basis of marginal costs excluding sunk costs, as prices will not then reflect the full resource costs involved in supplying the service on a sustainable basis. Therefore the important standard for allocative efficiency is long run incremental costs, a specific form of marginal cost, which includes sunk costs (valued on a replacement cost basis).

88. In its description of the effects of 'regulatory hold-up',[36] Ofcom itself acknowledges the adverse consequences if sunk costs are not recognised in charges. The charges will not cover Openreach's efficiently-incurred costs, and investors will not be permitted a fair return on their investments. In similar vein, the EU Access Directive[37] is clear that in setting access charges, a National Regulatory Authority 'shall' have regard to the [past] investments made by the regulated supplier, such that this allows a reasonable ROCE

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34 Ofcom consultation, paragraph A5.23.

35 Ofcom, 2010 WLA Market Review, paragraphs 2.22-2.23.

36 Ofcom, *Strategic Review of Telecommunications Phase 1 consultation document*, 28 April 2004, paragraph 5.77.

37 Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (the "Access Directive").

rate.[38] We are therefore very concerned that a form of regulation which disregards sunk costs should be discussed as offering one practical option for duct assets.

89. We strongly disagree with Ofcom's suggestion that 'dynamic efficiency' and 'regulatory certainty', "*could imply remuneration on the basis of all or none of the sunk costs, or something in between.*"[39] 'Dynamic efficiency' cannot be served by ignoring sunk costs where charges would be below the level sufficient to fund a sustainable network. Moreover, it would tend to increase rather than decrease regulatory uncertainty to indicate that charges currently set to recover sunk costs may at some stage disregard sunk costs.

4.2.4 Ofcom's considerations of productive efficiency support a full CCA approach

90. Ofcom's own analysis suggest that their consideration of productive efficiency supports a full CCA approach. In justifying the RAV Adjustment on the grounds of productive efficiency Ofcom refers to the differences in charges and not the absolute level of the anchor charge (say, for LLU). The impact of moving to a full CCA approach would be to increase the absolute level of charges while broadly maintaining the price differentials between services, thereby satisfying Ofcom's own views regarding productive efficiencies.

91. Ofcom defines productive efficiency as being:

> *"when the firm cannot decrease the cost of producing a given level of output by changing its production methods in any way"*[40]

92. As Openreach will be under price controls which provide incentives for cost minimisation, it will in any case have every incentive to minimise the cost of production and thus deliver "productive efficiency". It should therefore be recognised that considerations of this form of efficiency do not indicate whether an HCA or CCA valuation should be used and, indeed, price controls have in the past both been based on HCA cost standards and CCA cost standards.

93. Ofcom then proceeds to state that there:

> *"...is an asymmetry between the costs to the competitor of building a new network and the costs of using BT's network…[t]his is because BT's duct network has already been built and, as noted above, the assets are effectively largely sunk, whereas the costs to a competitor of building a new network have not yet been incurred i.e. all the duct would have to be purchased and laid in the ground."* [41]

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38 Access Directive, Article 13(1), as amended: "…To encourage investments by the operator, including in next generation networks, national regulatory authorities shall take into account the investment made by the operator, and allow him a reasonable rate of return on adequate capital employed, taking into account any risks specific to a particular new investment network project."

39 Ofcom consultation, paragraph A5.44.

40 Ofcom consultation, paragraph A5.36.

41 Ofcom consultation, paragraph A5.38.

94. From this, it is asserted that:

> *"...efficient prices should be set close to the marginal cost of using BT's duct."*[42]

95. Although under the heading of "Productive efficiency" Ofcom's comments about efficiency here seem to be more relevant to consideration of "allocative efficiency". We have commented above on this in our discussion on the relevance of sunk costs.

96. Ofcom's further observation under the same heading is that that:

> *"[p]roductive efficiency .. requires that the difference in charges between the services should reflect the difference in their incremental costs"*[43]

97. This refers to the differences in charges and not what is at issue here i.e. the absolute level of the anchor charge (say, for LLU), from which the cost differences are calculated.

98. Thus there is no basis to conclude that consideration of "productive efficiency" favours any one cost basis over another.

4.2.5 Regulatory certainty versus the importance of cost recovery for network assets

99. In making its proposals, Ofcom places significant weight on the continuation of the RAV Adjustment to maintain a stable regulatory environment. From this, Ofcom believes its approach is likely to promote sustainable competition and confer the greatest possible benefits on the end-users.[44] Implicitly Ofcom believe that reverting back to a full CCA valuation for pre-1997 assets might discourage overall investment (against the levels that would otherwise attain) and hamper the development of competition.

100. Policy stability can generally be a beneficial characteristic of regulation, but that does not mean that regulatory policy should not change regardless of circumstances. Regulatory policy in this area has changed at least twice before – in 1997, when CCA was introduced in place of HCA, and more recently in 2005, when HCA was re-introduced on the pre-1997 assets. Stability has therefore been a secondary consideration.

101. It is clear that Ofcom anticipated a full review of the 2005 decision[45] which must imply that regulatory stability is not an over-riding imperative in this case and that this issue would need to be judged on its merits at a future point in time. This is apparent from the Ofcom consultation:

> *"…In Part 2 Ofcom stated that it proposed to implement its proposals for modifying the path of cost recovery against the in-scope assets until such time as the competitiveness of the appropriate markets is re-assessed. This was indicated as likely being 2009/10. In order to provide some regulatory certainty regarding these changes Ofcom*

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[42] Ofcom consultation, paragraph A5.38.

[43] Ofcom consultation, paragraph A5.40.

[44] Ofcom consultation, paragraph A5.53.

[45] Ofcom consultation, paragraph 3.37.

undertakes to implement the conclusions of this review in the 2005/6 financial year and to implement the price adjustments through the normal cycle of price reviews of the relevant products, beginning with full MPF LLU. Ofcom will re-examine the conclusions of this review in light of the results of the next Telecommunications Strategic Review or in 2009/10 whichever is the earlier.'[46]

102. Stability must support a specific purpose if the regulator is to favour the application of costing principles which are not consistent with economic price signalling. Put in the alternative, one needs to ask, 'what *specific* detriments might arise from a change in policy?'

103. In this regard, Ofcom suggests that a return to full CCA valuation of all assets could undermine the business cases of the LLU operators.[47] However, Ofcom does not explain specifically why the business case for LLU operators might be undermined and we do not agree that this is likely to be the case. Any change to LLU and WLR prices, as a result of a CCA revaluation, would apply to all competitors (much as would a change in corporation tax or a change in the price of fuel) so it would not cause any one type of competitor to be at a disadvantage compared to another.

104. In this case a broader set of factors need to be balanced against Ofcom's concern that a return to full CCA valuation might contribute to a *perception* that regulation might not be consistent over time, with the risk that future competitive investment would be stifled.[48] These are:

- that lower prices would not necessarily create a better margin for WLR/LLU providers as the lower input prices apply to all suppliers and the extra margin is likely to be competed away
- the lower charges will remove a margin from other access infrastructure providers
- importantly, the lower charges deny Openreach cost recovery as we explain in section below.

105. Ofcom itself points out the importance of *relative* prices as opposed to *absolute* price levels for competition incentives in NGA as opposed to LLU or WLR-based services.[49] The very same logic must imply that price stability cannot also have a high importance when considering LLU and WLR-based competition.

106. If there was a prospect that only LLU operators would experience increased prices, it may undermine these operators. But a return to full CCA would not have the effect as it would apply to their competitors too. We accept that competitors who self-supply their access facilities might gain.[50] However, these are the very competitors who have been at a disadvantage whilst prices have been below cost, and they would only gain to the

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[46] Ofcom, *Valuing Copper Access*, 18 August 2005, paragraph. 5.22.

[47] Ofcom consultation, paragraph 3.44.

[48] Ofcom consultation, paragraph 3.44.

[49] Ofcom consultation, paragraph A5.49.

[50] This does not include BT Retail or BT Global services which purchases its access services from Openreach on the same terms as do its competitors.

extent that they are being granted the ability to compete in a market undistorted by prices being held below replacement cost.

107. For the reasons given above, we therefore consider that the Ofcom consultation puts undue weight on the importance of regulatory stability as a reason for not adopting a replacement cost methodology (i.e. full CCA) for Openreach's fixed assets.

4.3 No windfall from CCA valuation for pre-1997 assets

108. The remaining justification for the proposed approach is that a move to a full CCA valuation would deliver "windfall gains" to BT's shareholders. We strongly challenge the assertion that any such gains would result and we set out below why returning to a full CCA valuation for pre-1997 assets would not result in any windfall gain.

109. In Annex 5 of the Ofcom consultation, Ofcom explains its 2005 *Valuing Copper Assets* decision to revert to HCA valuation of BT's pre-1997 assets due to concerns around possible over-recovery of *incurred costs*.[51] Ofcom's assertions ignore the actual profile of investment and the fact that relevant shareholders only acquired the assets in 1984.

110. We acknowledge that there is potential for over-recovery during a switch from HCA to CCA if the asset has been consistently treated on an HCA basis over its lifetime and the actual circumstances mirrored a conceptual "single asset" model as illustrated by reference to Figure A5.1 of the Ofcom consultation. However, in practice these assets have not been consistently charged for on an HCA basis over their lifetime.

111. Prior to BT's privatisation in 1984, there cannot have been cost allowance under price regulation on an HCA basis. BT's shareholders acquired these assets many years after the assets were installed. Thus, they cannot have benefitted from the early years of the asset's lifetime when Ofcom suggest that HCA costs were higher than CCA costs, i.e. the periods equivalent to Periods 1 to 4 in Figure A5.1 from Ofcom's consultation, reproduced below as Figure 3. Rather, the beneficiary in those years would have been the government.

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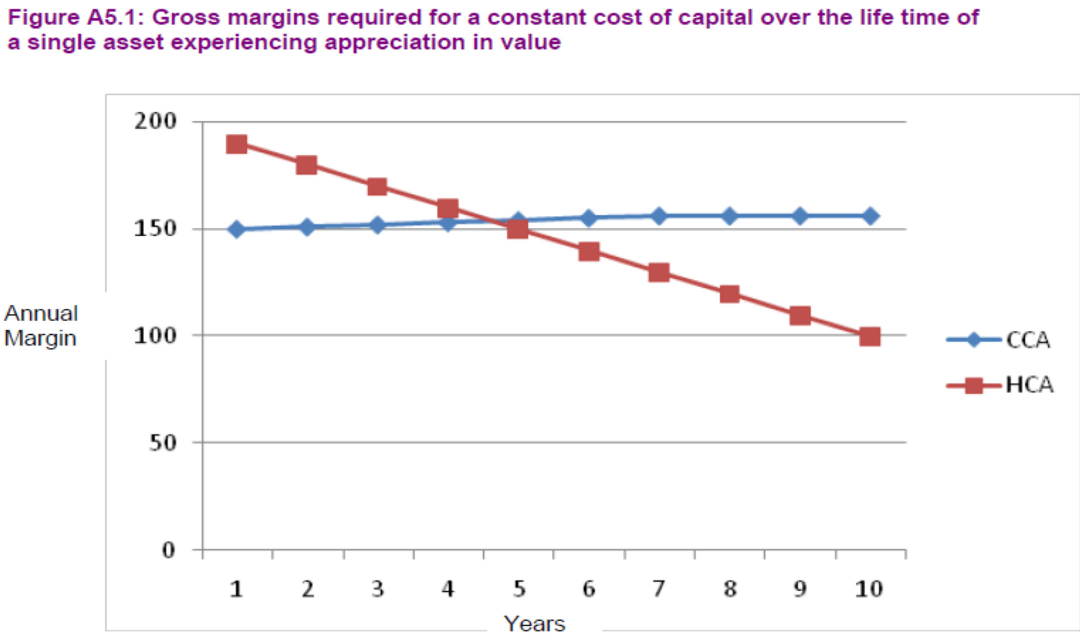
51 Ofcom illustrates their theoretical concern that a change from an HCA to CCA valuation basis leads to an over-recovery of incurred costs over the lifetime of an asset, refer Ofcom consultation, Figure A5.1.

Figure 3 Ofcom's simplified diagram to demonstrate a potential windfall



4.3.1 Quantitative analysis based on full CCA asset valuations

112. To move beyond the theoretical critique of the principles that Ofcom relies upon, we have developed a quantitative model based on actual historic capital expenditure ("capex") to demonstrate that BT shareholders would not experience any windfall from a return to full CCA.

113. The model which we developed estimates the profile of allowed revenues (i.e. depreciation plus return on capital) under HCA and CCA pricing based on actual historic capex by BT on duct assets installed from 1944 (and thus relevant to the period since privatisation) to 1996.

114. As described below, this model demonstrates that:

- Ofcom's claim that BT earned a windfall gain during 1997-2005 and would earn a further windfall gain from 2011 onwards if CCA pricing were reinstated is entirely dependent on revenues earned **before privatisation** in 1984, i.e. when BT plc did not even exist

- moving to CCA pricing from 2011 onwards would still result in an **under-recovery of costs**. In other words, contrary to Ofcom's claim, there would **be no windfall gain** if CCA pricing for pre-1997 duct assets were re-introduced.

115. The implications from this analysis are clear:

- Ofcom's justification for the continuation of the RAV Adjustment for pre-1997 assets on the basis that BT would otherwise earn a windfall gain is mistaken

- given the further absence of any other compelling reason to depart from the use of full CCA valuations in setting charges, Ofcom must therefore return to CCA pricing for all assets (pre- and post-1997) in order to ensure the correct economic build-or-buy signals are given to the market, as well as to ensure that BT's shareholders are adequately compensated.

Details of the model and analysis

116. The model takes capex on duct assets between 1944 and 1996 and, using the assumptions outlined in Box 1 regarding asset price growth, WACC and asset lives estimates a profile of "allowed revenues" under HCA and CCA pricing methodologies i.e. the implied revenues that would be permitted by regulation if either of the valuation methodologies were used to set charges.

Box 1: Modelling inputs and assumptions

Inputs

Capex (1944 – 1996): BT Fixed Asset Register

RPI inflation: Office for National Statistics ("ONS") data for 1948-2010. For 1944-47, inflation is based on indices contained in O'Donoghue, J. and Goulding, L. (2004), Consumer Price Inflation since 1750, Economic Trends 604, March.

Assumptions

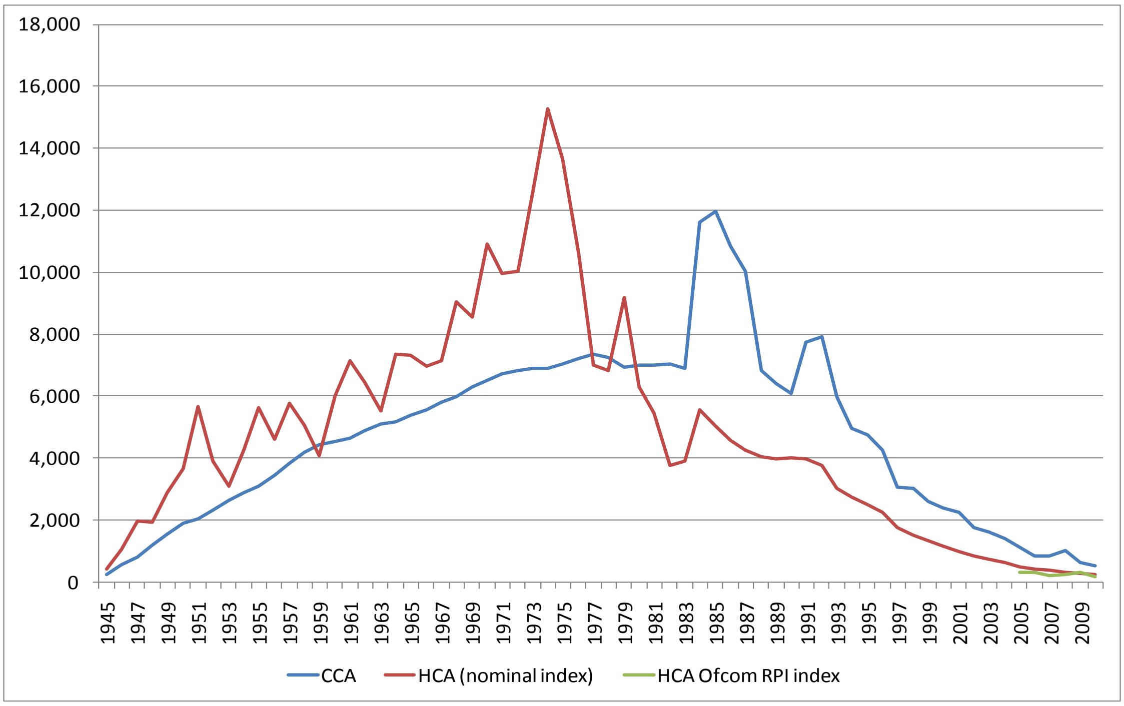
WACC: 1944-1983 (RPI + 5%); 1984-1992 (17.5%); 1993-1996 (15.0%); 1997-2004 (12.5%); 2005-2008 (10.0%); 2009-2010 (10.1%)

Annual asset price growth: RPI + X, where X is calibrated in the base case scenario to ensure that the Net Replacement Cost (NRC) in 2010 for all assets (ie, pre- and post-1997 assets) reaches the duct valuation of £7.5bn. Based on this calibration, X is set at 2.0% in the base case

Asset life: 40 years

117. The resulting profile of allowed revenues which represent the costs that can be recovered under HCA and CCA is shown below, expressed in 2010 terms (see Figure 4).

Figure 4 Allowed annual revenues under HCA and CCA, in 2010 terms (£m)[52]



Source: BT model

118. The results from the model are consistent with the two general principles outlined in the Ofcom consultation:

- first, if allowed revenues are based consistently throughout the assets' lifetime on either HCA (red line) or CCA (blue line), the net present value ("NPV") would be the same and there would be no under- or over-recovery. In both cases, the NPV matches the investments in the assets when discounted by an index derived from the WACC

- second, with asset price appreciation, HCA revenues will be above CCA revenues early in the assets' lifetime, with the pattern reversing in later years. This trend can clearly be seen in Figure 4 and is consistent with Ofcom's "single asset" model shown in Figure 3.

119. A key finding from our model is that the cross-over point between HCA and CCA revenues occurred around the late 1970s/early 1980s. Following Ofcom's assumption that prices were initially based on the HCA cost of assets, it is therefore clear that all of the benefit from the early years of the assets' lifetime, when HCA costs were higher than CCA costs, occurred before the privatisation of BT in 1984. Following Ofcom's logic, the gain over CCA allowance therefore accrued to the government and not to BT's shareholders. **This finding provides the basis for our first conclusion**: Ofcom's claim that BT earned a windfall gain during 1997-2005 and would therefore also earn a

52 From 2005 onwards, two HCA allowed revenue profiles are shown to capture Ofcom's RPI Indexation approach (green line). The standard HCA allowance continues to be the red line. Allowed revenues are expressed in 2010 terms by uplifting past revenues with a WACC Index constructed using the WACC in each year. Using the WACC to uplift/discount revenue allowances in different years ensures that the NPV of the HCA and CCA revenue profiles adds up to the same amount, as required in order to ensure no over- or under-recovery over the lifetime of the assets.

windfall gain from 2011 onwards if CCA pricing were re-instated, is entirely dependent on revenues earned before privatisation in 1984, i.e. before BT plc came into existence

120. The asset lifetime perspective must therefore be replaced by one which is more relevant to the factual history of BT's change from a state institution to a regulated, private sector company. The critical change was the sale of the assets to private sector shareholders in 1984. The relevant question now becomes whether the move to CCA pricing in 1997-2005 and the return to CCA pricing from 2011 onwards has or would lead to an over-recovery of costs **from the perspective of the new shareholders that acquired the assets in 1984.**

121. We use our model to answer this question:

- first, we need to work out what profile of revenue allowance from 1984 onwards would allow the new shareholders of the company to recover their original investment and earn a reasonable return

- second, we compare the revenue allowance against the estimated revenues earned by BT between 1984-2010 in order to assess whether the shareholders have been under- or over-compensated, as well as test the effect of a return to CCA pricing from 2011 onwards.

122. As set out in Box 2 below, based on the privatisation sale price, we can estimate that BT's new shareholders required a revenue allowance equal to 75.9% of the NRC of assets in 1984, i.e. a discount of 24.1% below the NRC. This is consistent with the observation by Carne, Currie and Siner[53] that BT was not sold significantly below the replacement cost value of its assets.

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[53] Simon Carne, David Currie and Martin Siner, *The Competition and Policy Implications of Regulatory Depreciation and the Asset Base*, Regulation Initiative Discussion Paper Series Number 25, London Business School, February 1999, page 16, http://www.simoncarne.com/wp-content/uploads/RAB.pdf.

Box 2: Estimating the required revenue allowance from the privatisation sale price

BT was privatised in 1984 at 130p per share. Around 3m shares were sold raising £3,900m for ~50% of the company. The implicit valuation for 100% of the company was therefore £7,800m.

As of 31 March 1984, the company had assets worth £14,076m in NRC terms, long term liabilities of £3,251m and net current assets (working capital) of £361m.

The new shareholders' required revenue allowance must be sufficient to allow them to recover their original investment and repay the company's creditors. In other words, the company's assets need to earn revenues, in March 1984 NPV terms, which are at least equal to the company's valuation (£7,800m) plus its long-term liabilities (£3,251m) minus the available working capital (£361m).

This is equal to £10,690m, which is **75.9% of the NRC in March 1984** (£10,690m / £14,076m = 75.9%).

Source: BT analysis of the 1984 Prospectus [54]

123. Based on our model, the opening value for the NRC of duct in 1984 was approximately £2,834m, so shareholders required £2,153m in allowed revenues (75.9% of £2,834m).

124. To work out the required total revenue allowance from 1984 onwards, we also need to add the capex expenditure made by BT between 1984 and 1996. Based on the data from the Fixed Asset Register discounted by the annual WACC in each year, we can estimate this to be £902m expressed in 31 March 1984 terms. Therefore, the total required revenue allowance from 1984 onwards, expressed in 31 March 1984 terms, is £3,055m (£2,153m + £902m).

125. The answer to the question whether the actual revenue allowances have exceeded or fallen short of this amount is shown in Table 2.

[54] British Telecom, *British Telecom: Offer for Sale of Ordinary Shares*, 1984, http://www.btplc.com/Sharesandperformance/Financialandotherinformation/Listinginformation/1984_Prospectus.pdf.

Table 2 Actual vs. Required allowed revenues, in 31 March 1984 terms (£m)[55]

Period	**HCA revenue allowance (£m)**	**CCA revenue allowance (£m)**	**Pricing basis from 1984**[(A)]	**Actual allowed revenues from 1984 (£m)**
Pre-privatisation (1944-1983)	£7,381	£5,470	n/a	n/a
1st price control (1984-1988)	£689	£1,509	HCA	£689
2nd price control (1989-1992)	£462	£827	HCA	£462
3rd price control (1993-1996)	£308	£586	HCA	£308
CCA pricing (1997-2004)	£262	£532	CCA	£532
HCA pricing (2005-2010)	£45	£145	HCA[(B)]	£45
SUB-TOTAL up to 2010	**£9,147**	**£9,069**		**£2,036**
Post-2010	£60	£138	CCA[(C)]	£138
TOTAL LIFETIME	**£9,207**	**£9,207**		**£2,173**
			Required Revenue Allowance (£m)	***£3,055***
			Up to 2010 (over/under-recovery)	*-£1,019*
			Lifetime (over/under-recovery)	*-£881*

Source: BT model

126. The last column in Table 2 shows the estimated revenue allowances BT obtained since 1984 consistent with the Ofcom explanation of the alleged windfall. For example, between 1984 and 1996, HCA pricing was assumed to be in place, followed by a period of CCA pricing (1997-2005) and a reversal to HCA in 2005-10. The total revenues under these assumptions are £2,036m in 1984 prices.

127. We show that the CCA revenue allowance after 2010 is £138m in 1984 prices, which means that total revenues would be £2,173m. This is around 29% (£881m/£3055m) short of the required allowance estimated above at £3,055m. This result is not unexpected, given the annual cost trends which we showed in Figure 4. Furthermore, even if Ofcom were to return to CCA pricing from 2011 onwards, shareholders would still be around 29% (£881m/£3055m) short of the required allowance. **This provides the basis for our second conclusion**: moving to CCA pricing from 2011 onwards would still result in an under-recovery of costs. In other words, contrary to Ofcom's claim, there would be no windfall gain if CCA pricing for pre-1997 duct assets were re-introduced.

4.3.2 Sensitivity analysis demonstrates that our conclusions are robust

128. We have conducted sensitivity analysis and this shows our conclusions are robust. The analysis is conducted on:

- *the asset price growth:* RPI + 0% and RPI + 1%, in addition to the Base Case of RPI + 2%; and

55 Notes to table: (A) We assume, consistent with Ofcom's reasoning, that allowed revenues were based on HCA pricing between 1984 and 1996, then switched to CCA pricing between 1997 and 2004 and finally reverted back to HCA pricing in 2005-10. (B) Between 2005 and 2010, HCA allowances are based on Ofcom's RPI Indexation approach rather than the standard HCA pricing methodology, i.e. the green line in Figure 1 rather than the red line. (C) Assumes a return to CCA pricing from 2011 onwards.

- *the required revenue allowance for the 1984 NRC and pricing basis between 1984-88:* in addition to the Base Case scenario where shareholders are assumed to have paid 130p per share, we have also modelled a scenario which captures the fact that share prices rose to 170p immediately after flotation. Under this scenario, we have estimated (using the same approach outlined in Box 2 above) that shareholders would have required a revenue allowance of 93.0% of the NRC in 1984 (i.e. a discount of 7.0% below NRC). Using this higher market value of the shares can be matched with an expectation that regulation would be based on prices close to CCA values. In this scenario, we therefore replace the HCA assumption for the period shortly after privation (1984-88) – which was consistent with Ofcom's logic – with a CCA assumption for this first price control period (i.e. the RPI-3% control set out in the 1984 Prospectus).

129. As shown in the table below, under all the different scenarios modelled, shareholders would continue to face a shortfall of revenues even if CCA pricing were re-introduced from 2011 onwards.

Table 3 Sensitivity analysis: Lifetime over/under-recovery (£m, in 31 March 31 1984 terms)

Real asset price growth (X)	**Required revenues as a % of 1984 NRC / Pricing basis in 1984-88**	
	75.9% / HCA (Base Case)	93.0% / CCA
0.0%	-£598	-£360
1.0%	-£729	-£444
2.0% (Base Case)	-£881	-£545

Source: BT model

130. Sensitivity analysis above shows that there are no plausible scenarios where a return to full CCA would lead to an over-recovery of cost.

4.4 Ofcom should use valuations set out in the Regulatory Financial Statements

131. As outlined above, there are no compelling reasons for Ofcom to deviate from full CCA. Therefore our contention is that Ofcom should use the audited data set out in the CCA RFS we publish each year to value duct assets.

4.4.1 BDO report does not raise any significant issues with the use of the RFS data

132. Ofcom refers to the work that it commissioned BDO LLP to carry out. Ofcom states that this was "*an independent assessment of BT's valuation methodology*" and says that BDO "*were not asked to undertake an independent valuation of BT's duct or to validate the current valuation*".[56] BDO describe the scope as being "*for the purposes of highlighting potential issues for further analysis*".[57]

56 Ofcom consultation, paragraph A5.115.

57 BDO, *Review of the BT Duct Valuation 2009/10 Report*, 21 March 2011, section 01.1.3 on slide 4, ("BDO Report").

133. It is not reasonable to attach significant weight to BDO's Report given that they were explicitly not asked to undertake an independent valuation of BT's assets and during their assessment BDO spent insufficient time with Openreach to fully understand our methodology: for example, BDO conducted only a few hours of calls/meetings with Openreach.[58]

134. While Ofcom makes a number of references to the BDO Report, it is clear that the report does not make any substantial criticisms of BT's approach. The BDO report does not contradict the view that the valuation of the duct assets for the 2009/10 RFS is reasonable and derived from a robust process.

4.5 RAV for post-1997 assets

135. Openreach believes there should not be any distinction between assets of different vintages, and therefore the RAV model would not be required. We consider all assets should be based on CCA values. Nonetheless, we address the Ofcom proposal in the event that Ofcom continues to consider such a distinction can be justified.

136. Ofcom's proposal for the post-1997 assets is to base the valuation on our actual capex, after applying:

- an index to account for increases in duct costs based on the GBCI, offset for assumed efficiency improvements over time

- a discount factor to reflect efficiency gains which might be available when building a new national network.

4.5.1 Indexation

137. BT's systems do not record when specific duct was installed. Therefore Openreach understands the purpose of indexation given that it is not possible to make an absolute valuation of only the post-1997 assets. In view of this, indexation based on capex, which is recorded each year, provides an alternative methodology which can be used to approximate a replacement cost valuation.

138. If an indexation valuation is preferred, then the question arises as to what is the most appropriate index to use. The purpose of indexation is to attempt to match valuations against replacement cost. We agree with Analysys Mason that an industry-specific cost index should be used for this purpose[59] and that the GBCI would be an appropriate index. This is more precise than the RPI and thus more likely to follow replacement costs for the specific activity in question.

139. Openreach accepts that a cost index might need adjustment for efficiency gains if the index is to reflect the unit cost of supply. The evidence suggests that the construction sector has not increased output per man hour as fast as 1% per annum over the relevant period and therefore that Ofcom's 1% annual adjustment to offset for productivity gains is too high. As explained in our response to Question 3.9, based on data from the ONS,

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[58] BDO Report, section 01.1.4 on slide 4 and Appendix A.1 on slide 19.

[59] Analysys Mason Report, page 46.

we consider that Ofcom should use a figure no higher than 0.5% as an adjustment factor if the GBCI is used. Using a higher figure will underestimate replacement cost.

140. There should be no annual efficiency adjustment factor to the RPI, if this is to be used, as this is a price and not a cost index.

141. Finally, Ofcom appears to have changed its position on the preference to use GBCI part-way through the consultation process, prior to receiving any formal consultation responses and without justifying the change. In particular, in response to a stakeholder query about the consistency of inflations applied to duct, i.e. whether RPI or GBCI, Ofcom clarified that:[60]

"*Modelling forward through the charge control period, however, we propose to use RPI as the most reliable know index and one that does more relatively closely with industry indices."*

142. To the extent that this suggests Ofcom's intention to use RPI instead of GBCI in calculating the value of the post-1997 duct, then Openreach does not agree and has set out above and in our response to question 7.6 that it considers GBCI a more appropriate index to use.

4.5.2 National Discount Factor

143. The national discount factor is applied to Openreach's absolute valuation of duct in the RFS to mirror the scale and scope economies that might be realised if the entire network were replaced all at once, rather than built on a piecemeal basis over many years. As such, the RFS valuation represents a hypothetical cost of replacing the Openreach assets such as might be incurred by a new entrant which was installing duct on a national scale over a relatively short time period.

144. As discussed in our response to question 3.10, Ofcom proposes to reduce its estimate of replacement costs for post-1997 assets (based on an indexation approach) by applying a national discount of 14.5% which, in effect, is to represent the costs faced by a hypothetical new entrant. This figure of 14.5% is applied by BT in its RFS, where any resulting changes in asset value are recognised as holding gains or losses in BT's Profit and Loss Account.

145. In contrast, the valuation of network assets which Ofcom is proposing to use in the charge control does not take into account any holding loss and consequently excludes the full value of the duct network. In this case, the effect of Ofcom's approach is an under-recovery of Openreach's efficiently-incurred costs. Given that this conflicts with Ofcom's stated objective for these charge controls, Ofcom must either:

- justify why such an outcome is appropriate, or
- not apply the national discount such that the valuation reflects the piecemeal basis on which Openreach invests in network assets in the real world.

[60] Ofcom response to stakeholder questions, published 29 June 2011, available at: http://stakeholders.ofcom.org.uk/consultations/wlr-cc-2011/clarifications/

4.5.3 The Analysis Mason Report

146. In developing its proposals for valuing the post-1997 assets, Ofcom draws upon the Analysys Mason report to substantiate its thinking. We have addressed many of the relevant issues raised by Analysys Mason above and in our responses to Ofcom's questions.

147. Openreach's key concern is the relative merit of absolute valuation and indexation. We are unclear what opinion Analysys Mason hold on this point. Their apparent conclusion is that:

> *"…in choosing between the different methods of updating an existing valuation, it is our view that indexing is the most appropriate method, though this will require occasional use of absolute valuation to limit any possible loss of accuracy of the index. This preference for indexation is largely due to its practicability and robustness, since it is based on external data sources that are readily available. It is also our view that it is likely to be appropriate in the case of duct assets to use an industry-specific index that takes account of changes in construction and civil works costs, adjusted for productivity gains…"*[61]

148. We understand this paragraph as stating that, for <u>updating</u> an existing valuation, indexation appears to be preferable. The preference for indexation appears to be primarily for practical reasons and as a short to medium term measure. However, if these practical reasons are not an issue, we do not believe the report provides any grounds for preferring an indexation approach.

149. Moreover, updating an existing valuation <u>still</u> requires an existing robust, absolute valuation of replacement cost to start from. Analysys Mason do not appear to explain why, if such a starting valuation can be generated, indexation is nevertheless still required. Given price controls are set on a periodic basis anyway and annual updating is not required, Openreach considers that the Analysys Mason Report does not provide any justification for a preference for indexation over an absolute valuation approach.

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[61] Analysys Mason Report, section 4, page 46.

5 Cost Allocation - Key Issues

150. This section considers the underlying cost assumptions made by Ofcom in its consultation, including cost allocation issues, inflation, efficiency, pensions deficit repair payments and the WACC.

5.1 Approach to cost allocation

151. The Cost Allocation model outputs costs on a CCA basis. As explained in section 4, Openreach agrees with Ofcom that in this case CCA provides the appropriate economic price signals for both suppliers and consumers, and provides the correct investment signals to potential market entrants.

152. Openreach is supportive of the cost modelling approach taken by Ofcom, which is consistent with the methodology endorsed by the CC. We believe that using data anchored to the Openreach Management Accounts and reconciled to the RFS provides a more accurate basis on which to set future prices compared to the traditional Cost Volume Relationship models.

153. The Ofcom approach consists of two main models (see section 3.3):

- the information used in the Cost Forecast model is Openreach management information for financial years 2009/10 (actual) and 2010/11 (actual and forecast). This is used by Openreach to project forward its expectations for the business based on various assumptions around volume, inflation and efficiency among others
- the Cost Allocation model is a simplified version of the RFS designed to achieve a similar unit cost outcome but using fewer and less complex allocation bases.

154. The financial year 2009/10, which is the base year of the Cost Allocation model, is anchored to the RFS via a full and detailed reconciliation of costs at the total and product level.

155. The second year of the model, financial year 2010/11, is then reconciled to Openreach's management accounts and plans.

156. Ofcom has then applied their own assumptions for volumes, inflation and efficiency in order to project costs forward.

157. Whilst supportive of the overall approach used, there are several key areas where we disagree with Ofcom in its implementation. Most notably, we disagree with Ofcom's approach and assumptions in the following areas:

- Ofcom's pay inflation estimate is too low at RPI, and should be RPI+1%
- Ofcom has not applied inflation to a number of cost categories
- Ofcom's efficiency target is unsupported by the evidence and is too high at 4.5%; it should be no higher than 3.5%

- corporate overheads are understated because Ofcom effectively apply a higher and incorrect rate of efficiency
- the allocation of repair costs understates LLU costs and overstates WLR costs
- EvoTAM costs should be spread across all LLU lines
- the WACC estimate for Openreach copper is too low
- where the recovery of efficiently incurred costs are disallowed in the Sub Loop Unbundling ("SLU") charges dispute, these costs must be reflected in this charge control.

5.1.1 Inflation

158. In its cost models, Ofcom increases costs to account for inflation. Non-pay costs, such as equipment, accommodation etc, attract an inflation rate which is below the RPI. Pay costs, such as labour, attract an inflation rate which is higher than the non-pay rate, and should be higher than RPI because, as set out below, wages historically increase at a faster rate than prices.

159. Openreach agrees that it is appropriate to reduce RPI to estimate non-pay inflation in order to make allowances for changes in value-added tax and mortgage interest costs. However, this estimate for **non-pay** inflation should not be used as the base for calculating **pay** inflation.

160. The base for calculating pay inflation should be RPI. Ofcom should then adjust its base inflation estimate upwards by 1% rather than the proposed 0.5% per annum, because:

- real wage inflation of 1.4% per annum is consistent with the long term historical trend (see Figure 11 in response to question 7.4, according to ONS data covering the period January 1991 to January 2011)
- the recent economic downturn has impacted negatively on real wage inflation. However, over the course of the charge control period, it is appropriate to assume that it will trend back to the observed long term historical average
- this would be consistent with recent CC precedent, which states that forecasts for real wage inflation should converge to the long term historical average by the end of the charge control period.[62]

161. Pay settlements are made with reference to RPI. However, instead of adding the real wage adjustment to RPI, Ofcom has in fact added this to their adjusted non-pay inflation rate (which Ofcom has reduced by 0.5% from the prevailing RPI rate). In other words, Ofcom allows for pay to increase in line with RPI only, and no real increase in pay rates is catered for. As mentioned above the long term real wage inflation trend is 1.4% per annum.

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[62] CC, *Bristol Water plc – A reference under section 12(3)(a) of the Water Industry Act 1991*, Report, 4 August 2010, Appendix K, page K25 paragraph 119 (calculations based on ONS data).

162. Finally, Ofcom has treated three cost types as "fixed in nominal terms" with regard to inflation, those being Light User Scheme, Directories and Application Support and Maintenance costs. These costs are driven by inflationary impacts as much as any other costs, indeed, it could be argued that certain cost types should have a higher rate of inflation applied given the specific nature of the costs (i.e. materials and delivery costs of the phonebooks). As per our response to question 7.4, Ofcom should correct this anomaly and apply inflation to these costs in their final decision.

5.1.2 Cost Allocation – Fault incidence, SLAs and EvoTAMs

Fault incidence

163. Ofcom has based its update of usage factors used for allocating repair costs on actual fault incidence data supplied by Openreach. The data shows that MPF has a higher incidence of faults compared with WLR, but less than WLR+SMPF. It is logical that voice-only lines (i.e. WLR only) have a lower fault incidence rate than lines with broadband because there will be broadband faults independent of voice faults.

164. The usage factor data which Openreach originally supplied to Ofcom implicitly incorporated not just the difference in fault incidence, but also the difference in repair service levels. The actual fault incident rate used by Ofcom to adjust the usage factor data provided by Openreach does not account for differences in repair service levels. Therefore, we propose that Ofcom should additionally adjust the fault rate incidence data to take into account differences in service levels, so that the usage factors represents both the impact of different fault rates and different service levels. That is, the usage factors should be amended to reflect the actual costs incurred for the different products.

165. Under current contract terms, LLU is guaranteed to be repaired a day faster than WLR. The number of people, and therefore costs, required to deliver the standard maintenance service for LLU services is greater than that for WLR. Taking both the fault rate incidence and service level impacts into account, Openreach estimates that repair costs for LLU are around 1.2 times greater than WLR. Openreach has set out in our response to question 7.10 a full explanation of the updated view of the usage factors it believes Ofcom should apply in the model for allocating repair costs to services.

Service Level Agreement/Service Level Guarantee ("SLA/SLG")

166. In April 2011, Ofcom asked the Office of Telecommunications Adjudicator ("OTA2") to review the SLA and SLG arrangements for WLR, MPF and ISDN2 provisions which require an engineering appointment. In this process, CPs have requested that a target lead time for appointments be introduced and backed by SLG payments. Any change in the SLA/SLG regimes, which results in Openreach incurring higher costs must be reflected in a commensurate change in the cost base. Ofcom and the OTA2 have indicated to Openreach that if there is a cost recovery issue, it should be addressed via these charge controls in an increase to the costs allowed in charges. Ofcom's final LLU/WLR decision must therefore consider and reflect as appropriate any changes to SLAs/SLGs or leave open the possibility to do so if changes are not agreed by the time of Ofcom's final statement.

EvoTAMs

167. Openreach considers that the cost of EvoTAMs should be fully allocated to SMPF. However, consistent with Ofcom's treatment of TAMs as explained in the 2004 WLA Market Review, Openreach considers that a pricing adjustment should be made such that EvoTAM costs are recovered across all LLU lines, rather than just SMPF.[63] This is explained further in our responses to questions 7.8 and 7.11.

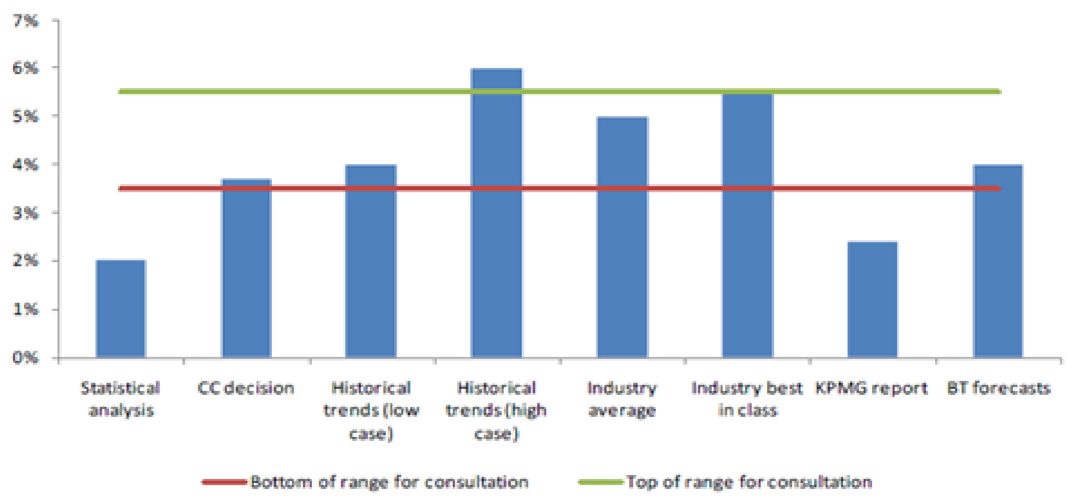
168. In the event that Ofcom does not treat EvoTAM costs consistently with TAM costs, then Ofcom must revisit the rationale for applying a pricing adjustment for TAM costs.

5.2 Efficiency

169. Ofcom proposes a target range for efficiency savings of between 3.5% and 5.5% each year, net of implementation costs, with a midpoint of 4.5%. We do not consider that this range nor midpoint is supported by the evidence Ofcom provides. Openreach considers, for the reasons set out below, that an appropriate efficiency target should be no greater than 3.5% per annum.

170. The evidence Ofcom used to inform its efficiency range is set out in Figure 5 below. Openreach has significant concerns with the levels presented by Ofcom for the three sources that are higher than its midpoint, including in particular the 'Best in Class' estimate (which should be excluded). Moreover, on inspection, it is not obvious why the bottom of Ofcom's proposed range is not lower, i.e. towards 2%.

Figure 5 Ofcom's range of evidence to inform efficiency



171. Ofcom's evidence does not support the upper end of its proposed range. In particular:

- the industry benchmark 'Best in Class" presented here is based on an assessment of costs in discrete functional areas. No one undertaking in the sample set can

63 Ofcom, *Review of the Wholesale Local Access Market*, Explanatory statement and notification, 16 December 2004, paragraphs 8.5 to 8.25, ("2004 WLA Market Review").

achieve 'Best in Class' in all areas. This is an expected outcome given each organisation's different decisions regarding trade-offs between areas of expenditure. The purpose of Ofcom's analysis should be to consider efficiency rates across a range of appropriate comparators. Therefore it is inappropriate for Ofcom's purposes to include 'Best in Class' as an indicator of the range of efficiency that could be expected from Openreach

- the industry average to which Ofcom refers has been incorrectly interpreted as an efficiency target. Openreach has commissioned E&Y to independently review the calculations that should be taken to estimate Openreach's relative efficiency to the industry "peer average" and it concludes that an appropriate efficiency target is the range of 1.9% to 2.6% per annum for this charge control – see section 5.2.3

- in terms of historic efficiency performance Ofcom should use the low case estimate instead of the high case. The high case estimate includes one-off efficiencies which cannot be repeated and therefore cannot be relied upon as a forward looking indicator of future efficiency – see section 5.2.4.

172. Turning to Ofcom's remaining sources of evidence, Openreach considers that an efficiency target of no greater than 3.5% per annum should be applied:

- the CC Determination stated that 3.7% per annum was the appropriate efficiency target for Openreach for the period to 2012/13[64] i.e. covering two-thirds of the duration of this control. One would not expect, and Ofcom does not evidence the case for a deviation from these recent findings

- Ofcom recommissioned the KPMG report. The previous version of this report was relied upon by the CC as the most important indicator of Openreach's scope for future efficiency gains. The updated KPMG report determined a figure of between 2.3% to 2.6% per annum, which is below the bottom end of Ofcom's range – see section 5.2.1 below

- Ofcom states that Openreach's forecast represents an efficiency target of 4% per annum but this fails to fully take into account that there is a degree of execution risk and that this is a challenging target – see section 5.2.5

- statistical analysis supports a 2% efficiency estimate which is significantly below the bottom of Ofcom's range and may suggest that Openreach is efficient – see section 5.2.6.

173. As a cross-check, it is worth considering how Ofcom's proposed efficiency target compares with the decisions of other UK regulators. In the majority of cases, these decisions set efficiency targets which are lower, and often significantly lower, than Ofcom's proposed figure (4.5%) – see section 5.2.7.

174. Finally, corporate overhead costs are understated because a higher rate of efficiency has been applied compared to the midpoint of Ofcom's efficiency range.

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[64] The Carphone Warehouse Group plc v Ofcom (Local Loop Unbundling), Case 1111/3/3/2009 ("LLU Appeal") and The Carphone Warehouse Group plc v Ofcom (Wholesale Line Rental), Case 1149/3/3/2009 ("WLR Appeal"), Competition Commission Final Determinations of 31 August 2010 and Competition Appeal Tribunal Rulings of 11 October 2010; paragraph 2.239.

5.2.1 Ofcom's Approach to Setting an Efficiency Target

175. Ofcom's overarching approach towards efficiency is to apply a top-down efficiency factor that applies to all cash costs. Ofcom therefore has:

> *"....applied a single rate, to all costs, intended to capture the effects of all efficiency gains, regardless of how they might be achieved."*[65]

176. A charge control should contain strong incentive properties for efficiency. The level of the control should allow Openreach to earn returns above its cost of capital if it manages its costs more efficiently than the target set by Ofcom. This acts as an incentive for Openreach to manage its business in an efficient manner so that other operators and end-users benefit in the future.

177. The CC Determination stated that it is appropriate to set an achievable efficiency target and it would not be wrong if it were exceeded:

> *"The purpose of efficiency targets is to promote efficiency over a longer period than one year, and it is not to predict the rate that can be achieved. The target set by Ofcom for Openreach is not necessarily wrong merely because it can be exceeded, or because a plan to exceed it is adopted. In a system of incentive-based regulation, efficiency targets should be capable of being met and exceeded."*[66]

178. The regulator must take a balanced approach when setting the control:

- if it sets the efficiency target too high, access prices for other operators will be too low, thereby encouraging other operators to enter the market inefficiently and leaving the regulated entity to under-recover efficiently incurred costs. The consequences of this are that the regulated firm may delay sensible investment decisions or not maintain the network in order to meet financial targets

- if the regulator sets the efficiency target too low, other operators will face input prices which are too high thereby discouraging efficient market entry, the regulated entity will make higher profits and end-users will be paying too much.

179. The ramifications to Openreach from setting an efficiency target that is too high are severe – the under-recovery of costs. However, the consequences for other CPs are not so high, indeed, should our service levels or maintenance of the network deteriorate in the aim of achieving the financial targets, then CPs are financially compensated through the SLA/SLG regime. As a result, Openreach effectively pays twice for the failure to achieve the efficiency target.

5.2.2 CC Determination and KPMG Report

180. The recent CAT ruling in the LLU Appeal was based on an assessment by the CC which determined that the level of efficiency savings in the price control should be

[65] Ofcom consultation, paragraph 7.53.

[66] CC Determination, paragraph 2.191.

3.7% for each year of the four years from 2009/10 until 2012/13.[67] This period encompasses the majority of the charge control period that Ofcom is consulting upon, with only the final year being beyond the CC Determination. One would not expect, and Ofcom does not evidence the case for, a deviation from these recent findings.

181. The CC Determination was primarily based on KPMG's report for Ofcom on efficiency, which it considered to be:

> *"....an objective indicator expressed on a forward-looking basis spanning the entire price control period, and it should be treated as the most important indicator for the general efficiency saving rate in each of the four years 2009/10 to 2012/13."*[68]

182. For its consultation, Ofcom engaged KPMG to update this report. KPMG have refreshed the data to come up with a much lower range of 2.3% to 2.6% per annum between 2010 and 2014.[69]

183. Ofcom has not provided a specific justification as to why it has deviated from the 3.7% determined by the CC, or indeed the updated KPMG updated report. As such, Openreach would expect a consistent approach between Ofcom's efficiency range and the CC Determination, and are surprised that the efficiency target set by Ofcom (4.5%) is significantly above the level set by the CC.

5.2.3 Industry Benchmarking Report

184. Ofcom relies on an industry benchmarking report to support the higher end of the efficiency range. BT Group plc participates in this benchmarking study. The contents of this report are subject to strict confidentiality requirements. Ofcom have reviewed the report and have quoted two industry efficiency figures (average and 'Best in Class') in the consultation. Whilst Ofcom recognises there may be limitations, it has still quoted figures of 5% to 5.5% per annum, without adjusting the figures to take into account these limitations.

185. The industry benchmarking report is utilised by Openreach as part of the planning process, in order to provide a guide to identify potential areas from which we may obtain cost savings. It is used as a cross-check against internally proposed cost reduction targets, but is not used to set efficiency targets themselves.

186. The 'Best in Class' benchmark is the least useful to Openreach in this process as it is impossible that any undertaking can achieve 'Best in Class' in every operational area. For example, extra costs or investment in one activity will result in lower costs elsewhere. Therefore Openreach tends to focus more on the peer average.

[67] CC Determination, paragraph 2.239.

[68] CC Determination, paragraph 2.226.

[69] Ofcom consultation, paragraph A7.18.

187. Openreach asked Ernst & Young ("E&Y") to:

- consider the extent to which the benchmarking report provides useful information in assessing the achievable efficiency improvements in the context of a charge control
- what the analysis contained in the benchmarking report may say about such improvements.

188. Following its review, E&Y concludes, as per Confidential Annex A, that:

- the benchmarking report has significant limitations if the purpose is to use the output to set an efficiency target for the purposes of a charge control
- it is inappropriate for Ofcom's purposes to include 'Best in Class' as an indicator of what could be expected from Openreach
- peer average is useful but the scope for efficiency improvements in Openreach suggested by the benchmarking study is between 1.9% to 2.6% per annum over the course of the charge controls.

[✂]

189. [✂]

190. [✂]

191. [✂]

192. [✂]

193. [✂].

194. [✂]

Figure 6 [✂]

[✂]

195. [✂]

196. [✂]

197. [✂]

198. [✂]

199. [✂]

200. [✂]

201. [✂]

5.2.4 Openreach Historic Efficiency

202. We agree with Ofcom that "…*historical rates are not necessarily a reliable guide to the future*".[70] Ofcom should therefore use historic trends with caution.

203. In 2009/10, Openreach reviewed its supplier arrangements of our largest outsourced contract for direct labour. This led to the rationalisation from multiple suppliers to a single supplier, Carillion Telent, of civil engineering services. In addition, the negotiation resulted in a longer contract term. There was a large one-off reduction in rates from the supplier. The base year costs already reflect the one-off reduction and during this charge control, such that there is no scope for further cost reductions in this area. On this basis, the historical efficiency savings achieved by Openreach is not a reliable indicator of the scope for future efficiency savings.

204. Therefore, Ofcom's "high case" estimate of Openreach historical efficiency is inappropriate as an indicator of future efficiencies because it includes significant levels of one-off savings that cannot be repeated. If Ofcom choose to use historic figures then the adjusted "low" case of 4%, shown in Figure 5 above is the more reliable indicator.

5.2.5 Openreach Forecasts on Efficiency

205. Ofcom refers to Openreach's planning documents as a source of evidence used to support its proposed efficiency range. We believe it is appropriate to consider Openreach's planned efficiency savings in order to set a target as part of the charge control process but Ofcom should exercise caution in using the Openreach forecasts as is apparent from the CC Determination.

206. The CC clarified that Ofcom should take into account a broad range of sources in setting the efficiency target of Openreach, rather than focusing solely on Openreach's internal plans:

> *"But we were not convinced that Openreach's internal budget and forecasts for 2009/10 provided a more reliable basis for Ofcom's overall assessment over the four-year period 2009/10 to 2012/13 that the other evidence obtained by Ofcom to measure the general rate of efficiency improvement, such as the KPMG efficiency review (which had a five-year forecast horizon), and historical indicators (which looked back two years).*"[71]

207. Openreach sets ambitious internal targets during the planning process that are more likely than not to overstate the achievable efficiencies. Ofcom considers that Openreach's forecast represents an efficiency target of 4% per annum but this fails to fully take into account that there is a degree of execution risk and that this is a challenging target.

208. Finally, it is generally accepted that forecast accuracy declines as the forecast extends in time. Caution should therefore be exercised when relying upon forecasts for outer years, and this view is endorsed by the CC:

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[70] CC Determination, paragraph 2.36.

[71] CC Determination, paragraph 2.190.

> *"The Openreach budget for 2009/10 provides a relevant benchmark for the rate of efficiency savings for at least the first year of the price control. Its relevance for subsequent years of the price control period would be no greater than the other evidence, including the KPMG efficiency review and historical indicators.*[72]

5.2.6 Statistical Analysis

209. The statistical analysis that Ofcom reference suggests an efficiency target of around 2% per annum, which is below the bottom of Ofcom's proposed range. This therefore appears to have been excluded from Ofcom's consideration of the appropriate efficiency target to set in the charge controls.

210. Ofcom have provided no justification for apparently ignoring the results of the statistical analysis in setting the proposed range for efficiency. This is all the more notable given that in Ofcom's Defence in the LLU Appeal, Ofcom had a strong view that the statistical analysis was very relevant:

> *"Further, the range of benchmarks used by CPW...is incomplete and tends to overstate potential efficiency gains. For example, it ignores benchmarks that would define the bottom of the range (such as the NERA report) and appears to overstate benchmarks at the top of the range…"*[73]

211. In 2008, Ofcom commissioned NERA to perform a Stochastic Frontier Analysis ("SFA") study which is used to assess levels of efficiency and productivity using statistical techniques. The SFA methodology allows for the identification of the two different elements of efficiency gains, namely Catch Up Efficiency (i.e. the difference between the regulated firm against an efficiency comparator or the efficiency frontier) and Efficiency Frontier Shift (i.e. the improvement in efficiency achieved over time by already-efficient firms). This study suggested that the BT Network was 3.8% more efficient than the upper decile, thereby suggesting that no catch-up is required.

212. Similarly, in 2010, Deloitte[74] performed both SFA and Total Factor Productivity ("TFP") studies for BT as part of its review of the Wholesale Broadband Access charge control. The studies by Deloitte indicate that BT is more efficient that the upper decile i.e. BT should be considered efficient.

213. Based on the above information it does seem clear that the efficiency level for Openreach could arguably be set with a much lower efficiency target than that currently proposed by Ofcom. Such a figure: *"might suggest caution before suggesting that Openreach is particularly inefficient"*.[75]

5.2.7 Efficiency targets for other UK regulated firms

214. As a further cross-check, it is worth considering how Ofcom's proposed efficiency target compares with the decisions of other UK regulators. In the majority of cases,

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72 CC Determination, paragraph 2.192.

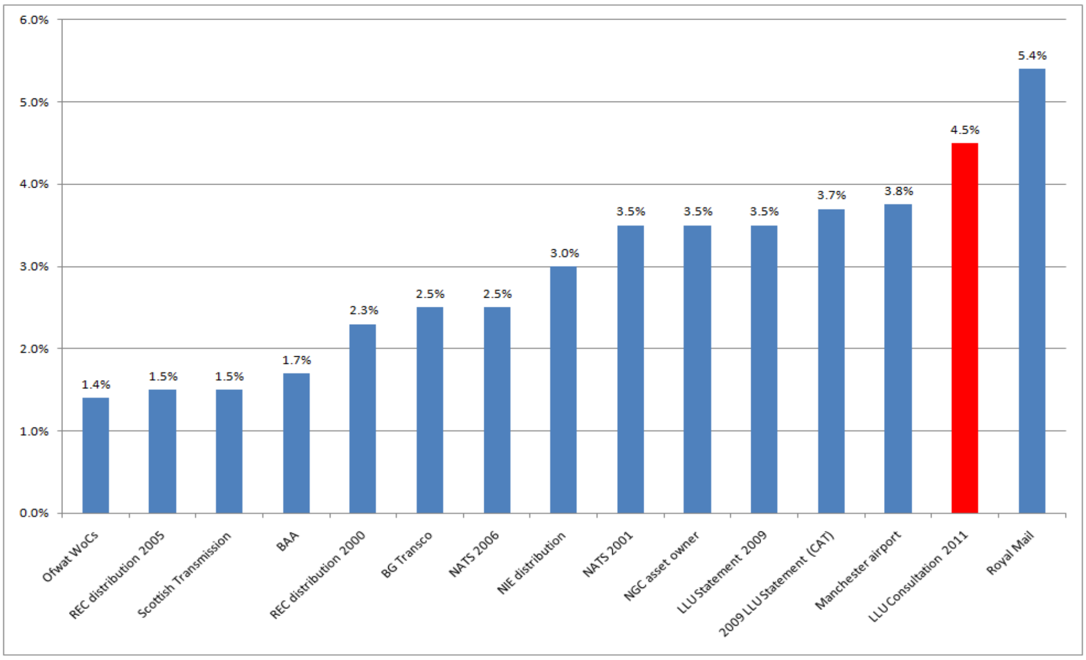
73 Ofcom, *The Carphone Warehouse Group Plc v Office of Communications*, Defence, Annex A, paragraph 63.

74 Deloitte LLP, *The Efficiency of BT's Network Operation – Report for BT*, 30 September 2010, page 2.

75 Ofcom consultation, paragraph A7.13.

these decisions set efficiency targets which are lower, and often significantly lower, than Ofcom's proposed figure (4.5%). It would appear that Ofcom's proposal sets a very high efficiency target compared with those applied to other regulated firms in the UK. This lends further support to our view that Ofcom overstates the potential for efficiency gains by Openreach and that an efficiency target of no more than 3.5% per annum is more appropriate.

Figure 7 Comparison of general efficiency target of Ofcom against other regulators (based on LECG report for Network Rail 2008)



215. The figure above shows real reductions per annum given by LECG in a report for Network Rail in 2008 for 12 out of 13 price controls that commenced in 2000 or later and which apply to operating costs.[76] The recent Ofcom targets set for Openreach in 2009 for LLU and WLR services and the CAT's ruling in the LLU Appeal have been added.

216. Royal Mail is the only firm to have a higher target applied. In this case, it is important to note that this it has been regulated for only 10 years. All firms to the left of Openreach have been regulated for around 20 years, which is not a surprising trend, as greater efficiency reductions would be expected in the early post-privatisation years.

217. Nor has there been any underlying change in the relative Openreach position as a result of reviews completed after the LECG survey was compiled. For example:

- in setting the electricity distribution price controls to apply from 2010 to 2015, Ofgem assumed 1% per cent a year ongoing efficiency improvements for both Operational Activities and Network Investment[77]

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76 LECG, *Assessing Network Rail's scope for efficiency gains - A report for Network Rail*, 3 April 2008, page 55.

77 Ofgem, *Electricity Distribution Price Control Review*, Final Proposals - Allowed revenue - Cost assessment, 7 December 2009, paragraph 5.5

- for price controls on gas distribution from 2008 to 2015, Ofgem considered that an efficiency assumption of 2.5% per annum applied to opex was appropriate[78]

- for price controls to apply to water and sewage charges from 2010 to 2015,[79] Ofwat assumed a continuing efficiency improvement factor of 0.25% a year for both water and sewerage base operating expenditure. Their assumptions regarding catch-up factors ranged across suppliers from between 0% and 2.9% a year for water and 0% and 2.2% a year for sewerage. These figures suggest an average efficiency target of around 1.5%[80]

- for charges at Heathrow and Gatwick Airports from 2008 to 2013, the CAA maintained a 1.5% per cent efficiency factor.[81]

5.2.8 Application of Efficiency – Corporate Overheads

218. As mentioned previously Ofcom applies a single efficiency rate to all relevant costs. Ofcom has also been consistent in its approach to applying the efficiency target in its modelling, but it seems that Ofcom has inadvertently applied a higher rate of efficiency to corporate overheads which must be corrected.

219. The Openreach forecast for Group transfer costs had different efficiency factors applied against each line item reflecting the scope for efficiency savings for that line item. For example, corporate overheads had a higher level of efficiencies applied than Ofcom's proposed midpoint of its efficiency range, whereas accommodation costs had a lower level of efficiencies applied.

220. For the majority of Group transfer costs Ofcom has created its own forecast:

- the base year data costs are forecast forward by Ofcom by inflating the costs by their assumed inflation rate each year, and

- next, these inflated costs are reduced by Ofcom's proposed midpoint of its efficiency range in each year.

221. Exceptionally, this approach was not applied to corporate overheads. Instead, Ofcom has lifted and shifted Openreach's forecast costs into its model for each year without applying the inflation and efficiency adjustments to the base year. As a consequence, Ofcom has effectively applied a higher level of efficiency than its assumed efficiency rate across Openreach's total cash costs.

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http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_3_Cost%20Assessment%20with%20SS%20comments.pdf.

78 Ofgem, *Gas Distribution Price Control Review*, Final Proposals, Decision Document, 3 December 2007, page 1, http://www.ofgem.gov.uk/NETWORKS/GASDISTR/GDPCR7-13/Documents1/final%20proposals.pdf.

79 Ofwat, *Future water and sewerage charges 2010-15: Final determinations, Protecting consumers, promoting value, safeguarding the future*, November 2009, paragraphs 4.10.1 and 4.10.2, http://www.ofwat.gov.uk/pricereview/pr09phase3/det_pr09_finalfull.pdf.

80 (0% plus 2.9% plus 0% plus 2.2%)/4 plus 0.25% = 1.5%.

81 CAA, *Economic Regulation of Heathrow and Gatwick Airports 2008-2013*, 11 March 2008, paragraph 5.15, http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf.

222. Therefore, there are two solutions for Ofcom to rectify this error:

- make the approach to corporate overheads consistent with Ofcom's approach to other Group transfer costs
- reduce Ofcom's assumed rate of efficiency to take account of the higher level of efficiency applied to corporate overheads (see response to question 7.10 for more detail).

223. Ofcom should adopt a consistent approach and remove the anomaly whereby corporate overhead costs are understated.

5.3 Pensions deficit repair payments

224. Ofcom has made no allowance in its costs model for any of the annual pensions deficit repair payments that BT is currently required to make in relation to the period of the proposed charge control. These are a cost of BT doing business going forward and, in so far as they result from pensions costs that were efficiently incurred, it is reasonable and consistent with Ofcom's regulatory duties and stated objectives for this charge control that they be included when calculating the cost base for regulated charges for Openreach's LLU and WLR services going forward. Annex B provides further detail on why BT considers that pensions deficit repair payments should be taken into account when setting these charge controls.

5.4 WACC

225. We have submitted our detailed response to Ofcom's WACC proposals in the context of the Wholesale Broadband Access ("WBA") charge control consultation, together with an independent report by Oxera.[82] This provided extensive arguments, evidence and analysis to support the view that Ofcom's proposed reduction in BT's WACC is excessive and disproportionate. We understand Ofcom is due to publish shortly a decision on the "rest of BT" WACC that will apply to the WBA charge control. This decision will also contain non-binding estimates of BT Group's and Openreach's WACC. We therefore reserve the right to respond to make further comment on the appropriateness of Ofcom's WACC statement to the WLR and LLU charge controls once the statement has been published.

226. At this stage, however, we do think it is important to emphasise the need for consistency between the assumptions used in the LLU/WLR models and the WACC. In particular, we draw Ofcom's attention to the fact that a different set of RPI inflation assumptions for 2013/14 has been applied in the pre-tax nominal WACC and the charge control model - 2.5% in former and 3.0% in the latter. As we argued in our WACC response to the WBA consultation, we believed, based on the latest available forecasts at the time, that 3.0% was the appropriate forecast to use for both WACC and, by extension, all charge control models.

82 See BT, *BT's response to Ofcom's cost of capital proposals contained in recent Charge Control consultations*, April 2011, and Oxera, The cost of capital to BT: An assessment in relation to Ofcom's WBA charge control consultation, April 2011. Both documents are available from http://stakeholders.ofcom.org.uk/consultations/wba-charge-control/?showResponses=true.

5.5 Sub-Loop Unbundling and Physical Infrastructure Access

227. Both SLU and PIA are out of scope of this charge control. However, Ofcom should be aware of potential issues regarding allocation of costs that are dependent on future volumes of these nascent products, which have the potential to substitute WLR and LLU products.

228. Ofcom's approach to cost allocation is unclear with regard to costs associated with SLU. In the recent determination on the dispute regarding SLU, Ofcom identifies certain costs elements which it believes should be removed from the SLU cost stacks but does not indicate how such costs should be recovered.[83]

229. We maintain that the specified cost elements relate to SLU and that there is a need for such reasonable incurred costs to be recovered against relevant SLU products. This leaves open the question of how such legitimate costs are to be recovered. It would be entirely unacceptable for Ofcom to leave Openreach in a position where it cannot recover legitimately and efficiently incurred costs because of Ofcom's actions in resolving the SLU pricing dispute.

230. For example, the only option available to Openreach is to recover the costs (e-side and associated network costs) associated with SLU-MPF rental, if Openreach is not allowed to recover them through the SLU-MPF rental charge, is to recover them across the WLR and MPF lines (excluding SLU lines). This would require changes to the proposals Ofcom is currently consulting on in this charge control. We consider these to be serious issues of policy that Ofcom does not appear to have considered in its determination on SLU, and we urge Ofcom to address these policy objectives in the charge control statement. Although SLU volumes are currently very small we believe the policy issue needs to be addressed now and not wait until volumes increase and Openreach under-recovers its efficiently incurred costs. Furthermore the introduction of PIA could speed up the take up of SLU to deploy NGA networks and therefore accelerate the under-recovery.

231. With regard to the pricing of PIA, Openreach considers it highly inappropriate that the Ofcom consultation contains a question about the approach that Ofcom should adopt. We note the following:

- PIA is outside the scope of the LLU and WLR charge controls which are the subject of the Ofcom consultation
- PIA is a separate product and subject to a different remedy (a cost orientation obligation, not a charge control)
- stakeholders interested in PIA cannot be assumed to have reviewed and responded to the proposals for a charge control on LLU and WLR, which supports Openreach's view that the Ofcom consultation is not an appropriate place to raise these issues.

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83 Ofcom, *Determination to resolve a dispute between DRL/Thales and BT relating to Sub Loop Unbundling charges*, 15 July 2011.

232. Openreach therefore requires Ofcom to recognise the fundamental difference between the LLU and WLR charge controls on the one hand and the nature of the PIA obligation flowing from the 2010 WLA Market Review on the other hand. Ofcom should therefore not draw any conclusions about PIA pricing in its final statement.

6 LLU and WLR Ancillary baskets

233. The scope and structure of the baskets for LLU and WLR services is a complex area that had considerable focus during the recent LLU Appeal. In that case, the CC found that Ofcom should not have set a single RPI-X control applicable to the MPF Ancillary, SMPF Ancillary and Co-Mingling baskets, and concluded that MPF New Provide should be charge controlled separately. The CC also found that an additional constraint was required on the Co-Mingling basket, and as a consequence Openreach was prevented from making upward price changes to particular services in that basket.

234. The purpose of using baskets, rather than individual controls, across the large range of LLU and WLR ancillary services is that it reduces the complexity of the arrangements and provides Openreach with the flexibility to price efficiently. Openreach believes that the basket structure should allow it to change respond to changing market conditions without any constraints that unduly restrict its pricing decisions. We set out below our comments on whether Ofcom's proposals are consistent with these objectives.

235. The approach that Ofcom has taken in these charge controls in relation to ancillary services is generally appropriate, and it is clear that Ofcom has taken heed of many of the points made by the CC. However, it appears that Ofcom has gone further than required in imposing restrictions on the basket and, therefore, risks losing sight of the objectives of the baskets in a charge control. This is a key concern for Openreach:

- Openreach does not consider that the inertia clause is necessary
- Ofcom's proposed range of 2% to 7.5% is too narrow, and removes Openreach's flexibility to efficiently price services within the basket e.g. reduces Openreach's ability to maintain sensible price relativity between major products such as singleton and bulk variants of a particular product
- in the event that Ofcom consider that an inertia clause is necessary, it should not be narrowed from the 10% level set in the 2009 LLU Statement.

236. Additionally there are a number of detailed points Openreach would like to make about Ofcom's proposal for the treatment of ancillary services:

- it is appropriate to remove any price regulation (cost orientation and/or charge control) from enhanced repair services and for consistency Ofcom should similarly remove price regulation from enhanced provision services
- it is inappropriate for Ofcom to regulate Special Fault Investigation ("SFI") services as these are outside the market
- Ofcom should de-link the pricing of the MPF Transfer and SMPF Connection/Migration products as this inappropriately drives the price for MPF Transfer below cost
- products that are regulated through the Leased Lines Charge Control ("LLCC") and the LLU charge control should only be subject to regulation once

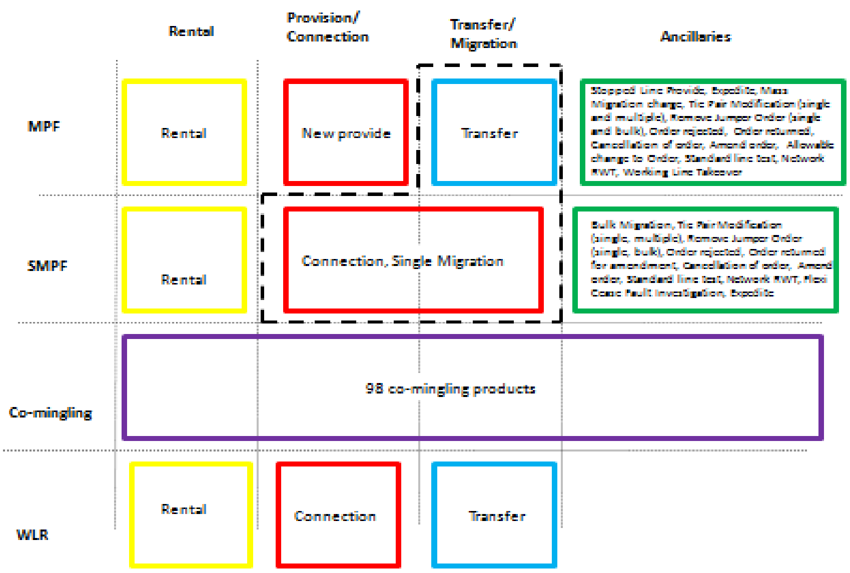
- Openreach considers that the price of WLR Transfer should reflect its efficiently incurred costs and therefore be set on a glidepath to recover CCA FAC costs over the charge control period

- Openreach requests that the controls come into effect 8 weeks after publication of the final statement to allow 4 weeks prior to the 28 day price notification period to undertake work required for 100+ price changes.

<u>Ancillary basket structure</u>

237. The figure below depicts the structure of the baskets in diagrammatical form, where each box represents an individual, or basket, control. The figure below also shows a ring around MPF Transfer and SMPF Connection/SMPF Migration (which are some of the key volume services) as Ofcom proposes to apply a quasi-basket across these services with an individual control applied to each product.

Figure 8 Structure of baskets



238. At the basket level, the charge controls should allow prices to properly reflect costs. In the 2009 LLU Statement, Ofcom included the key volume products (such as SMPF Connection) within the ancillary baskets, however they were subject to restrictive sub-caps which prevented Openreach from being able to recover costs across the basket. In this control, Ofcom has proposed to remove some of those key volume products from the baskets to allow prices to reflect costs.

6.1 Openreach needs flexibility to achieve a commercially aligned portfolio

239. Any basket structure by Ofcom must allow Openreach the commercial flexibility for the pricing of ancillary services to enable it to drive efficient use of its resources and achieve a consistent portfolio. The commercial objective to drive CPs to efficiently utilise Openreach resources may be compromised where prices do not reflect costs or where Openreach undertakes relatively greater activity and incurs relatively higher cost

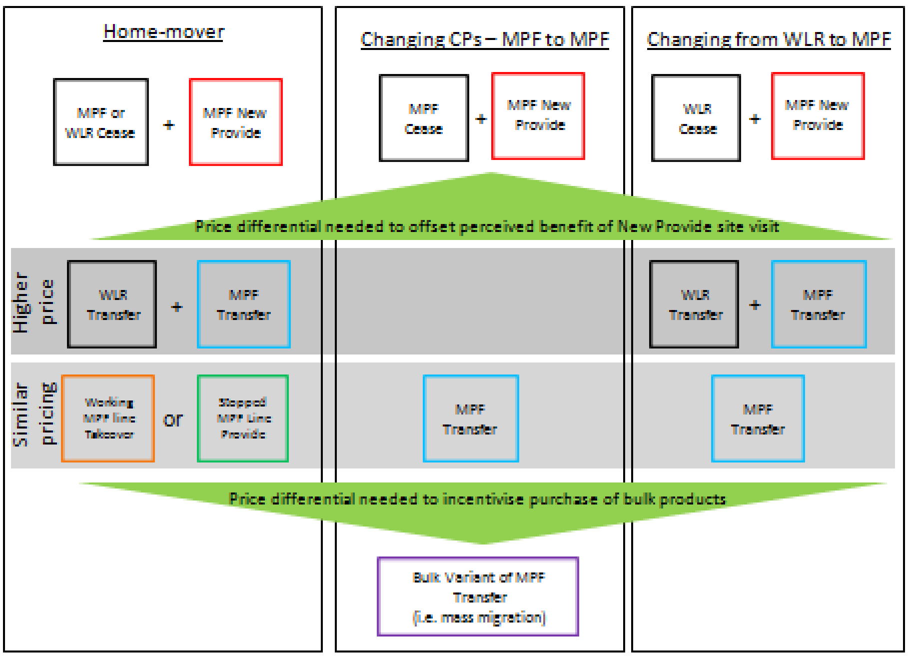
in providing a product in a way which more efficiently uses resources over the longer term. To drive the efficient use of Openreach’s resources, there is a hierarchy of prices that drives particular behaviour by CPs.

240. A key commercial objective is to price products in such a way that CPs will self-select the products which efficiently utilise Openreach resources. Ofcom’s proposals may compromise this objective where there are product choices involving different levels of costs for a similar outcome.

241. For example, it is appropriate that the MPF New Provide product is more expensive than the MPF Transfer, MPF Working Line Takeover (“WLTO”) or MPF Stopped Line Provide products. Otherwise CPs will be incentivised to purchase MPF New Provide, where Openreach must undertake potentially inefficient truck rolls to install lines at end-users properties where a line already exists. It would be unduly restrictive for Ofcom to impose regulation that prohibited this sort of sensible pricing hierarchy.

242. The ideal pricing hierarchy for different migration and new connection scenarios is shown in Figure 9 below.

Figure 9 Price hierarchy for key MPF volume products



243. In addition, the choice of product variants by CPs due to inappropriate price differentials can also lead to end-users experiencing more inconvenience than if a better product were chosen. Ofcom’s proposals to reduce the price of MPF Transfer will have the effect of prejudicing Openreach’s ability to achieve the ideal pricing hierarchy shown in the Figure above without under-recovering efficiently incurred costs.

244. Openreach discusses the various alignment and commercial portfolio issues associated with Ofcom’s basket proposals below.

6.1.1 Weighted average of costs for basket of MPF Transfer and SMPF Connection/ Migration

245. As a matter of principle, Openreach does not disagree with Ofcom's proposal to align charges for MPF Transfer and SMPF Connection/ Migration to FAC over the charge control period, as these products require similar activities. Ofcom proposes to achieve this by including these services in a quasi-basket with individual controls which align the prices for MPF Transfer, SMPF Connection and SMPF Migration using a weighted average of the forecast CCA FAC costs of the products in 2013/14, in accordance with the costs outlined in the table below.

Table 4 MPF Transfer, SMPF Connection and SMPF Migration[84]

Product	Price as at 31 March 2011	FAC cost estimate for 2013/14	Weighted average cost estimate in 2013/14
MPF Transfer	£38.64	£37.03	£32.35
SMPF Connection	£38.64	£29.87	
SMPF Migration	£38.64	£34.55	

246. In practice however, the proposal results in MPF Transfer and SMPF Migration being priced below Ofcom's estimate of FAC in 2013/14, and this may result in inefficient extra demand for these products. The pricing also has a knock-on impact onto the pricing structure that Openreach seeks in order to drive efficient use of its resources and provide the best possible end-user experience. In particular, the MPF Transfer price is proposed to be priced around £5 below cost at £32.35, which is likely to have the following unintended consequences:

- MPF Same CP Mass Migration charge (i.e. the bulk variant of MPF Transfer) may need to be priced at an appropriate discount to MPF Transfer to encourage efficient usage, and therefore lowered from the Initial Charge of £34.80
- MPF Tie Pair Modification, which is primarily used by CPs to re-jumper lines at the exchange to new equipment, involves similar activity to MPF Transfer, and therefore may need to be lowered from the Initial Charge of £39.25 to a level commensurate with MPF Transfer
- MPF Tie Pair Modification (Multiple Re-termination), which is the bulk variant of the MPF Tie Pair Modification product priced at an Initial Charge of £34.80 may need to be priced at an appropriate discount to the singleton product to encourage efficient usage. It could also be priced at a level commensurate with MPF Same CP Mass Migration charge

[84] Ofcom consultation, Figure 4.8 and Figure 7.15.

- MPF WLTO, which is usually moved by an end-user that is moving premises, is at an Initial Charge of £45.75 and may need to be lowered to a price close to the level of MPF Transfer to encourage usage

- MPF Stopped Line Provide, which is used when a CP seeks to supply service to premises that has an existing but dormant MPF or WLR line, is at an Initial Charge of £45.75 and price aligned with MPF WLTO. Openreach would also need to consider whether to lower the price of the service to maintain alignment with MPF WLTO

- similar but smaller reductions may also be required to the SMPF Tie Pair Modification (Retermination), SMPF Bulk Migration and SMPF Multiple Retermination prices.

247. The individual and combined effects of reacting to the MPF Transfer price reduction proposal is certain to lead to an under-recovery of costs. Openreach should be allowed to recover its efficiently incurred costs and set prices in a manner that encourage the efficient use of its resources. Therefore, Ofcom's proposal to align charges for MPF Transfer and SMPF Connection/ Migration to FAC over the charge control period is disproportionate and inconsistent with Ofcom's objectives in the charge controls.

248. Instead, Openreach suggests that MPF Transfer is removed from the quasi-basket and set on a glidepath to its own CCA FAC over the charge control period.[85]

6.1.2 Alignment of singleton and bulk jumper removal prices

249. Openreach agrees with Ofcom's proposal to make a starting price adjustment to initially align MPF and SMPF 'jumper removal order' products in their respective pricing baskets, without further restrictions during the charge control period. In this case, using the volume-weighted average price as the starting price in the charge controls appears to be a pragmatic approach.

250. For consistency, Openreach requests that Ofcom similarly aligns the starting price of the bulk variants of the MPF and SMPF jumper removal order products.

6.1.3 Maintaining alignment of charges for equivalent services

251. As noted above, Openreach seeks to set the same price for MPF and SMPF variants of the same product (such as rejected, amended, or change orders; or standard line tests). Ofcom proposes including these products in the respective MPF and SMPF ancillary baskets, but does not propose additional pricing restrictions given that the prices are currently aligned. However, the MPF and SMPF baskets have different Xs, thus the prices would diverge over the charge control period if their prices moved in line with the basket controlling percentage. This effect would be further exacerbated the greater the additional constraints that are imposed on each basket.

252. To maintain alignment over the charge control period for these particular equivalent services, Openreach will use up the flexibility provided by the inertia clause thereby reducing the flexibility for the key services in the basket. Therefore, Openreach

[85] There is also a need to be mindful of broader regulatory obligations in setting prices in this manner.

considers that the inertia clause must not be reduced from the level from the 2009 LLU Statement of 10% to enable Openreach to continue to align these product prices.

6.1.4 Regulating prices only once

253. Openreach requires that Ofcom commits to regulating each co-mingling service within one charge control only. Over 50 products which are currently regulated via the LLCC are also proposed to be regulated in the Co-Mingling basket in the Ofcom consultation, including:

- space products
- power products
- tie cables.

254. It would be difficult for Openreach to comply with both the LLCC and a future LLU charge control on the same products, as the timing and the level of price changes required differ. As a matter of good regulatory practice, products should be regulated under one charge control only.

6.2 Restrictions on baskets to prevent anti-competitive conduct

255. There are already a large number of restrictions, regulations and law that prevent Openreach from acting in an anti-competitive manner. There is no need for Ofcom to impose additional constraints or tighten the existing controls imposed in the 2009 LLU Statement (and as subsequently adjusted by the CC). Openreach considers that additional basket constraints beyond the levels already in place are unwarranted. Importantly, the CC stated that "*we do not consider that BT did actually take advantage of the opportunity to 'game' the co-mingling basket*".[86]

256. The SMP obligations found in 2010 WLA Market Review and the 2010 WLR Market Reviews and which apply to services in the ancillary baskets, where appropriate, include:

a) a cost orientation obligation

b) a requirement to provide Network Access on fair and reasonable terms, conditions and charges

c) a requirement not to unduly discriminate against particular persons or against a particular description of persons in relation to matters connected with Network Access

d) a requirement to notify charges and terms and conditions.

257. Furthermore, through the Undertakings which BT voluntarily agreed with Ofcom in 2005, Openreach is incentivised to treat all its customers equivalently and there are measures in place to ensure that it does so. General UK and EU Competition Law, such

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[86] CC Determination, Appendix H, paragraph 47.

that it applies, also prohibits BT from acting in an anti-competitive way and acts as a strong disincentive against such conduct.

258. In relation to the Ancillary baskets, Ofcom has already proposed a range of restrictions:

- a restriction on the aggregate pricing of each basket as well as restrictions on the percentage changes permissible on some individual products (i.e. RPI-X controls and some charge ceilings in the first year of the controls)
- an inertia clause on individual products, which is proposed to be in the range of 2% to7.5% — such that Openreach is not permitted to charge more than the Controlling Percentage increased by the level of the inertia clause, and no less than the Controlling Percentage reduced by the level of the inertia clause, on individual products
- SMP obligations on all products covered by the relevant market reviews, noted above.

6.2.1 Inertia clause

259. Openreach does not consider that an inertia clause is necessary for the baskets. This is because:

a) in contrast to the previous controls, Ofcom is proposing that each of the baskets has a separate RPI-X control that is designed to achieve cost recovery. Separate baskets remove the scope for price discrimination and gaming

b) the largest products have been removed from the baskets and the theoretical ability of Openreach to "game" prices is greatly reduced

c) there are a large range of other regulatory and competition law restrictions and prohibitions which limit Openreach's pricing freedom.

260. In the event that Ofcom considers it appropriate and proportionate to impose an inertia clause, then it should be the greater of either the 10% level which was used in the 2009 LLU Statement, or the largest absolute value of RPI-X for a basket. This is because:

- Ofcom has previously considered that an inertia clause below 10% would inappropriately and unduly restrict Openreach's pricing flexibility within the baskets
- the inertia clause should not be tighter than the largest absolute value of RPI-X on any basket; if this were the case then all prices in the basket would have to be changed irrespective of the extent to which prices reflect costs. For example, the SMPF Ancillary basket control is proposed to be RPI-10.9% and yet Ofcom is proposing to tighten the inertia clause to between 2% and 7.5%
- Openreach needs maximum flexibility from the inertia clause to ensure that prices reflect costs
- Openreach needs additional flexibility to enable it to achieve price alignment for products which have a similar cost or function.

261. These points are described more fully in our response to Question 4.5 where we also provided worked examples. Overall, Openreach considers that the purpose of a basket is to provide pricing flexibility, and given the objective of a commercially aligned basket and the inherent uncertainty of volumes, the inertia clause removes the flexibility that the basket provides. That is, the range of the inertia clause constraint proposed by Ofcom is contrary to the objectives of the basket.

262. Finally, Openreach considers Ofcom's proposed range of 2% to 7.5% for the inertia clause goes beyond the findings of the CC. In particular, the CC did not propose to tighten the inertia clause for any basket, and that the inertia clause was a factor in the CC finding that restrictions on the MPF basket and the SMPF basket were sufficient to prevent Openreach from manipulating prices within the baskets.[87] Bearing this in mind, it seems that Ofcom is being overly cautious in proposing a tighter inertia clause.

6.3 Cost orientation and value-added products

263. Openreach does not consider that Ofcom should apply a charge control or cost orientation obligation to any enhanced services where a core services already exists and is regulated. Such regulation will limit Openreach's incentives to further develop and invest in new value-added services, which are purchased at the discretion of the CP. Removal of the cost-related obligations will provide the right regulatory clarity and incentives to Openreach to ensure that CPs have a greater choice of value-added products to obtain from Openreach, or where contestable, source from alternative suppliers, to the benefit of end-users.

264. Ofcom accepted these arguments when considering appropriate regulation for WLR and removed the cost orientation obligation for services beyond the core regulated product. In reaching this decision, Ofcom cited a range of reasons including:

- there is substitutability between WLR enhanced service options and the ability of some CPs to opt-out of purchasing these services altogether imposes a market driven constraint on these services
- the Service Harmonisation initiative is likely to result in improvements to the range and quality of service level options available
- that some risk to innovation may result from the imposition of an obligation that restricts or controls pricing
- the absence of clear guidance on how a basis of charges requirement would be interpreted would create a risk that incentives to innovate would be diluted
- the framework of regulatory controls on WLR provides general safeguards which allow Ofcom to intervene.[88]

265. These considerations also hold for LLU for the reasons set out in the remainder of this section.

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87 CC Determination, paragraph 3.196.

88 Ofcom, *Charge Controls for Wholesale Line Rental – implementation and cost orientation*, Second Statement, 23 February 2010, paragraphs 4.8 – 4.15.

266. Openreach considers that enhanced repair service levels and enhanced provision services are value-added services that provide additional elements which are not provided as part of the rental service. We believe that CPs will only purchase the enhanced repair service levels, and other discretionary services, where the price reflects the economic value of the product to the CP, and in turn, the end-user.

267. The benefits of allowing services to develop absent of price regulation (cost orientation, charge controls, etc.) can clearly be seen by the development of the SFI2 product. This service has an innovative modular design structure that allows CPs to arrange a bespoke visit from an Openreach engineer for their end-users. The incentive to invest in such a new service is created by Ofcom not applying unnecessary regulatory constraints.[89]

6.3.1 Enhanced service levels should not be subject to cost orientation

268. Openreach supports the effective removal of cost orientation obligation from LLU enhanced service levels for fault repair as these are discretionary spend of LLU CPs and aligns the regulatory framework with WLR.

269. The factors which Ofcom identified in the 2009 WLR Statement to remove the cost orientation obligation from enhanced service levels apply equally to the LLU portfolio. Openreach considers the full benefits of the regulatory framework for enhanced service levels, which focuses on promoting innovation, would only be realised if the LLU framework was aligned with the WLR framework. In particular, Openreach considers that:

- the Service Harmonisation programme provides evidence of its willingness to innovate in this space
- it needs the regulatory freedom to take further risks on such investments and to enable new services to be offered with minimum intervention
- inconsistency in regulatory approach between WLR and LLU may make Openreach more risk averse to broader innovation across the portfolio.

270. Therefore, Openreach supports Ofcom's proposal to remove the cost orientation obligation from enhanced service levels for LLU. We believe that this provides the right framework for innovation and will provide benefits to industry and end-users. For continued innovation and development in this area the regulatory regime needs to be clear and needs to let the market (via Openreach and the CPs) drive development. We provide an analysis of Ofcom's options for enhanced care in our response to question 4.19.

89 The provision of non-regulated value-added services is consistent with the terms of the Undertakings agreed between BT and Ofcom. The Undertakings stipulate that Openreach can supply non-regulated products, and that when it receives a request from a CP for such a product, Openreach is "free to treat those requests as would any other commercial organisation and to accept or reject them on the basis of, among other things: (a) fit with the assets, skills and resources and terms of reference of Openreach; (b) commercial attractiveness to Openreach; and (c) opportunity cost to Openreach" (see section 5.11).

6.3.2 Expedite connections should not be charge controlled or subject to cost orientation

271. Expedite services allow faster provision of the MPF and SMPF service to end-users compared to standard provision times. On this basis, CPs have the freedom to decide whether or not to offer a faster connection option to their end-users, and thus the product provides a value-added proposition. MPF and SMPF Expedite services should not be subject to a charge control or a cost orientation obligation. Ofcom's proposal to impose both a charge control and a cost orientation obligation on MPF and SMPF Expedite services is excessive and inconsistent with its treatment of the enhanced fault service. For the reasons outlined above, Openreach does not consider that a cost orientation obligation should apply to these discretionary services.

272. Further, it is inappropriate for Ofcom to apply a charge control to MPF and SMPF Expedite services on the basis of aligning the regulation. MPF Expedite service was subject to a charge control in the 2009 LLU Statement in apparent error – for example, the service was not listed in the baskets in the consultation stage[90] although it was included in the final statement without explanation and without consultation with stakeholders. The proposed extension of the charge control to SMPF Expedite compounds the apparent error.

6.3.3 SFI products should not be regulated

273. Ofcom proposes to require the alignment of the prices for the MPF and SMPF variants of the Special Faults Investigation ("SFI") product, and to impose general remedies. Openreach considers that these proposals are unnecessary given that this product is outside of the WLA market.

274. SFI is a product which enables CPs to request a Digital Subscriber Line ("DSL") skilled engineering visit to investigate and resolve the root cause of an end-user broadband problem. The CP would only use this service where there is no obvious Openreach fault and the line meets the copper standard Supplier Information Note ("SIN") 349, which is the standard required for MPF. In the event that a MPF or SMPF line does not meet the standard of SIN 349, which specifies characteristics of a line up to and including 100MHz, then the fault is fixed under the standard LLU repair service provided with the rental product.

275. Openreach does not believe that SFI should be subject to any form of regulation, including general remedies, as it is used to address issues outside of the specification of a standard LLU service. SFI is only used by CPs in relation to issues with provision of service on a line above 100MHz. That is, it is outside the standard LLU market. The source of the end-user broadband problem may also be outside of the demarcation of LLU line e.g. in the end-user premise. On this basis, it is unclear why Ofcom considers that general remedies apply to this product.

276. SFI2, the current generation of SFI products, was developed following discussions with industry. The innovative modular structure for the various SFI options meets the specific needs of our CPs, and provides the CP with the ability to limit the scope of

[90] See Ofcom, *A New Pricing Framework for Openreach*, Second Consultation, 5 December 2008, pages 166-167 where the MPF Expedite product is not listed in the MPF "Auxiliary" basket.

activities performed by Openreach and thus also control the amount of spend. Further, it is clearly a value-added product which CPs can purchase at their discretion, for example they can undertake their own diagnostics of the line, or utilise competitor companies such as Qube or Geek Squad to resolve broadband issues within the customer premise beyond the NTE.

277. SFI is a value-added service which CPs will only be purchased at their discretion. CPs will not purchase the product if the price does not reflect their willingness to pay. On this basis, Openreach disagrees that general remedies or any form of pricing restriction should apply to SFI, as such regulation will reduce Openreach's incentives to undertake further innovation and investment in this space.

6.4 WLR Ancillary services

278. This section considers WLR specific ancillary issues, in particular the WLR Transfer charge and the obligation to provide WLR ancillary services.

6.4.1 WLR Transfer charge

279. Openreach considers that the price for WLR Transfer should reflect its efficiently incurred costs. The current price for WLR Transfer is £3.09, which is significantly below Ofcom's forecast CCA FAC of £16.30 in 2013/14. The artificially low price distorts the consumption decisions of WLR and LLU CPs, and may also be impacting end-user decisions in the retail voice markets.

280. The WLR Transfer costs that are not recouped via the product price are recovered via the WLR Rental product over the period of the average customer life. In practice, however, LLU CPs have being using WLR Transfer as a migration tool prior to moving their customers to MPF in bulk once their Point of Presence ("PoP") is established. As a result, the end-user is not purchasing WLR Rental for a sufficient period to enable Openreach to recover its efficiently incurred costs.

281. Openreach therefore considers that WLR Transfer should be set on a glidepath to recover its CCA FAC over the charge control period. This would be consistent with the approach currently applied to WLR→MPF and MPF →MPF transfers. Openreach recognises that WLR CPs will consider that this could disrupt the retail market, however the smooth glidepath over the charge control period will allow CPs to adapt, and it would remove the market distortion that may be artificially driving retail churn.

6.4.2 Obligation to provide WLR Ancillary services

282. Ofcom notes that it is proposing an amendment to SMP Condition AAAA10 to make clear that the obligation to provide WLR includes, when requested by a third party, such ancillary services as may be reasonably necessary for the use of WLR.[91]

283. Openreach does not consider this amendment is appropriate:

- Openreach considers that this proposal increases the scope of SMP Condition AAAA10. Changes to SMP Conditions should only be made once Ofcom has

[91] Ofcom consultation, paragraph 5.15.

carried out the necessary analysis of the market in question as per section 85 of the Communications Act 2003

- furthermore, there is an existing SMP condition which already requires Openreach to supply Ancillary services upon reasonable request. SMP Condition AAAA1.b imposes the Statement of Requirements ("SOR") process on Openreach, and requires the provision of services upon reasonable request from a CP. Should there be any Ancillary service that Openreach is not currently providing, CPs can make a request under the existing SOR process.

6.5 Current v prior year weights

284. Openreach agrees with Ofcom that the use of current year weights is not an appropriate or proportionate approach and that prior year weights are better for WLR and LLU.[92] Openreach considers that arguments for current year weights are flawed.

285. Ofcom notes that the CC identified a shortcoming with the use of prior year weights in ancillary baskets whereby Openreach could theoretically outperform the price cap by imposing larger price increases for products that are increasing in volume relative to other products in the basket. Openreach does not accept that it would or could in practice conduct itself in the manner described by the CC. Moreover Openreach did not game the basket in this way during the last charge control. As Ofcom notes, it has "*…not seen any evidence of gaming use of 'Prior year weighting' by BT*".[93]

286. There are significant practical problems arising from the use of current year weights. In practice, using current year weights would create a two-stage process, whereby:

- Openreach announces price changes for a given year of the charge control (typically 90 days in advance of the commencement of the charge control year, as required under the relevant SMP condition), based upon Openreach's forecast of revenues for each product within a basket for a given year

- at the end of that year, when actual revenues become known, there is a correction process to the extent that the revenue-weighted Percentage Change using actual revenues is materially different to that based on forecasted revenues.

287. BT considers that such an approach creates difficulties at both stages.

[92] Ofcom consultation, paragraph 4.73.

[93] Ofcom response to stakeholder questions, published 29 June 2011, available at: http://stakeholders.ofcom.org.uk/consultations/wlr-cc-2011/clarifications/.

Inability to forecast negates practicality of current year weightings

288. At the first stage, Openreach faces a number of particular challenges in relation to forecasting revenues:

- there are 98 individual products in the proposed Co-Mingling basket, 15 in the proposed MPF basket and 14 in the proposed SMPF basket which would each require separate forecasts
- Openreach's CP customers are unlikely to pass on to Openreach at the beginning of the relevant period what is still speculative information about their possible wholesale and/or retail plans. Such plans are highly commercially confidential
- volumes of ancillary products are volatile and are generally CP driven – for example, CPs may change the timing of establishing PoPs in exchanges based on their own commercial reasons, and this can significantly alter the volume demands for particular ancillary services in a given month or year
- Openreach is not able to forecast significant changes in demand absent CPs communicating forecasts or making public announcements. As BT identified in its response to Ofcom's LLCC consultation:[94]

> *"Due to the nature of the Openreach business, it is dealing with 'derived demand', the business being dependent on CPs' actual demand and their ability to provide accurate forecasts."*

289. CPs have no obligation to provide Openreach with accurate forecasts in relation to purchase of ancillary products. Should CPs be required to provide Openreach with forecast volumes to comply with a charge control, then the CPs could have an incentive to manipulate their forecasts to attempt to game the regulation (i.e. provide low volumes for services which they anticipate taking large quantities of), and there would be no sanction against those CPs for that gaming.

290. Average revenue can be affected by the product mix within the basket. For example, average revenue will fall if the quantity sold of a lower price product within the basket increases relative to the quantity sold of a higher priced product.

291. Any forecasting is therefore likely to be inaccurate in light of these challenges. That degree of uncertainty increases the likelihood of there being substantial amounts involved in any correction process. This will create uncertainty and disruption for CPs and may raise practical issues about how such payments should be made/reclaimed by Openreach.

Lack of recent precedents

292. Openreach is not aware of any recent precedent where current year revenues have been used in charge controls. In contrast, as observed by Ofcom in its consultation, prior year

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[94] BT, *BT Response to Ofcom's Consultation paper: Leased lines charge control: a new charge control framework for wholesale traditional interface and alternative interface products and services*, 6 March 20009, page 16. Available from http://www.ofcom.org.uk/consult/condocs/llcc/responses/BT1.pdf.

weightings have been used in other charge control[95] and that "*this charge control formula has a proven track record*". In particular, Ofcom noted its concerns over the use of forecasts:[96]

> "*As we explained in paragraphs 3.46 to 3.75 of the December Consultation, the use of prior year weights has some significant advantages given the nature of the TI market. In particular, the prior year weighted control relies on already published revenue information when setting prices to comply with the control. This means that BT will know at the start of each charge control year the weight the control would attach to any price changes it makes. This makes BT's task of complying with the charge control less complex and is more transparent to stakeholders.*
>
> *By contrast, the alternative approach (using current year weights) would require BT to forecast revenues and to set its price based on expected revenues from each service. A forecast would be necessary because current-year revenues are by definition not known until the end of the price control year. This forecasting requirement would make charge control compliance more complex and less transparent. This is because we would not have a benchmark on which to compare or challenge data from BT and it might therefore be susceptible to gaming.*"(emphasis added)

293. Openreach supports Ofcom's retention of prior year weights in these charge controls, and does not consider that arguments for current year weights would provide a better outcome to CPs in relation to addressing concerns regarding gaming.

6.6 Governance and timing

294. Openreach has two primary concerns around governance and timing. These both relate to the limited period of time that Openreach will have to determine the appropriate price changes required to meet the proposed controls.

295. Ofcom is proposing to reduce the price notification period for LLU services from 90 days to 28 days in the first year of the charge control, and for the charge control to be effective 28 days after publication. Consequently, where a charge ceiling applies then to comply with the regulation Openreach would be required to notify the price change on the day that Ofcom publishes the final statement. Also, the way in which the basket requirements are drafted means that should Openreach not notify the price changes on the day of publication, then it would have to provide greater price changes in the first year of the control to account for the lag, and then under-recover in the second year of the control. Given that the final statement is likely to require 100+ price changes, Openreach requests an additional 4 weeks at the start of the charge control to undertake due diligence prior to the required notification of the prices. We consider that this would provide greater clarity and transparency to stakeholders about the prices they are likely to face over the charge control period.

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[95] Ofcom consultation, paragraph 4.35.

[96] Ofcom, *Leased Lines Charge Control – A new charge control framework for wholesale traditional interface and alternative interface products and services*, Statement, 2 July 2009, paragraphs 3.121-3.122. Available from: http://www.ofcom.org.uk/consult/condocs/llcc/llccstatement/llccstatement.pdf.

296. Should Ofcom's statement be delayed beyond autumn 2011, then Openreach also notes:

- prices to be effective from 1 April 2012 need to be notified by 31 December 2011 — Openreach will need to have completed internal governance for these prices changes prior to notification, and this usually takes at least one month. On this basis, Ofcom should also reduce the notification period to 28 days for 2012/13 price changes (i.e. notify on or by 3 March 2012)

- Openreach needs to have time to assess the impact of price changes in the market from the 2011/12 charge control prices before it considers 2012/13 prices — otherwise, it will not be in a position to assess pricing impacts if a particular price change has significantly altered a product demand profile

- significant delay may result in it becoming inappropriate and disproportionate for Openreach to impose price changes for 2011/12.

297. Finally, Openreach requests that Ofcom formally verifies that Openreach complies with its charge control requirements in a given year. Such an arrangement would be beneficial to Openreach and other stakeholders as it would provide greater confidence and certainty to all stakeholders that Openreach was complying with the charge controls.

7 Answers to the Ofcom questions

298. This section provides Openreach's responses to the questions raised in the Ofcom consultation.

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

299. Openreach agrees with the principle of consistency between the WLR and LLU charge controls.

300. The Openreach Financial Framework Review, which preceded Ofcom's consultations leading to the 2009 WLR and LLU Statements, was initiated to remove the substantial under-recovery of costs across Openreach's regulated copper access products, which was particularly extreme in the case of MPF. This had created inappropriate price differentials between MPF and WLR+SMPF which had produced a distorting arbitrage between these alternative wholesale inputs, which in turn had market-distorting effects.

301. Much of the cost base for the WLR and MPF charges is based on the same methodologies, allocations and elements. Therefore, to minimise any potential distortions in glidepaths it is crucial that the methodologies, allocations and assessment of the cost base are conducted in a consistent and aligned manner, where possible concurrently. Therefore, we agree with Ofcom's proposal to set synchronised charge controls for LLU and WLR.

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

302. Openreach prefers market reviews, and the period covering charge controls, to be set for a longer period than three years to encourage stability and investment. This is because the well-known incentive effects of a 'RPI-X' control are best realised by a longer charge control period.

303. Moreover, Ofcom's proposed charge controls will run for less than 3 years given that the controls are unlikely to be in place until autumn 2011. The previous LLU and WLR charge controls ran for less than 2 years, and the recent trend in charge control durations is shown in the table below.

Table 5 Duration of recent charge controls

Charge Control Statement	Start and End Dates	Duration
2009 LLU charge controls	22 May 2009 – 31 March 2011	22 months
2009 WLR charge controls	26 October 2009 – 31 March 2011	17 months
2011 LLU charge controls	Autumn 2011 – 31 March 2014	At best, 30 months
2011 WLR charge controls	Autumn 2011 – 31 March 2014	At best, 30 months

304. Openreach accepts, however, that Ofcom's proposals for a three year duration is consistent with the EU Electronic Communications Framework. We therefore,

somewhat reluctantly, agree that this control should expire on 31 March 2014. It is important that in future Ofcom's timeline should allow subsequent controls to run for at least three years.

Question 3.3: Do you agree with Ofcom's 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 continuation of the RAV approach in Question 3.5 below.)

305. Openreach agrees with Ofcom's proposal to use a CCA FAC methodology to establish the cost base for the next LLU and WLR charge controls.

306. The Ofcom consultation refers to the fact that the CC essentially endorsed Ofcom's use of CCA FAC as the cost basis for the previous set of LLU and WLR charge controls, and we agree with the CC's reasoning and decision.

Question 3.4: Do respondents agree with our 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 our financial modelling? Please give reasons for your answer.

307. Openreach understands the process Ofcom has used to cross check the allocation of costs in the financial modelling and we agree that there is no requirement to create a hypothetical model.

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?

308. Openreach does not agree with Ofcom's assessment that the decision on the treatment of pre-1997 duct assets set out in Ofcom's 2005 Valuing Copper Access statement remains appropriate for this set of charge controls. The valuation basis should be the replacement costs of the assets as this provides the appropriate economic price signals for both suppliers and consumers, and sends the correct investment signals to potential market entrants. It also provides a fair return to BT's shareholders without creating any "windfall gain". Openreach's views are explained in full in section 4 above.

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. We consider this to be consistent with economic considerations and the European Commission's NGA recommendation. 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.

309. Openreach does not believe the RAV Adjustment is an appropriate mechanism for valuing network assets, as per our comments in section 4 above.

310. Furthermore, we consider it highly inappropriate that Ofcom consultation contains a question about the approach that Ofcom should adopt with regard to PIA pricing for the reasons set out in section 5.5. Therefore, Ofcom should not draw any conclusions about PIA pricing in its final statement for the WLR and LLU charge controls.

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.

311. Openreach agrees that it remains appropriate for the post-1997 assets to be valued on a CCA basis. Retaining the existing CCA approach in respect of the post-1997 assets also provides greater regulatory certainty to stakeholders.

312. As noted in section 4, Openreach believes that *all* assets should be valued following CCA principles.

Question 3.8: Do you agree with our assessment that 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? If not, please give your reasoning.

313. Openreach understands this question seeks stakeholder views on two separate issues:

- first, whether Openreach's revaluation of post-1997 assets is inconsistent with alternative estimates of replacement values
- second, whether Openreach's revaluation does not form an appropriate basis for setting charges.

314. We believe it is useful to recall how the revaluation figure was calculated. Openreach's valuation of the post-1997 assets is taken from the RAV Model. We built that model to Ofcom's specification following Ofcom's 2005 Valuing Copper Access statement. BT has updated this model in the interim period and the model has been provided annually to Ofcom for review.

315. We update the RAV model annually by adding: (1) new information from BT's management accounts on capital spend and depreciation; and (2) the input of asset price change for the year from the RFS.

316. The way in which the RAV Model is structured means that the asset price change affects only the post-1997 assets and only the relevant proportion of the increase in the valuation of the post-1997 assets is included in the RAV. In addition, a price change can only be entered against the most recent year. This means the price increase in 2009/10, which implicitly included an adjustment for undervaluation of spend in previous years,[97] causes an apparent distortion of spend in the most recent year.

317. We therefore considers that the valuation of £2.9 billion has been reasonably derived following the application of a methodology specified by Ofcom, a practice which has been shared with Ofcom over a number of years. To the extent that the approach to date does not achieve the intended objectives of the RAV approach, Openreach has been, and is, willing to explore how the calculation should be changed. However, we do not

[97] As Ofcom recognises, refer second bullet in Ofcom consultation, paragraph A5.197.

consider it is fair to suggest that we have erred or been inconsistent in not applying changes, which up to this point have also not been suggested by Ofcom, when specifying the model, as being of relevance.

318. Further to our comments in section 4, we also discuss two of these factors (the national build factor and an adjustment to the index for productivity) in our responses to Questions 3.9 and 3.10 below. In terms of the inflation factor used in the RAV model to date, we wish to be clear that at no point has Openreach changed the methodology unilaterally – the only scope for amendment (e.g. to correct for an underestimation in previous years) within the model, agreed with Ofcom, is to reflect this correction in the year in which it takes place.

319. The unavoidable consequence of only being able to apply a correction in the final year of the RAV Model is to create a significant change in the valuation of the capital spend in the final years. Ofcom correctly note in the consultation document that this has occurred,[98] although the source of the data used to support this view is unclear to us.

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 these indices is set out in Annex 4? Please give reasons for your answer.

320. Openreach does not consider that Ofcom should treat post-1997 assets differently from pre-1997 assets and that both should be based on their CCA value. However, we provide our views on indexation on the basis that Ofcom has proposed such a methodology for post-1997 assets.

321. Ofcom proposes using the General Building Cost Index ("GBCI") (published by Royal Institution of Chartered Surveyors ("RICS")) as the most appropriate index for the value estimation in this charge control.[99] It proposes to apply this to incurred costs each year, to derive what Ofcom describe as "an alternative absolute valuation"[100] for the post-1997 duct asset. Our understanding is that this is intended to represent the CCA value of the duct base installed from 1 August 1997 onwards (i.e. the post-1997 assets).

322. We accept that while there may be a role for indexation in estimating CCA values over relatively short timescales, it is nevertheless important to recognise that Analysys Mason's conclusions clearly point to the use of indexation as a medium term (at most) methodology. The reason for this is that only a perfect index (in the sense it exactly matches changes in the cost of the asset in question) will lead to the same value as using a robust CCA absolute valuation. In fact, no index is perfect and more errors are likely to accumulate the longer any one index is used. We therefore view indexation as a "second best" option when compared to a robust absolute valuation.

323. If, however, indexation were to be used, then the question arises as to what is the most appropriate index. For example, one option might be to use the RPI if one were to consider that the cost of producing the asset was to increase in line with the average for

98 Ofcom consultation, paragraph A5.155.

99 Ofcom consultation, paragraph 3.85.

100 Ofcom consultation, paragraph A5.167

the whole economy.[101] However, an indexation approach designed to mimic a replacement cost valuation, needs to consider whether or not the cost of producing that asset has tended to rise in real terms (when the index should be higher than the rate of increase in the RPI) or tended to fall in real terms (implying an index lower than RPI) relative to the average for all other goods and services in the economy.[102] In short, RPI does not account for sector-specific trends.

324. We therefore agree with Analysys Mason that such considerations should be dealt with by the use of an industry-specific cost index and whether any productivity adjustment is appropriate. Clearly an appropriate sense check should be part of such an approach. For example, it would be expected that an adjustment would not tend to lead to counter-intuitive results, such as to push an industry specific index below RPI when the asset considered is one which was generally increasing in cost relative to other goods and services in the wider economy.

325. Ofcom shows the impact of a 1% annual adjustment offset for productivity[103] which we consider is likely to be too high if the intention behind indexation it to attempt to match valuations against replacement cost. There is compelling evidence which suggests that the construction sector has had much lower increases in output per man hour than in the market sector as whole and that these have been below 1%.

326. For example, a paper by the Office for National Statistics ("ONS") shows that average annual labour productivity, between 1995 to 2008, grew by around 0.8 % in construction, compared to more than 2% in the economy as a whole. [104] This can be seen in the Figure below, where the construction sector is marked as "F". These figures are for output per hour worked.

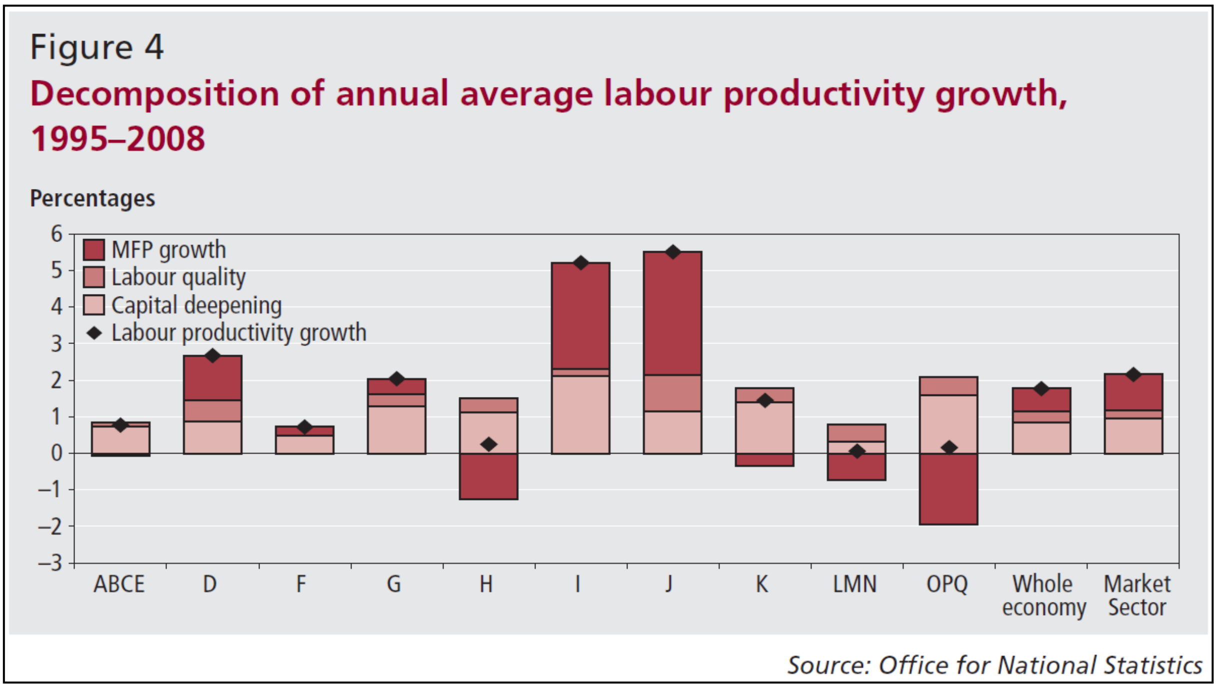
[101] This is why X is usually positive under RPI-X regulation, the assumption being that unit costs are forecast to fall relative to those of the economy as a whole. This might be, for example, because the supplier can be assumed to make better efficiency gains than possible throughout the economy on average.

[102] There are two main reasons why the cost of the asset might tend to rise relative to all other goods and services, (i) the asset requires a substantial proportion of inputs the cost of which themselves have been increasing above RPI and (ii) the rate of increase in productivity is lower in producing the asset than the average economy-wide rate of improvement.

[103] Ofcom consultation, paragraph A5.179.

[104] Katy Long and Mark Franklin, *Multi–factor productivity: estimates for 1994 to 2008*, Office for National Statistics, Economic & Labour Market Review, Vol 4, No 9, September 2010. Available at: http://www.statistics.gov.uk/elmr/09_10/downloads/ELMR_Sep10_Franklin.pdf.

Figure 10 ONS Paper on Labour productivity growth by industry classification, 1995-2008



327. Further, as can be seen from Figure 10 above, the ONS data shows that about 60% of the 0.8% increase was due to "capital deepening" i.e. the use of more capital in the productive process (that is, labour productivity was achieved only by using more of other inputs). This implies that the rate of decrease in unit costs will be less than 0.8% as the capital deepening will itself have required expenditure. We therefore consider that Ofcom should use a figure of below 0.8% for the adjustment factor and 0.5% is a more appropriate amount. This figure would be on the basis that all multi-factor productivity growth[105] would be included in the adjustment, plus some of the impact of capital depending.

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.

328. As discussed in section 4.5.2, Openreach does not agree with the proposal to discount the indexed valued by an estimate of a national roll out of duct in the manner proposed by Ofcom.

329. Openreach considers that 14.5% is a reasonable estimate of the savings a hypothetical entrant to the fixed access network market could achieve if they were to build their new network in a highly planned manner over a relatively short period of time. However, we do not consider that the costs of such a hypothetical entrant provide the right standard to apply under the approach being proposed by Ofcom. Our view is that a discount

[105] According to the authors of the ONS Report cited here, MFP can be described as capturing the value of 'disembodied technical change' (i.e. advances in technology not embodied in capital) such as increased knowledge due to R&D, improved management techniques, changes in organisational structure or more efficient utilisation of ICT.

should not be applied to the value of the post-1997 assets (whether indexed or not). These points are explained below.

The 14.5% national build discount

330. Before discussing the national build discount, it is helpful to recall the background to this figure, which appears in our RFS.

331. In the 2007/08 RFS, BT introduced a national discount factor in the absolute valuation for duct assets. Before this, BT's CCA valuation of duct was derived from the contractual rates from the mid-1990s and applying an index to them to bring them up to date. This was on the basis that the duct build programme had been extensive and thus sufficiently similar to a national build that the rates could be used for valuing the assets as if a national build was being undertaken. However, from the mid-1990s BT's procurement started to change, with less duct being built via smaller jobs. This implied higher charges on a per unit basis given the lower level of activity.

332. We therefore started using an estimate of hypothetical cost which would reflect not the costs incurred, but the forward-looking costs which an entrant might face. The discount was intended to reflect the savings that might be gained from a total platform replacement over a short period of time, including the value of economies of scale, revisions in working practices and the effects of competitive tendering arising in connection with such a large infrastructure project. The size of the discount factor was based on a judgment at the time which reflected the views of a number of senior managers within BT.

333. In the same year in which the national discount factor was introduced, 2007/08, we also started to use a more accurate source of data, PIPeR as the basis for estimating the quantity of assets in the network. On the basis of this new information, BT's estimate is that the quantity of assets increased significantly,[106] however, there was no corresponding increase in the overall asset valuations between 2006/07, the final year before these changes, and 2008/09. The increase due to the additional quantity of assets was offset by a reduction in price via the discount factor.

334. In the 2009/10 RFS, BT awarded a long term contract to a sole national provider of civil engineering services (Carillion Telent).[107] This contract was awarded by Openreach following a highly competitive tendering process that enabled scale economies to be realised. Thus, the reduced rates in the current contract themselves represent significant reductions in costs over time.

335. Following the award of the tender, the level of the national build discount used to estimate hypothetical replacement costs was reduced to 14.5%. By working with a single supplier and using an analysis of their cost structure, the Carillion Telent contract also enabled Openreach to undertake a more rigorous approach to estimating the

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106 This increase was based on new information from a system called PIPeR (Physical Inventory for Planning and eRecords) which applies digital mapping processes to BT's local network.

107 BT, *Current Cost Accounting Detailed Valuation Methodology 2009/10*, 28 July 2010. See: http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2010/DetailedValuationMethodology2010.pdf

discount factor to be adopted. As a result, the 2009/10 RFS estimated the replacement cost as £6.5 billion, based on contract rates reduced by 14.5%.

336. BT has recently revisited the discount to ensure that it provides a reasonable estimate of the savings which might be made, and therefore that the RFS continues to provide a valuation which reflects the specific replacement cost of a hypothetical entrant.

337. As part of this review we have engaged an independent external expert in quantity surveying and construction management. The expert has built a model to identify what discount is probable if a hypothetical national build of Openreach's network assets was required. The expert concludes that a national discount of between 8% and 9% is appropriate. The report is attached at Confidential Annex C.

<u>The national discount should not be applied to a valuation based on BT's incurred costs</u>

338. Ofcom's proposals for valuing Openreach's access assets is that:

> *"we consider that the decision on the treatment of [pre-1997] duct assets set out in the 2005 review remains sound…. and that for the purposes of this charge control the value [of post-1997 assets] should be based on an indexation of post-1997 expenditure, <u>with allowance for BT's estimate of the economies of scale for large scale construction</u>."* [108] *(emphasis added)*

Thus, the post-1997 assets would be reduced in light of "economies of scale for large scale construction". In other words, Ofcom will introduce a cost reduction based on a hypothetical new network build by carrying-over the figure of 14.5% as used in the RFS.

339. We believe Ofcom's adjustment is inappropriate. The costs of a hypothetical entrant do not provide the right standard to use alongside the proposed indexation approach to the post-1997 assets. There are two basic approaches to asset valuation, (i) to use the full replacement cost in setting regulated access charges (which we consider is the right approach as it sends out the right market signals) or (ii) to base asset values so that incurred costs can be recovered. Ofcom should adopt one approach, and apply assumptions that fit the chosen approach. Applying assumptions from a different approach, without ensuring that the rationale for applying them is relevant, is clearly wrong.

340. In particular, we consider that Ofcom's proposal ignores the fact that the impact of introducing a national discount factor would be likely to deny Openreach the ability to recover its efficiently-incurred costs. For example, if the valuation of post-1997 assets is to be based on incurred costs then, clearly, writing out 14.5 % of these costs means that Openreach is not being permitted to recover its incurred costs. Openreach does not believe that Ofcom has accounted for the implied holding loss which would result from the discount applied in the RAV model i.e. the holding loss, if correctly applied would increase the costs to be recovered to the value prior to applying the discount.

341. In our view, if asset valuation for the purpose of setting charge controls is to be based on *actually* incurred costs (and this is the way any indexation will be applied) then this

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[108] Ofcom consultation, paragraph 3.42.

should only be on the level of Openreach's efficiently incurred costs and not costs which might be possible in a wholly different (and hypothetical) set of circumstances i.e. a hypothetical entrant building a new national platform over a short timescale.

342. A similar issue was considered by the CC in the LLU Appeal. In that context, TalkTalk argued that efficient forward-looking costs were those based on the use of Next Generation Network ("NGN") technology and that these should have been used by Ofcom as the basis in setting relative MPF and WLR charges. In assessing this matter, the CC recognised a distinction between costs of a new entrant and of Openreach:

> *"Our view is that [TalkTalk's] evidence that NGN is the more efficient technology was primarily based on the perspective of new entrants and had limited relevance for considering the efficiency of BT's investment plans."*

343. The CC went on to state that:

> *"We do not accept that the appropriate cost benchmark is determined by the costs of a new entrant."*[109]

344. We consider these statements in the CC Determination to be highly relevant, as the duct valuation (which includes the national discount) in BT's RFS shows the costs from the perspective of a new entrant. For the purpose of setting charge controls, however, the CC suggests the application of a discount factor, as used in the RFS approach, is not the right methodology to adopt.[110]

345. Further, Ofcom has justified the use of an indexed HCA approach for the pre-August 1997 duct to avoid what it believes is the potential for the over-recover of these costs.[111] It would then be inconsistent to seek to impose a discount factor which is very likely to result in an *under-recovery of costs* on the post-1997 duct. Cost recovery on the basis of incurred costs is the clear basis for Ofcom's reduction in valuation of the pre-1997 assets, and for consistency of approach this principle should also be applied to the post-1997 assets. If this does not happen, then the overall impact of Ofcom's approach would be to deny Openreach a sustainable basis to recover its efficiently incurred costs. The fact that these costs are higher than those which might be incurred by a hypothetical entrant, building a national platform over a relatively short period, is not relevant if the focus is on permitting Openreach to recover *its* efficiently-incurred costs.

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[109] CC Determination, paragraph 3.78.

[110] If Ofcom considers that there should be consistency between the RFS and the asset valuation used for charge control purposes, then the RFS can be changed to bring this about. The clear point though is that the RFS cannot do two things at once – both match a valuation for charge control purposes and reflect a 'national build' replacement cost in circumstances where the two valuations are different. This is the current position in that the RFS does not show the RAV.

[111] Ofcom consultation, paragraph A5.13.

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?

346. Openreach assumes here that the first question is in fact a statement, and therefore addresses the question as to "*whether it is reasonable to expect BT to achieve below national costs on average?*" It is our understanding that Ofcom neither needs, nor intends, to make an assumption about the costs Openreach can achieve relative to the "national average".

347. First, for the pre-1997 assets, we understand that Ofcom intends to use an indexed HCA value, so the issue of using "below national average costs" does not arise.

348. Second, for the post-1997 assets, Ofcom proposes to use annual capex with (i) some form of indexation which may then be subject to adjustment (for assumed productivity gains over time) and (ii) an adjustment for scale economies from a national build. We have covered both of these adjustments in our responses questions 3.9 and 3.10 respectively.

349. Additionally, by using capex, which reflects actual spend, as a basis for valuation, Ofcom already reflect the costs that Openreach achieved. Therefore, if Openreach experienced lower costs, this is automatically taken into account.

350. There seems to us also some confusion about what the Analysys Mason says on this issue. Ofcom states that Analysys Mason suggest that Openreach appears be achieving better value for money in its costs than the UK industry average and that "*this could be by as much as 2% each year*". [112] We do not consider that this is suggested by the Analysys Mason Report. Rather, the 2% used by Analysys Mason refers to an assumed annual increase in industry productivity, not that Openreach's costs decrease by 2% a year from the industry average.[113]

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

351. Openreach understands the reason for Ofcom's general preference for glide paths and that there are circumstances in which some adjustments could be justified at the start of the control. As Ofcom states in the consultation, such an approach avoids discontinuities in prices over time and leads to a more stable and predictable regime for investors and for purchasers. It will also maintain efficiency incentives for cost reduction by allowing some of the benefits of over-performance to be carried over into any subsequent control.

112 Ofcom consultation, paragraph A5.177.

113 Analysys Mason Report, pages 42-43.

352. Ofcom gives three reasons for departing from the use of a glide path and one-off reductions:

- there are strong allocative efficiency arguments for bringing prices into line with cost sooner
- the previous charges were unregulated or are not subject to charge control and where Openreach's charges are high relative to costs
- there is a need to align charges for corresponding ancillary services provided alongside MPF and SMPF where the charges for MPF and SMPF variants are materially out of line and this may have a distorting effect on the market. [114]

Ofcom should also recognise that it can get its forecasts of unit costs wrong (for example, if volumes decline faster than it forecasts in the presence of economies of scale). Openreach considers that in such circumstances it should be recognised that some one-off adjustments (increases) might be appropriate to avoid continuing, and inadvertently amplifying, the effect of a mis-forecast into the subsequent control.

353. Moreover, adjustments should certainly not only be "one-way" i.e. always downwards, as seems to be envisaged in the Ofcom consultation.

> 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 12? Please give reasons for your answer.

354. Openreach supports the Ofcom proposal to maintain the same arrangements for demonstrating compliance, however Openreach also notes:

- Ofcom should remove the formal reporting requirements for low volume products
- Ofcom should formally verify whether or not Openreach has complied with its charge control requirements following each charge control year.

<u>Low volume products</u>

355. Openreach has consistently provided and presented to Ofcom the information set out in SMP Condition FAA4(A).14 of the 2009 LLU Statement and AA4(A).10 of the 2009 WLR Statement to demonstrate compliance with the basket controls, three months after the end of each charge control year. However, detailed volume data has not been available on all co-mingling products, especially where volumes are known to be small (e.g. LLU Internal Tie Cable Cease - Cease of 31-40 Cables, 20CN Enhanced Specification LLU Internal Tie Cable (1) for Co-location and Co-Mingling).

356. When providing the compliance statement to Ofcom each year, there has been a significant burden on Openreach of obtaining detailed volume information for low volume products. To address this burden, Openreach and Ofcom have informally agreed a number of pragmatic workarounds for the purpose of basket reporting.

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114 Refer Ofcom consultation, paragraph 3.96.

Openreach believes that these workarounds should be formalised and proposes that low volume products should be excluded from the reporting requirements altogether.

Confirmation of compliance

357. Openreach considers that it would be beneficial to itself and other stakeholders for Ofcom to formally verify that the price control requirements are being met, within a month of Openreach supplying the compliance data. This 'signing off' arrangement should provide greater confidence and certainty to all stakeholders that Openreach is complying with the charge controls.

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 answers.

358. Openreach agrees that there are no reasons why Ofcom should break from regulatory precedent and move away from the use of RPI as a measure of inflation indexation. As Ofcom states, the RPI remains a widely used measure of general inflation and is typically used to set price caps in other sectors subject to economic regulation. Whilst not being perfect, it is not clear that any other index is preferable.

359. Openreach also agrees with Ofcom's proposal that the change in RPI for the year to 31 October preceding the start of each Relevant Year should be used.

360. We comment further on some implementation issues in using the RPI in our answer to Question 7.4

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.

361. Openreach agrees with Ofcom's proposal to retain the 'carry over' provision within the new controls which require Openreach to make adjustments to the Controlling Percentage in each Relevant Year to account for any under/over provision in prior Relevant Years.

362. The carry-over and carry-under provisions are required in the event that Ofcom places overly restrictive controls on the baskets. For example sub-caps or an overly tight inertia clause, which prevent cost recovery across an entire basket in a given year. Openreach may also need to rely upon these clauses if Ofcom's charge control does not provide enough flexibility to commercially align our prices.

363. In the first year of the charge control, delays to Openreach notifying the new prices may increase the need to use the carry-over clause. Price changes to discharge the obligations for the First Relevant Year will ideally need to be announced on the same day that Ofcom publish the Final Statement so that Openreach can meet the "target revenue change". Openreach will not have perfect foresight of the charge controls framework until the Final Statement is published and will not be in a position to announce price changes on the date of publication given the need for due consideration and internal governance processes. For each day this takes, Openreach is required to over-achieve against the required Percentage Change in the First Relevant Year to

comply with the "target revenue change" clause. Openreach considers that Ofcom should allow 4 weeks for it to complete due diligence prior to notifying the prices, which will reduce Openreach's potential reliance on the carry-over provision following the first year of the control. This point is considered further in the answer to 3.16, below.

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.

364. Openreach considers that any price changes made prior to 1 April 2012 should be subject to a minimum of 28 days notice. However, as noted above, Openreach believes that an additional 4 weeks is needed in the first year of the control to allow for internal governance to implement the 100+ price changes – therefore we request that the charge control only becomes effective 8 weeks after publication of Ofcom's final statement:

- impact of 90 day notification: Given that the Ofcom Final Statement is unlikely to be published until autumn 2011, a requirement for 90 days price notification would be likely to result in the charge controls applying for a period of less than 3 months in the first year. Openreach would not consider such a control to be proportionate.

- 28 day notification for Second Year: furthermore, in the event of delay to the publication of Ofcom's Final Statement, we believe that Ofcom should consider whether a 28 day price notification period would be appropriate also for the Second Relevant Year of controls. For example, if Ofcom does not publish until December 2011, then Openreach will have to quickly announce price changes on or before 31 December 2011 to be effective from 1 April 2012. This does not give sufficient time for internal governance. Openreach therefore proposes a 28 day notification period for the Second Year of the control.

- drafting: with regards the notification period, Openreach considers that the wording of the draft legal instrument is ambiguous. In particular, it refers to "amendments to charges made prior to 1 April 2012". It is not clear whether this refers to amendments announced prior to 1 April 2012, or amendments which become effective prior to 1 April 2012.

- internal governance: finally, we note that the comments above in relation to price notification in the First Relevant Year are based on the understanding that the formula for "D" in clauses FAA4(A).3 and FAA4(A).7 is set to 28 days after the publication date. This drafting makes no allowance for the time it takes to make decisions and gain internal agreement on the prices to be made for the first relevant year especially in light of the number of products affected in the ancillary baskets. Openreach considers that period should instead be 8 weeks after the publication date (allowing 28 days for the notification period and 28 days for internal governance and decision making for the price changes in the first relevant year).

Question 3.17: Do you agree with Ofcom's proposal that charge ceilings 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.

365. Openreach is broadly supportive of the proposal to impose charge ceilings for key services for the First Relevant Year of the new controls (where such a control is appropriate and proportionate). We consider that this approach provides greater clarity to our customers as to price levels for the first control year and will simplify implementation for Openreach of the price changes for the key services in the first year.

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

366. In general, Openreach's preference is to have broad baskets to give greater flexibility in setting prices to reflect market demand and so as to align prices with costs over the control period.

367. However, if, as Ofcom propose, the MPF and SMPF line rental have separate charge controls then we believe that the corresponding Xs need to be set in such a way such that prices align with underlying costs over the period of the charge control.

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

368. Openreach understands that certain CPs have expressed concern that BT is likely to discriminate in favour of its downstream business which consumes WLR+SMPF. As noted in section 6.1, Openreach is incentivised to treat all its customers equivalently and there are measures in place to ensure that it does so. Moreover, the CC found that Openreach has not engaged in gaming in relation to the only basket where it found that there may have been scope for it to do so.

369. The ability of Openreach to engage in gaming is limited given other restrictions which apply to its behaviour. Ofcom already has the powers to prevent and deal with such practices. There are also a number of additional regulatory and legal restrictions and prohibitions which limit Openreach's ability to price as it sees fit. For example, the regulatory obligations found in the relevant market reviews conducted by Ofcom (which cover the majority of Openreach's products – including MPF and SMPF) contain a number of prohibitions which restrict BT's commercial freedom (including the general cost orientation obligation[115] which applies to LLU products).

370. Further obligations found in the 2010 WLA Market Review include:

i) a requirement to provide network access on reasonable request

115 Ofcom's 2010 WLA Market Review imposed a cost orientation obligation upon BT for services falling within the remit of the review. This obligation makes it clear that BT must be able to demonstrate to the satisfaction of Ofcom that charges offered, payable or proposed for Network Access are reasonably derived from the costs of provision based on a forward looking long run incremental cost approach allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.

ii) a requirement not to unduly discriminate against particular persons or against a particular description of persons in relation to matters connected with Network Access

iii) a requirement to publish a Reference Offer in relation to the provision of Network Access

iv) a requirement to notify charges and terms and conditions.

371. Similarly, general UK and EU Competition Law also prohibits BT from acting in an anti-competitive way and acts as a strong disincentive against any such conduct. Therefore, Openreach does not consider that it has the incentive or the ability to game.

372. Nevertheless, Openreach accepts Ofcom's proposal for separate baskets for MPF ancillary services, SMPF ancillary services and for Co-Mingling services as a means of addressing the concerns of the CPs referred to above. Although as argued elsewhere, we do not consider additional constraints beyond the separate price controls applied to each basket are required.

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?

373. Openreach agrees that there should be basket specific (i.e. RPI-X) controls as opposed to a single control applied to all baskets. This approach enables full cost recovery on each basket.

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

374. Openreach agrees that measuring compliance using prior year weights is a proportionate and practical approach and notes that the approach has worked successfully in previous charge controls.

375. Openreach agrees with Ofcom's reasons for using prior year revenue weights.[116] As explained in section 6.5 of this response, current year volume weights have several disadvantages, including:

i) <u>price volatility</u>: Price is likely to be volatile where Openreach adjusts prices mid-control year to reflect forecast vs. actual volume variances.

ii) <u>practicality:</u> There are the practical considerations of gathering and validating forecasts from CPs in order to inform the revenue weights. This gathering of data would need to be done in time for any subsequent control year. As Ofcom point out, the accuracy of such forecasts cannot be guaranteed and would place an administrative burden on CPs, Openreach and Ofcom.

376. Ofcom expresses the concern over potential gaming that could arise whenever prior year revenue weights are used, although has acknowledged that it has not seen any

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116 Ofcom consultation, paragraphs 4.35-7.75.

evidence of this.[117] Such a concern is misplaced as Openreach is dependent on the forecasts provided by its customers and there have been a number of cases where actual orders have significant diverged from forecast. The potential for gaming is therefore limited to the extent that Openreach has been given accurate volumes forecasts for all its products, and that those forecasts come to fruition. As noted previously, Openreach does not consider that it has the incentive or ability to game the baskets.

Question 4.5: Do you agree that 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 2% to 7.5%.

377. As explained in section 6.2.1, Openreach does not consider that an inertia clause is necessary for the baskets. This is because:

- in contrast to the previous controls, Ofcom is proposing that each of the baskets has a separate RPI-X control that is designed to achieve cost recovery. Separate baskets remove the scope for price discrimination and gaming
- the largest products have been removed from the baskets and the theoretical ability of Openreach to "game" prices is greatly reduced
- there are a large range of other regulatory and competition law restrictions and prohibitions which limit Openreach's pricing freedom.

378. In the event that Ofcom considers it appropriate and proportionate to impose an inertia clause, then it should be the greater of either the 10% level which was used in the 2009 LLU Statement, or the largest absolute value of 'RPI-X' for a basket. This is for the reasons explained below.

379. First, Ofcom has previously considered that an inertia clause below 10% would inappropriately and unduly restrict Openreach's pricing flexibility within the baskets. In justifying its conclusion to select the upper end of its proposed range of 5% to 10% inertia clause range in the 2009 LLU Statement, Ofcom stated: "*it would be inappropriate to unduly restrict Openreach's decisions within the baskets*".[118]

380. Second, the inertia clause should not be tighter than the largest absolute value of 'RPI-X' on any basket. This is because the inertia clause requires the movement of each and every charge in a basket to be within the range of 'RPI-X' plus or minus the inertia clause. Where 'RPI-X' is greater than the inertia clause, this means that all prices in the basket must be changed irrespective of the extent to which prices reflect costs.

381. Ofcom's current proposal for the inertia clause (to be within the range of 2% to 7.5%) could remove Openreach's ability to maintain the price of a product at its current level depending on the level of RPI and/or the inertia clause. See below for an example in the case of the SMPF basket.

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[117] Ofcom response to stakeholder questions, published 29 June 2011.

[118] Ofcom 2009 LLU Statement, paragraph 6.27.

Table 6 Ability to maintain prices in the SMPF basket for different scenarios

Basket	RPI	X mid-point	RPI-X	Inertia %	Maximum change %	Minimum change %	Range allows for no price change?
SMPF	4.0	10.9	-6.9	7.5	0.6	-14.4	Yes
SMPF	3.4	10.9	-7.5	7.5	0.0	-15.0	Yes
SMPF	3.0	10.9	-7.9	7.5	-0.4	-15.4	No
SMPF	4.0	10.9	-6.9	2.0	-4.9	-8.9	No
SMPF	3.4	10.9	-7.5	2.0	-5.5	-9.5	No
SMPF	3.0	10.9	-7.9	2.0	-5.9	-9.9	No

382. Third, Openreach needs the maximum flexibility from the inertia clause to ensure that prices reflect costs. At the top of Ofcom's proposed inertia clause range, Openreach is only just able to achieve this for the SMPF Jumper Removal product with an inertia clause of at least 7.22% (towards the top of Ofcom's range) in order to align price with cost over the control period. This analysis, however, assumes that Ofcom's RPI assumption is accurate. Where it is not, Ofcom's proposed 7.5% upper bound is too restrictive.

Table 7 SMPF Remove Jumper needs maximum flexibility

SMPF remove jumper	P0 Price	2011/12	2012/13	2013/14	2013/14 Cost
	£28.85				£28.69
RPI		4.50%	3.0%	3.0%	
X		-10.90%	-10.90%	-10.90%	
RPI-X		-6.40%	-7.90%	-7.90%	
Inertia % required		**7.22%**	**7.22%**	**7.22%**	
Resulting Price Change		0.82%	-0.68%	-0.68%	
Resulting Price	£28.85	£29.09	£28.89	£28.69	£28.69

383. Fourth, Openreach needs additional flexibility to enable it to achieve price alignment for products which have a similar cost or function. A 7.5% inertia clause does not allow Openreach to set prices to ensure alignment of prices for similar services. For example, consider the case of the MPF Jumper Removal Bulk product. Table 8 below shows how we would be unable to align its charge with that of the SMPF equivalent (which is currently priced at £24.88).

Table 8 Maximum price increase for the MPF Bulk Jumper Removal

MPF Ancillary basket	Initial charge	2011/12	2012/13	2013/14
RPI		4.50%	3.00%	3.00%
X		-7.50%	-7.50%	-7.50%
RPI-X		-3.00%	-4.50%	-4.50%
Max inertia clause (7.5%)		4.50%	3.00%	3.00%
MPF Bulk Jumper Removal (max price)	£ 10.80	£ 11.29	£ 11.62	£ 11.97

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

384. Openreach agrees that Ofcom should not align or intervene to narrow the differential in charges for MPF and SMPF Expedite. Indeed, Openreach does not consider that Ofcom should intervene in the pricing of these products at all. Please see section 6.3.2 for our explanation.

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

385. Openreach agrees that the price of jumper products should be aligned. However, the bulk variants of the jumper removal products should also be aligned.

Maintaining alignment of the singleton product

386. The MPF jumper and SMPF jumper products are proposed to be in separate baskets, with different controlling percentages. In order to *maintain* alignment of prices over the control period Openreach needs an inertia clause towards the top end of Ofcom's proposed range.

Alignment of the bulk variant

387. Ofcom proposes start price adjustments in "Annex to condition FAA4(A)" parts 1 and 2. For both MPF and SMPF, the proposed initial charge for jumper removal is only applied to the singleton product and is not applied to the corresponding bulk product. This will mean that the price for bulk products will be misaligned, especially in the case of MPF, as the table below illustrates.

Table 9 Ofcom proposals for aligning the jumper removal products

Product	Existing Price	Ofcom proposed start price
MPF Jumper Removal	£16.80	£28.85
MPF Jumper Removal Bulk	£10.80	£10.80
SMPF Jumper removal	£29.89	£28.85
SMPF Jumper removal Bulk	£24.88	£24.88

388. For consistency, and to achieve the commercial objective of aligning prices for similar services, Openreach requests that Ofcom aligns the prices of the bulk variants of the SMPF and MPF Jumper Removal products using the volume weighted average price.

389. To align the prices of the MPF and SMPF bulk variants absent a starting price adjustment, Openreach notes that using all of the flexibility in the inertia clause still fails to achieve this alignment.

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?

390. Openreach agrees with Ofcom's approach of using a weighted average of current prices to estimate the 2010 price of the service for jumper removals.

391. Ofcom have used MPF and SMPF volumes and the FAC for 2010/11 to determine the weighted average price and FAC for jumper removal. However, Ofcom's proposed approach of aligning prices with associated costs relies heavily on an inertia clause range that is too restrictive and this is explained more fully in our answer to question 4.7.

Question 4.9: Do you agree that option 1, that is ensuring the 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 the misalignment of prices?

392. Openreach agrees with the principle of alignment of prices for similar products. Our concern, however, is to ensure that we have sufficient flexibility within the baskets to enable us to maintain this price alignment and consistency with cost recovery over the period of the controls. As set out in our response to previous questions, we believe that the combination of separate controls for each basket when combined with the inertia clause will seriously inhibit our ability to achieve this objective.

393. In relation to Ofcom's options, Openreach agrees with Option 1 and notes:

- <u>option 1,</u> which proposes alignment of charges only at the beginning of the charge control period, is the better approach for ensuring alignment of similar charges, however the inertia clause will need to give Openreach the flexibility to maintain alignment over the course of the charge control.

- <u>option 2,</u> which proposes alignment of charges throughout the charge control period, removes the flexibility for Openreach to align prices with costs where there is divergence of prices for similar services over the charge control period. Openreach agrees that this Option would be complex and too granular a solution, not giving Openreach the flexibility to adjust prices. Openreach also notes that the proposal of using sub-caps does not necessarily address the requirement to maintain alignment over the period of the control: sub-caps merely set upper bound for prices but do not require alignment per se.

- <u>Option 3,</u> which proposes merging each pair of similar MPF and SMPF charges into a single service and charge control all similar services in a single basket, allows for MPF and SMPF charges to be placed into a single basket but Openreach believes this approach is an unnecessarily complex solution.

394. There are a range of products for which the alignment principles should hold, not just the jumper removal product noted by Ofcom. Whilst for some of these (e.g. cancellation and amend products) the prices are currently the same, the fact that the SMPF and MPF products are in different baskets subject to different controlling percentages means that it is even more important not to unduly constrain the separate baskets.

Question 4.10: Do you agree that a charge control of RPI-X should be imposed on MPF new provide to bring the charge into line with CCA FAC by the end of the charge control period?

395. Openreach believes that the RPI-X charge control on MPF New Provide will allow Openreach to align prices with costs over the period of the control. This proposed approach is in line with the CC Determination.

Question 4.11: Do you agree that charge controls control in the range RPI-7.3% - RPI-10.3% (base case RPI-8.8%) 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?

396. Openreach does not agree with Ofcom's proposal to maintain alignment of the charges for MPF Transfer and SMPF Connection/Migration by imposing a charge control bring the prices to the weighted average of the forecast CCA FAC cost stacks in 2013/14 for these products. As discussed in section 6.1.1, this proposal has unintended consequences on a range of other products in the portfolio which, to achieve commercial alignment, will result in Openreach not recovering its efficiently incurred costs over the charge control period.

397. To avoid these unintended consequences, Openreach considers that Ofcom should ensure that the price of MPF Transfer is reflective of its efficiently incurred costs over the charge control period (i.e. MPF Transfer is separately controlled on a glidepath to its CCA FAC by 2013/14), and separately ensure that the combined SMPF Connection/Migration product is also priced to align with efficiently incurred costs.

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

398. Openreach agrees that the charges for MPF and SMPF cease should be zero and costs recovered from rental charges.

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?

399. Openreach agrees that there should continue to be a co-mingling basket but believe that the number of products in this basket is too high. As per our answer to question 3.13, we propose that the reporting requirements are formally relaxed for low volume products.

400. Openreach notes that many of the co-mingling products are also subject to the LLCC, where historically the X level has been the same however the RPI statistic differs and

the controls are on an October – September year instead of April – March year. These results in contradicting requirements for price changes. Openreach accordingly requires Ofcom to commit to regulating each co-mingling service within a single charge control only.

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?

401. Openreach agrees that time related charges ("TRCs") should remain out of the scope of the charge control. Openreach considers that price regulation is unnecessary and disproportionate, and notes that:

- many products (not just LLU) use TRCs. TRCs cannot therefore be price controlled here without considering the impacts on adjacent and separate markets
- TRCs are already regulated under the LLCC. Any additional regulation would add unnecessary complexity and ambiguity
- TRCs are used for activities outside-of-the-normal and are in this sense 'value added', not normally subject to price control regulation
- TRCs are used in a competitive environment (e.g. Qube and Geek Squad provide value added services that compete with the services subject to TRCs).

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?

402. As discussed in section 6.3.3, Openreach does not consider it appropriate that Ofcom introduces general remedies or applies a charge control to Special Fault Investigations (SFI) or the upgraded version known as SFI2.

403. SFI sits outside the scope of the MPF and SMPF standard product of 100 MHz, and can be used for a range of services such as customer wiring and/or equipment which are beyond the Openreach network boundary. Furthermore, SFI is a discretionary service beyond the standard contractual service and is only ordered by a CP when the standard rental service returns a line test "okay". In the event that the fault is found to be on the Openreach network, then we do not charge the CP for the service. The CP also has the ability to limit the scope of the activities performed by Openreach given the modular structure of the SFI2 product that was agreed with industry.

404. On the basis of the above, Openreach considers that the introduction of any regulation for SFI (i.e. either a charge control or general remedies) would be neither appropriate nor proportionate.

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

405. Openreach does not consider it appropriate that Ofcom applies general remedies to SFI/SFI2, and therefore does not agree that any form of pricing restrictions should apply.

406. Ofcom proposes that to impose a requirement on Openreach that the prices for MPF and SMPF variants of SFI remain aligned throughout the charge control period. This proposal is unnecessary because SFI2 is a single product that does not differentiate between MPF and SMPF. Indeed, the work conducted by Openreach engineers for each of the SFI2 modules is the same for MPF as it is for SMPF.

407. Finally, the SFI variant known as SFI1 was withdrawn on 12 March 2011 and thus the proposed SMP condition FAA4(A).11(a) is redundant.

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?

408. Openreach agrees that the electricity charges should remain out of scope for the charge control. Openreach reviews the electricity rates each quarter and passes through any changes in the wholesale rates (both up and down) to CPs. We further note that electricity charges fall within the remit of Ofgem and not Ofcom.

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?

409. Openreach does not agree that MPF and SMPF Expedite connections should be charge controlled within the MPF and SMPF ancillary baskets. As discussed in section 6.3.2, we also do not consider that a cost orientation obligation should apply.

410. Ofcom's reason for applying the charge control appears to be to align the regulation of MPF and SMPF. However, the MPF Expedite service was included in the 2009 LLU Statement in error – the proposed extension of the charge control to SMPF Expedite compounds the error.

411. Openreach also does not consider that a cost orientation obligation should apply to Expedited services. These services allow faster provision of the MPF and SMPF service to end-users compared to standard provision times. On this basis, CPs have the ability to decide whether or not to offer faster connection option to their end-users, and thus the product provides a value-added proposition.

412. Demand for the Expedite product will determined by the price of the service, i.e. whether it reflects the willingness to pay of the CP, and the price and timeframes provided by the standard connection service. Low volumes for the service are not necessarily indicative of a weak pricing constraint being provided by the standard connection service — there could be a variety of reasons for the current demand profile including that MPF CPs predominately supply services to residential end-users.

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.

413. As set out in section 6.3, Openreach considers that it is not necessary for Ofcom to either charge control or impose a cost orientation obligation on LLU Enhanced Care services.

414. Openreach considers that enhanced and discretionary LLU services should not be subject to a cost orientation obligation. In its consultation for the 2009 WLR review, Ofcom was rightly concerned that applying cost orientation to value-added services "*may act to inhibit Openreach from providing additional services in the future as it may consider it will not be able to make a return on its innovation*".[119]

415. The factors which Ofcom identified in the WLR Charge Control to dis-apply the cost orientation obligation from enhanced services apply equally to the LLU portfolio. Openreach considers the full benefits of the regulatory framework for enhanced services, which focuses on promoting innovation, would be realised if the LLU framework was aligned with the WLR framework. In particular, Openreach considers that:

- the Service Harmonisation programme provides evidence of its willingness to innovate in this space
- it needs the regulatory freedom to take further risks on such investments and to enable new services to be offered with minimum intervention
- inconsistency in regulatory approach between WLR and LLU may make Openreach more risk averse to broader innovation across the portfolio.

416. Therefore, Openreach considers that the removal of the cost orientation obligation from enhanced services for WLR provides the right framework for innovation and that industry would benefit if the framework was similarly extended to LLU.

417. In the Ofcom consultation, Ofcom consider four options for the regulatory treatment of LLU Enhanced Care services. Openreach notes that for:

- option 1, which proposes to continue to apply the cost orientation obligation, Openreach considers that absence of clear guidance on how a basis of charges requirements would be interpreted would create a risk that incentives to innovate would be diluted and innovation would therefore be "chilled"
- option 2, Openreach supports the proposed removal of the cost orientation obligation. However, Openreach considers that Ofcom has erred in its analysis as we consider that MPF line rental services appear to be predominantly supplied to residential end-user customers. For example, TalkTalk and Sky's retail strategy is to provide a bundle of services to residential end-users and their success is shown through the decrease in the volume of WLR Core rental services. Ofcom's reference to the comments of CPs in relation to whether LLU service levels are discretionary focus on the supply of services to business customers, not residential customers which appear to be the focus for MPF providers
- option 3, which proposes a charge control for enhanced care, Openreach agrees that directly charge controlling these services would not be appropriate and may negatively impact future pricing innovation

119 Ofcom, *Review of the fixed narrowband services wholesale market – Consultation*, 19 March 2009, paragraph 13.25.

- Ofcom's preferred Option 4, Openreach supports Ofcom proposals that prices for LLU enhanced service levels do not become misaligned from the respective WLR enhanced service level.

418. Given the recent Service Harmonisation process and Openreach's commercial objective to align WLR and LLU service levels, Openreach does not object to the requirement to align prices. We also note that the framework of regulatory controls on LLU provides general safeguards which would allow Ofcom to intervene in the event that these services are provided on a basis that was not fair and reasonable, including the obligations to provide network access and new network access on fair and reasonable terms and conditions; to provide LLU services; to notify charges and not to unduly discriminate.

419. Openreach considers that a regulatory framework whereby the cost orientation obligation is removed from value-added services provides the right incentives to innovate. Openreach considers that there is substitutability between LLU enhanced service level options and, in addition, the ability of some customers to opt-out of enhanced service levels altogether imposes a market driven constraint on charges for these services. Therefore, we strongly believe that CPs will only purchase the enhanced care levels and other discretionary services where the price reflects the economic value of the product to the CP, and in turn, the end-user, of those additional elements which are not provided as part of the rental service. The market, rather than regulation, will provide the strongest basis for continued innovation in this space.

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

420. New services may over the period of the control, partially or fully replacing existing charge controlled services. Openreach therefore agrees that in such circumstances, the new services should be included in the charge controls.

421. Additionally, Openreach would expect to discuss and agree with Ofcom how the new services should be treated, including addressing the following matters:

- the revenue weights applicable to the new and/or replaced services

- the extent to which the new service wholly or partially replaces the existing service.

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?

422. In general, Openreach's preference is to have broad baskets to give greater flexibility in setting prices to reflect market demand and so as to align prices with costs over the control period.

423. However, if, as Ofcom propose, the WLR core rental services has a separate charge control, then the corresponding X needs to be set in such a way such that price aligns with the underlying cost over the period of the charge control.

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

424. Openreach generally prefers broad baskets for services to provide greater pricing flexibility. In the case of WLR Transfer, given the significant mis-alignment between prices and costs, Openreach considers that a separate charge control is appropriate.

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.

425. Openreach considers that prices should fully recover efficiently-incurred costs. As explained in section 6.4.1, we consider that WLR Transfer price should be set on a glidepath to CCA FAC over the charge control period.

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

426. Openreach considers that it is imperative that the cost orientation obligation should be removed from WLR Transfer services. Under both options discussed in the Ofcom consultation, the price of WLR Transfer would remain below the DLRIC until at least 2013/14. Under Openreach's preferred option, which is to align prices to CCA FAC over the charge control period, the price will still remain below LRIC for most of the charge control period.

427. It seems perverse to set a WLR Transfer on a price below LRIC and to expose Openreach to challenges that it has not priced this product on a cost-orientated basis. Therefore it seems prudent for Ofcom to dis-apply the cost orientation obligation from WLR Transfer services for this charge control period.

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?

428. As a matter of principle, Openreach's preference is to have broad baskets to give greater flexibility in setting prices to reflect market demand and so as to align prices with costs over the control period.

429. However, if, as Ofcom propose, the WLR Connection services has a separate charge control, then the corresponding X needs to be set in such a way such that price aligns with the underlying cost over the period of the charge control.

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.

430. Openreach agrees that a charge control would not be practical for MPF to WLR conversion given the low volumes of services, thus the charge control would not be appropriate or proportionate.

431. The low volumes for MPF to WLR conversion are not necessarily a reflection of the fact that end-users are not migrating from MPF back to WLR. Rather, to improve the

customer experience for the end-user a CP may opt to use the WLR New Provide service instead which requires an engineering visit and the ability to discuss with the end-user where they would like the Network Terminating Equipment ("NTE") located.

432. In contrast, the MPF to WLR conversion may only require an Openreach engineer to undertake jumpering activity on the frames, although such a process is faster as there is no appointed visit required to the end-user.

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?

433. Openreach agrees that the charge for MPF to WLR conversion should not be aligned precisely to the charge for WLR to MPF Transfer.

434. MPF and WLR are not directly comparable, given that the MPF service includes the ability to utilise broadband services. Therefore, such an alignment would not be comparing similar services. While the prices for MPF to WLR conversion and the MPF Transfer were aligned in the past, the current differential reflects the different regulatory treatment. Further, there are some minor cost differences between the MPF Transfer service and WLR to MPF Conversion, therefore precise alignment would not be appropriate.

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

435. Openreach agrees that charges for calling and network features should not be subject to a charge control.

436. A charge control is not required for Calling and Network Features since market forces and customer choice already act as clear constraints to inappropriate pricing where these services are very much consumed as optional value-adds the WLR Core service. Openreach significantly reduced prices (in the order of 85%) for these services as part of a six month special offer than ran from 1 February to 31 July 2009. This offer was made to stimulate increased take-up of these services. Subsequently, Openreach reviewed the impact of offer, taking into consideration a number of factors including the network's capacity to handle higher volumes.

437. From 1 January 2010, Openreach decreased most of the WLR Calling and Network Feature prices to the same level as the Special Offer that ran during 2009. Three products have had to be excluded from this price reduction, namely Caller Display, Call Waiting and 3 Way Calling. The special offer prices resulted in increases in consumption for these services which were demanding on network capacity and which could not be sustained on an ongoing basis.

438. Prices for many Network and Calling Features, such as Call Diversion or Call Barring, are very low on a per month basis e.g. £0.08 rental per month. Further, as the take up of VoIP based calling services increases, many of these services can be reproduced and are subject to competition. For example, Skype offers calling and network features.

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

439. Openreach agrees that pre-validation charges should not be charge controlled.

440. Pre-validation services, which provide information to a CP about the features on an existing line, are only used by WLR2 CPs as such data is available to WLR3 CPs via the Equivalence Management Platform. The WLR2 platform was scheduled to be closed on 30 June 2011, and therefore the pre-validation service was withdrawn with the WLR2 contract at that time.

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

441. Openreach agrees that ISDN to WLR conversion should not be subject to a charge control.

442. Volumes for ISDN to WLR conversion are currently very low. While volumes for ISDN2 and ISDN30 services are forecast to decline over the charge control period, the migration is not expected to be to WLR. In the case of ISDN30, Openreach expects significant decline in volumes as end-users move to alternative services such as SIP Trunking based products.

443. Furthermore, the price for ISDN to WLR is constrained by the price of WLR New Provide. The costs involved in a conversion include reconfiguration of the switch including a new line card and new jumper, and only the copper path is reused. The actual costs are likely to be higher than the price for WLR New Provide, and thus the price is constrained by the commercial realities faced by CPs.

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

444. Openreach agrees that cancellation charges should not be charge controlled as such a control would provide incorrect incentives to Openreach to become more efficient.

445. The current price of £3.50 for cancellation prior to the Point of No Return ("PONR") was set following an assessment of the distribution of costs incurred by Openreach before the PONR. This is because Openreach often undertakes some activities, such as jumpering work at the exchange, in advance of the Customer Required Date ("CRD") for an order.

446. It would be inappropriate for Ofcom to apply an efficiency target to these cancellation costs, as the only way to ensure the costs incurred prior to PONR are lower is to move the work to the CRD. That is, the control would have the effect of incentivising Openreach to be less efficient in delivering the service.

447. In relation to the charges for cancellation after the PONR, this is currently set at the full cost of the order. Ofcom has indicated that it will interpret the cost orientation obligation as meaning that it would not expect the cancellation charge to exceed the

charge of the original order.[120] Openreach requests that changes to the interpretation of the cost orientation obligation are reflected in Ofcom's upcoming guidelines on this subject.

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?

448. As per our answer to question 4.14, we agree that time related charges should remain out of the scope of the charge control.

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

449. In general, Openreach agrees with the modelling approach taken by Ofcom. As noted in section 5.1, this is consistent with the methodology endorsed by the CC. We believe that using data anchored to the Openreach Management Accounts and reconciled to the RFS provides a more accurate basis on which to set future prices compared to the traditional Cost Volume Relationship models.

450. As with the previous charge control, there are two main models:

a) the information used in the Cost Forecast model is Openreach management information for financial year 2009/10 (actual) and financial year 2010/11 (actual and forecast) and this is used by Openreach to project forward its expectations for the business based on various assumptions around volume, inflation and efficiency among others

b) the cost allocation model is a simplified version of the RFS designed to achieve a similar unit cost outcome but using fewer and less complex allocation bases.

451. The financial year 2009/2010, or the base year, of the Cost Allocation model is anchored to the RFS via a full and detailed reconciliation of costs at the total and product level.

452. The second year of the model, financial year 2010/2011, is then reconciled to Openreach's management accounts and plans.

453. Whilst supportive of the approach used, there are several areas in its implementation where we disagree with Ofcom, most notably on the assumptions about future efficiency assumptions and the way in which these are applied throughout the Cost Forecast Model (see also our responses elsewhere in this document).

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.

454. Openreach considers the task times it provided to Ofcom to be an accurate reflection of the actual time taken by engineers to successfully complete the activities listed. Openreach use the same data, albeit in aggregated form, to assess expectations of future business performance (although using different volume and efficiency scenarios). It is also used to measure current performance against targets by Openreach management.

120 Ofcom consultation, paragraph 5.49.

455. These task times are representative of an efficient organisation with an obligation to provide a universal service and are an average across all geographies covered. Any comparison provided by other stakeholders needs to take this into consideration.

456. Using these task times along with the other relevant operational and financial data, Openreach has been able to reconcile its 2009/10 actual financial performance (via the Cost Forecast and Cost Allocation Model) to the RFS for the same year. We are therefore confident that the task times used in the modelled base year are materially representative of the actual times used by Openreach in that year. In terms of the forecasting approach it would seem reasonable to either:

- apply a general assumption about productivity and apply it across the cost base (as Ofcom have done) recognising that in reality some elements of the cost base may fall above or below target, or
- to attempt to forecast each element (including task times) independently.

457. In our view combining the two approaches outlined above is problematic, especially if there is a "global" top-down efficiency assumption and then further adjustments are made that result in the overall number being higher than the stated target. In this case it would be necessary to adjust the "global" efficiency target or justify why a higher overall efficiency target is warranted.

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

458. Openreach does not agree with Ofcom's assumptions on efficiency. We believe the range is much too high and the subsequent base case of 4.5% is not an appropriate figure for this charge control. We believe a figure at the bottom end of Ofcom's range (3.5%), or below, is an appropriate rate to set Openreach in this charge control based on the supporting evidence available.

459. Please see section 5.2 of this response for further comments on efficiency.

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

460. Openreach's view on Ofcom's proposed assumptions regarding the impact of inflation on costs was provided in section 5.1.1, and we expand upon those views below.

Non-pay Inflation

461. Openreach agrees that Ofcom's adjustment to the inflation rate to apply to non-pay costs to account of the impact of VAT and changes to mortgage interest costs seems reasonable.

Pay Inflation

462. The assumptions Ofcom has used for Pay Inflation underestimate the true cost to Openreach.

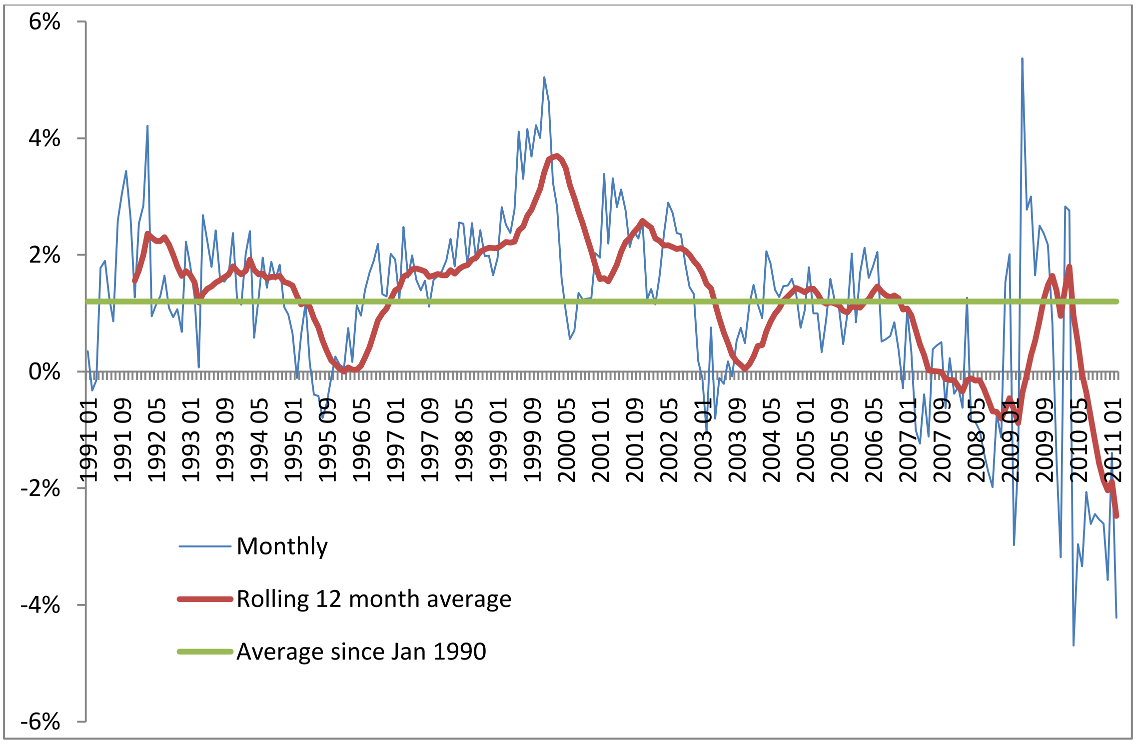
463. Ofcom has taken its non-pay inflation rate of RPI-0.5% and added a 0.5% increment to derive an estimate of real wage inflation. This approach assumes that Openreach pay costs increase in line with RPI and there is no real wage inflation over the control period.

464. [✂]

465. The approach taken by Ofcom does not take into account the historical evidence of real wage inflation that has been used by the CC to inform their *Bristol Water* determination in August 2010.[121]

466. According to the CC, the long term real earnings growth for the private sector is 1.4%. This rate is for the period up to July 2008, subsequently the trend reversed with RPI growing at a faster rate than earnings. The most recent data from the ONS gathered by the CC showed that pay was increasing at a faster rate than inflation. They took this evidence to support their argument that forecasts should not be based on historical data alone and should be based on a convergence of their forecast of wages and RPI to long term historical averages by the end of the price control period.

Figure 11 Graphical view of Real Average Earnings in the Private Sector (Source: ONS)



467. Following the CC lead, Ofcom should assume real pay growth of at least 1% per annum over the assumed RPI for each year of the control period.

468. This outcome is shown in the table below with the 2010/11 data being the actual Openreach pay growth (excluding contractors) for that year and the forecast periods

121 CC, *Bristol Water plc – A reference under section 12(3)(a) of the Water Industry Act 1991*, Report, 4 August 2010, Appendix K, page K25 para 119 (calculations based on ONS data).

showing our view of the calculation of real wage inflation, over and above Ofcom Base Case assumptions for RPI:

Table 10 Forecasts for inflation

	Actual 2010/11	FC 2011/12	FC 2012/13	FC 2013/14
Nominal pay growth	7.2%	4.0%	4.0%	4.0%
RPI (Ofcom)	5.0%	3.0%	3.0%	3.0%
Real pay growth	2.2%	1.0%	1.0%	1.0%

469. This outcome would be consistent with the 2009 LLU Statement where Ofcom said that "…*Openreach's long term estimate of real wage inflation of 1.0% per annum provides a reasonable basis for modelling pay costs and holding gains*".[122]

<u>Cost Lines Fixed in Nominal Terms</u>

470. Ofcom also make reference to some costs lines that have been "fixed in nominal terms" in the Ofcom consultation[123]. Ofcom have subsequently confirmed that three transfer charges have been treated as "fixed in nominal terms", these being Light User Scheme; Application System Maintenance; and Directory costs.[124]

471. Openreach disagree with this approach for the following reasons:

a) directory costs will be impacted in future periods by inflation like any other cost. These costs are incurred in BT Retail and passed on to Openreach via a transfer charge. The Directory costs consist of the cost of production, materials and distribution of the phonebook. It is inconceivable that these different costs will be immune from inflation over the period of the charge control. Ofcom does not provide a justification for treating these costs any differently from other cost types, specifically why they believe that inflation should not be applied and this should be corrected in the final decision

b) Ofcom does not provide any justification for treating Application Support and Maintenance costs as fixed in nominal terms. These costs are charged to Openreach by BT Operate and will be affected by inflationary impacts given these costs are principally labour related. There is a strong argument that these costs should in fact be inflated according to the Pay Inflation rate let alone the Non-Pay rate. Ofcom should correct this anomaly

c) Light User Scheme costs are disallowed from the WLR and LLU cost stacks so the point about inflation being applied is moot in this case.

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[122] Ofcom 2009 LLU Statement, paragraph A6.65. This finding is not affected by the CC Determination that BT's pay freeze in 2009/10 should mean that no pay inflation should be allowed in that year.

[123] Ofcom consultation, paragraph 7.58.

[124] Ofcom response to stakeholder questions, published 29 June 2011, available at: http://stakeholders.ofcom.org.uk/consultations/wlr-cc-2011/clarifications/

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

472. The cost of replacing the copper assets frequently fluctuates. Ofcom took the spot price for copper on the 31 March 2009, the date for the balance sheet date, as input into the 2009 LLU Decision. Openreach argued against this approach in the consultation leading to the 2009 LLU Statement. However, now that it has adopted that approach, for regulatory consistency of approach, it is appropriate to continue to use that methodology.

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

473. As explained in our answer to 7.1 above, we are in agreement with the approach taken by Ofcom to forecasting costs, including capex.

474. In relation to the CCA valuation of the assets we have covered the issues of the RAV and the RAV Adjustment in section 4. However, there are a number of modelling issues in respect of the RAV model that we would like to address below. For the other asset types discussed in this question we are in agreement with the approach taken by Ofcom.

RAV Background

475. Ofcom have proposed valuing the post 1997 duct assets using an index and are consulting on a range of values:

- an upper limit of £2.2bn, based on the GBCI index and applying a discount factor of 14.5%
- a lower limit of £2.0bn, based on the GBCI index with an efficiency factor of 1% per annum and applying a discount factor of 14.5%.

476. Ofcom has used the midpoint of £2.1bn as its base case for the consultation.

477. Ofcom has published the RAV model, which is intended to support the £2.1bn valuation as noted above that feeds into its charge control model. However, there are a number of issues with this:

- Ofcom have definitions for upper and lower limits, but not the mid-point used, making it difficult for them to produce the mid-point as an output from their RAV model
- capex does not line up with indexation models (see below)
- other holding losses are included in the valuation of post-1997 assets (see below)
- Ofcom have used RPI as the index to generate forecast holding gains, not GBCI
- Ofcom have not applied a discount factor in their RAV model (see below).

Comparison of capex sequence in RAV model with indexation models

478. The actual capex in the RAV model does not align with that used in the indexation models. The RAV model uses a number of sources for its post 1997 capex sequence:

- 1997/98 to 2004/05 Fixed Asset Register download for 2005/06 financial year of Gross Book Value ("GBV") by year of registration
- 2005/06 to 2006/07 Fixed Asset Register download for 2006/07 financial year of GBV by year of registration
- 2007/08 onwards capital spend by year.

479. The indexation models are based on 2009/10 data:

- Fixed Asset Register download by year of registration for assets registered at year end cut off
- assets registered after the cut off, but still in the 2009/10 financial year
- work in progress.

480. As a result, the RAV model capex is circa £100m lower than the indexation models and the GBV included is further reduced by Other Holding Losses. The combined effect of these two factors is that the GBV from the RAV model is circa £200m lower than the 2009/2010 indexation models at £2.7bn and that, although unclear, this under-valuation appears to flow through to forecast years.

Ofcom have used RPI, not GBCI, for forecast periods

481. In the RAV model, Ofcom have assumed RPI for the purposes of calculating Holding Gains in future periods and this is inconsistent with the approach taken to value historical assets.

482. Ofcom states that indexation using RPI gives a similar result as GBCI-1% and this is supported by (perhaps based on) comparing the valuations of assets acquired from 1997 to 2010.[125]

483. However, this apparent correlation cannot be assumed to hold for future periods. Indeed, a forecast of GBCI is readily available from the RICS for the duration of the charge control period and is shown below in comparison to the assumptions Ofcom have used in the modelling.

[125] Ofcom consultation, paragraph 3.71.

Table 11 RPI index compared with GBCI index

	RPI		GBCI	
	Index	Increase	Index	Increase
Mar-10	143.8		290.3	
Mar-11	150.3	4.5%	303.0	4.4%
Mar-12	154.8	3.0%	312.2	3.0%
Mar-13	159.4	3.0%	322.9	3.4%
Mar-14	164.2	3.0%	333.1	3.2%

484. Ofcom should amend the RPI assumptions used to calculate the Holding Gains in the model to reflect the GBCI forecast.

Ofcom have not applied a discount factor to future capex

485. In valuing historic post-1997 assets (those acquired up to March 2010), Ofcom proposes to apply a discount factor to BT's capex. However, this approach has not been applied to assets forecast to be acquired from April 2010 onwards in Ofcom's RAV model. Ofcom has therefore not been consistent in valuing past and future assets, nor has Ofcom applied their own methodology set out in the consultation document.

486. The effect of this is to retain 14.5% of the forecast capex as capital employed and not take this cost to the P&L as a holding loss, thereby reducing the costs to be recovered.

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

487. Please refer to our response on the treatment of pensions deficit repair contributions costs in section 5.3 and Annex B.

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?

488. Openreach contends that the cost of EvoTAM should remain 100% allocated to SMPF in the cost stacks. However, there should be a pricing adjustment, equivalent to the LLU System Set Up cost adjustments that spreads these costs across DSL lines. The full evidence to support this position is provided in our answer to Q7.11.

489. In summary, EvoTAM technology is being used for line testing 21CN enabled DSL lines in those exchanges where this is available. This is a new technology that is available to all CPs and as such should be classified as BT DSL Set Up costs according to the tests Ofcom set out in its 2004 WLA Market Review.

490. Ofcom make reference to a connection charge to the EvoTAM for customers wishing to use this technology. It should be made clear that the "connection charge" to which Ofcom refer is in fact a re-jumper charge which covers the actual cost of an engineer moving jumpers in the exchange. It does not cover any of the cost of investment of the

EvoTAMs so cannot be used as an argument for excluding these costs from the Core Rental Services cost stacks.

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

491. Please see section 5.4 for Openreach's response to this question.

Question 7.10a: With reference to Annex 8 (Group Transfers), do you have any comment on our approach to allocating costs?

492. Openreach notes Ofcom's approach to projecting costs using the actual Openreach data for 2009/10 and 2010/11 and applying from then their own assumptions for inflation and efficiency. It is our view that Ofcom should either take this same approach for all Group Transfer costs or seek to forecast each on an independent basis.

Corporate Overheads

493. Ofcom has used BT's own cost estimates for the Corporate Overheads Group Transfer. As noted above, this is inconsistent with the approach Ofcom has taken for other cost types where they have taken the base year cost and applied their own assumptions for non-pay inflation and efficiency. Openreach has discussed this point in relation to Corporate Overhead costs in section 5.2.8.

Accommodation

494. Openreach has uncovered a minor error in the information it supplied to Ofcom in relation to the breakdown of Accommodation costs between Telereal, Energy and Monterey was incorrect. It should in fact have been Telereal (60%), Energy (30%) and Monterey (10%). The correct breakdown of these costs is in the public domain from the earlier appeal into the LLU Decision in May 2009 so the oversight by Openreach should have minimal impact on other stakeholders.

Cumulo Rates

495. Openreach is in agreement with the approach taken by Ofcom to project forward Cumulo Rates costs and would like to underline Ofcom's comment that there is still much uncertainty over the level of Cumulo costs over the charge control as the 2010 list of rateable values in England, Wales and Scotland are still subject to review.

7.10b With reference to Annex 8 (Allocation of Openreach Costs to Products), do you have any comment on our approach to allocating costs?

Base 1 Allocation: Cumulo Rates

496. The allocation base for Cumulo Rates was kept static in the model for simplicity. However, analysis has been conducted by Openreach showing that if a dynamic base had been used it would not have resulted in a materially different outcome.

497. It is also important to highlight that the adjustments that Ofcom have made to the Cumulo Rates forecast has effectively stripped out any effect of NGA on the numbers.

Base 2 Usage Factors: Repair of E-Side Copper and Duct / Repair of D-Side Copper and Duct

498. Ofcom have used fault incidence data, provided by Openreach, for the base 2 usage factors which are used to allocate these costs to products. These are different to the usage factors that Openreach uses in the RFS and those that were originally provided to Ofcom in August 2010. The table below shows the two sets of usage factors:

Table 12 Fault rate usage assumptions

Product	Openreach August 2010	Ofcom Base Case
WLR Basic Rental	1.00	1.00
WLR Premium Rental	1.00	1.00
MPF Rental	1.30	1.04
SMPF Rental	0.30	0.15

499. Openreach strongly believe that the true cost of repair for MPF Rental customers is greater than the cost of repair for WLR Rental. As set out below, Openreach has evidence that the ratio of 1.04x that Ofcom assume understates the true cost differential and should be adjusted accordingly.

500. Openreach has undertaken further analysis on this matter. Consequently, Openreach considers that Ofcom should take into consideration two factors when settling on the final usage factors to be used in the modelling. Firstly, the fault incidence rate, which Openreach has provided to Ofcom, and secondly the impact of providing different service levels.

Table 13 Service levels for the Core Rental Services products

Product(*)	Service level
WLR Basic Rental	Service level 1
WLR Premium Rental	Service level 2
MPF Rental	Service level 2
SMPF Rental	Service level 2

** Some of the above products contain lines using higher service levels (3 or 4), however, these represent less than 1% of the total volume in the case of MPF and SMPF products and circa 4% of the WLR Basic volume base*

501. Openreach has conducted an exercise which calculates the different costs of providing service levels 1 and 2. This exercise used a sample of data taken from Openreach management systems and is judged to be representative of the national experience. It shows that the number of engineers required to deliver service level 2 is 20% greater than those required to deliver service level 1.

502. Taking the above findings from the analysis of providing the different service levels and using the fault incidence data previously provided gives the usage factors for modelling purposes contained in the table below:

Table 14 Revised fault usage factors

Product	Service Level	Fault incidence		Service level factor		Usage factor
WLR Basic Rental	SL1	1.00	x	1.00	=	1.00
WLR Premium Rental	SL2	1.00	x	1.20	=	1.20
MPF Rental	SL2	1.04	x	1.20	=	1.25
SMPF Rental	SL2	0.15	x	1.20	=	0.18

503. Openreach believes that using the usage factors shown on the far right of the above table will result in prices more reflective of the cost of providing these services.

7.10c With reference to Annex 9 (Review of unit costs), do you have any comment on our approach to allocating costs?

504. Openreach has no comments in response to this question.

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

TAMs

505. Ofcom allocate all of the costs associated with the Test Access Management System ("TAMs") to MPF in their Base Case modelling as the MPF Rental is the only product that uses this technology. However, Ofcom then perform a pricing adjustment that moves the prices for MPF Rental down and SMPF upwards, in effect spreading these costs across all LLU lines. Openreach considers that Ofcom should treat EvoTAMs in the same way as TAMs.

506. Ofcom sets out its justification for applying the pricing adjustment to TAMs in the 2004 WLA market review. In particular, Ofcom explored the principles of cost recovery for "LLU Systems Set Up" and noted:

- in relation to **cost causation**, it did not provide decisive guidance on the allocation of "LLU Systems Set Up" costs[126]

- in relation to the **distribution of benefits**, Ofcom found that "all customers who use broadband over the economic life-time of the LLU systems, not just those served by BT's unbundled loop, benefit from the increased competition and should contribute towards the costs incurred by BT to make LLU available; i.e. the LLU system set up costs"[127]

- in relation to **effective competition**, Ofcom found that "since BT DSL and LLU system set-up costs are likely to be different, achieving a level playing field would involve pooling LLU costs with equivalent system set-up costs incurred by BT to

[126] Ofcom, 2004 WLA Market Review, paragraph 8.7.

[127] Ofcom, 2004 WLA Market Review, paragraph 8.9.

provide DSL services and then sharing these costs across all local loops used to provide DSL services". [128]

507. The above references make it clear that Ofcom intended for LLU System Set Up costs to be spread across all DSL lines and this was achieved by the adjustment that Ofcom made. It is also clear that BT DSL system set up costs should be pooled with LLU system set up costs and spread across all DSL lines.

508. Consequently, Openreach believes that EvoTAM investment, which is the equivalent 'BT DSL set up cost' to the TAM cost that Ofcom classify as 'LLU system set up cost', should be pooled with the LLU system set up costs and allocated across all DSL lines.

509. In the event that Ofcom does not treat EvoTAM costs consistently with TAM costs, Openreach requests that Ofcom revisit the rationale for applying a pricing adjustment for TAM costs. Openreach would contend that the LLU market is now mature with strong competition and as a result there is little merit in effectively subsidising the MPF product by consumers of the SMPF service.

LLU Ceases

510. It is unclear to Openreach whether Ofcom has amended the volume assumption for LLU ceases given the zero pricing of the product, and whether this adequately takes into account the increased usage of flexi-cease compared to jumper removal product.

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

511. Openreach agrees with Ofcom's approach to deriving glidepaths. The methodology appears consistent with that reviewed by the CC.

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?

512. Openreach agrees with Ofcom's proposal in this instance to base charges on CCA FAC. In this case, and consistent with the CAT judgment, Openreach does not object to the price differential based on LRIC being used as a cross-check against productive inefficiency distortion while relying on the CCA FAC method to allocate all costs between products sensibly.

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

513. Ofcom's approach to the assessment of the likely differences in LRIC between MPF and WLR/WLR+SMPF is consistent with its approach in the 2009 WLR Statement. The CAT found that Ofcom did not err in relation to the differential per the 2009 WLR Statement.

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128 Ofcom, 2004 WLA Market Review, paragraph 8.15.