Charge controls for Wholesale Line Rental and related services

Consultation

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Section 1

Summary

Introduction

1.1 This consultation sets out our proposals for charges controls on Wholesale Line Rental and related services.

1.2 Wholesale Line Rental (“WLR”) is a product Openreach supplies to Communication Providers (“CPs”), allowing them to rent access lines on wholesale terms, and resell the lines to customers. This product gives consumers the opportunity to choose alternative suppliers who can provide them with access and, in almost all cases, calls service and has been a key aspect of increased competition in fixed narrowband services.

1.3 In the current consultation *Review of Fixed Narrowband Services Wholesale Markets*[1] (“the Wholesale Review”), Ofcom has confirmed the continuing need for WLR as one of the key remedies addressing BT’s significant market power (“SMP”) in the market for the provision of exchange lines.

1.4 In the Wholesale Review we are consulting on our view that there is a single market for wholesale analogue exchange lines rather than separate markets for business and residential wholesale analogue exchange lines defined by the Office of Telecommunications (Oftel) in 2003. As a consequence, we are proposing to modify the structure of the charge controls to reflect this revised view of the market and the use of the regulated services.

1.5 We are proposing to move from rental charge controls on both a residential and a business lines to a single control on a new core WLR rental service (based on revised *WLR Basic* service) which will be available to residential and business customers. Openreach will be free to continue to offer enhanced care services, such as its existing *WLR Premium* service, to customers and these will not be subject to specific charge controls. We also propose new charges for new line provision and the transfer of lines.

1.6 The proposed new controls would apply until March 2013.

Background

1.7 The current charge ceilings for WLR services were set in the 24 January 2006 statement, *Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services*[2] (the “WLR Statement”). Reflecting the separately defined markets for wholesale analogue exchange lines for residential and business customers, Ofcom set two separate rental charge ceilings at that time.

[1] http://www.ofcom.org.uk/consult/condocs/review_wholesale/
[2] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

Service	Current charge ceilings for annual rental
Residential WLR	£100.68
Business WLR	£110.00

1.8 These charge ceilings were fixed in nominal terms, i.e. they have not changed over time. When they were set, we explained that it would probably be appropriate to review the charges within the first few years of operation once the new WLR3 product had been launched (which was expected in 2007)[3]. Since then, BT has held the charges at the ceilings.

1.9 In 2007, we commenced a review of the WLR and also the local loop unbundling (LLU) charges under the auspices of the Openreach Pricing Framework review[4]. In the course of that review, in response to a recommendation by the European Commission, and in recognition of the possible changes to the market for analogue wholesale access, we concluded that it was appropriate to separate the determination of the LLU and WLR charges.

1.10 The underlying analysis of Openreach costs in the Openreach Pricing Framework review is nevertheless equally applicable to WLR and LLU. Further there is a clear need to coordinate underlying assumptions used in the determination of WLR and LLU charges given the large common cost base. Accordingly, we have drawn heavily on that analysis as the basis for our proposals for WLR charges in this consultation.

Conclusions

1.11 In this consultation we are proposing:

- As set out in Section 3, the current controls on Residential and Business WLR will be replaced by a single control, for a core WLR service (a slightly modified form of *WLR Basic*). The core WLR rental service will be available to all customers, residential and business, and will include a standard level of service;

- Separately, Openreach may provide higher service levels at an additional charge. We are consulting on whether a cost orientation obligation should apply to these services;

- As set out in Section 4, the control will apply for the period to March 2013, allowing us the option to align future LLU and WLR charge controls. The price of the new WLR core rental service should move towards the fully allocated cost of providing the service by 2012/13 with a straight line glide path, starting at the present charge and with no one-off adjustment;

[3] See paragraph 1.16 of the WLR statement and paragraph 3.17 of the LLU statement.
[4] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/

- As set out in Section 5, we are also proposing price controls for some related services, WLR line transfers and new connections. We are proposing that the new connection charge be reduced to reflect the estimated fully allocated cost. We are also proposing to maintain our previous policy of allowing for some of the WLR transfer system cost to be recovered through the WLR rental charge;

- As explained in Section 4 and 6, the fully allocated cost of *WLR Basic* will be based on the analysis set out in the Openreach Pricing Framework, updated to take account of specific factors. These include the changes to the BT next generation network development (21CN) and the restructuring of the controls to focus on a core WLR rental;

- The proposed charge controls are set out in Section 7, together with proposals for implementation and an explanation of who the proposals meet the relevant legal tests.

- Also as set out in Section 7, the current volatility in the RPI statistics means that we do not consider it to be appropriate to implement a RPI-X control with constant Xs over the period. Specifically, RPI in October 2009 (the reference point for the 2010/11 control) is likely to be negative. We have therefore proposed higher (or less negative) Xs in the 2010/11 control than in subsequent years. On this basis, we propose that prices will be within the ranges set out in the table below.

	Current price	**Oct 09 – March 10**	**2010/11**	**2011/12**	**2012/13**
New WLR Core Rental Service	£100.68	£100.68	RPI +3 to RPI +4	RPI - 1 to RPI - 0	RPI - 1 to RPI – 0
WLR transfer charge	£2.00	£3.00	RPI +3 to RPI +4	RPI - 1 to RPI - 0	RPI - 1 to RPI - 0
WLR new connection	£88.00	£67.00	RPI -16 to RPI-15	RPI - 20 to RPI - 19	RPI - 20 to RPI - 19

Section 2

Background and approach

Introduction

2.1 In this section we set out the background to the current WLR price controls, which were imposed as price ceilings. We also set out the context for this review will take place including:

a) summarising the proposals made in the March 2009 Wholesale Review which provides the authority and scope under which this review can take place;

b) summarising *A new pricing framework for Openreach*[5] the recent statement on the pricing of copper access products and services, which established a cost analysis for such products including WLR which we will adopt in this review; and

c) the legal framework in which we operate when considering and proposing charge controls as an SMP service condition.

Background and history

2.2 Wholesale Line Rental ("WLR") is a product Openreach supplies to Communication Providers ("CPs"), allowing them to rent access lines on wholesale terms, and resell the lines to customers. This product gives consumers the opportunity to choose alternative suppliers who can provide them with access and, in almost all cases, calls service. WLR has been a key aspect of increased competition in fixed narrowband services.

2.3 In 2003 Oftel conducted the *Review of the fixed narrowband wholesale exchange line, call origination, conveyance and transit markets*[6] which found that BT had SMP in the exchange line markets. BT was required to provide WLR as a result of SMP service condition AA10. This continued the position under the previous regime when, from 2002, BT had been required to provide WLR as part of its licence conditions.

2.4 In addition to the requirement to provide WLR, the 2003 review also imposed charge controls on various services including the provision of WLR. The charge controls were set on an RPI +/- X basis.

2.5 In September 2005 BT offered and Ofcom accepted a set of undertakings pursuant to section 154 of the Enterprise Act 2002. The undertakings included the commitment to establish a new, functionally separate organisation, Openreach, in order to manage BT's wholesale access network. Openreach's remit, therefore, includes the provision of WLR.

2.6 The pricing of WLR was further reviewed in 2006. Ofcom published *Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services*[7] on 24 January 2006. This document reviewed the pricing for WLR services and concluded that price ceilings were necessary. The price ceilings were set for the provision of residential and business WLR services as follows:

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[5] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/
[6] http://www.ofcom.org.uk/static/archive/Oftel/publications/eu_directives/2003/fix_narrow0803_1.pdf
[7] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

Residential WLR	-	£100.68 pa
Business WLR	-	£110.00 pa

2.7 In addition the existing charge control provision, set in the 2003 review, was removed.

2.8 The charge ceilings were fixed and, therefore, not indexed, but the 2006 review noted that they could be subject to further review as appropriate.

2.9 By 2008 it was clear that certain charges for regulated network access services provided by Openreach needed to be reviewed. Ofcom published a first consultation document *A new pricing framework for Openreach* on 30 May 2008. The review intended to look at specific charges for regulated network access services including the charges currently set for business and residential WLR. A second consultation was published on 5 December 2008 and a final statement was published on 22 May 2009 ("Openreach Pricing Framework Statement")[8]. The Openreach review, and how it relates to this review, is discussed in more detail below.

WLR services share of Openreach revenues and returns

2.10 WLR services represent around 56% of Openreach's total revenues, with sales (internal to BT and external) of c£2.96 Billion expected in 09/10.

2.11 WLR Rental represents the greater part of this revenue with sales totalling £1.63 Billion and £0.579 Billion respectively for *WLR Basic* and *WLR Premium*.

2.12 The returns on capital employed for *WLR Basic* and *WLR Premium* and WLR as a whole over the last three years are:

	07/08	08/09*	09/10**
WLR Basic	13%	6%	9%
WLR Premium	17%	12%	14%
WLR all services	16%	11%	12%

Source: BT information provided for the Openreach Pricing Framework

** Provisional*
*** Projected*

2009 Review of the wholesale fixed narrowband markets

2.13 Mindful that the wholesale access markets themselves had not been reviewed since 2003, we also commenced a market review of wholesale narrowband fixed markets, which included wholesale exchange line services.

2.14 On 19 March 2009 we published the Wholesale Review consultation document.

Market definition and market power assessment

2.15 In the Wholesale Review, we proposed a single market for wholesale analogue exchange line services in the UK (excluding the Hull area). This proposed market definition differs from the two separate markets defined by Oftel in 2003, namely:

[8] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/statement.pdf

- Wholesale residential analogue exchange line services; and
- Wholesale business analogue exchange line services.

2.16 The rationale for Ofcom's proposed market definition of a single wholesale analogue exchange line market is set out below.

2.17 On the demand side, the wholesale products for residential and business analogue lines are sufficiently similar to be regarded as belonging to the same product market, through a chain of substitution argument. In the previous market review, these markets were found to be separate. Since then, the products supplied have become less differentiated, with service levels now the key difference between residential and business users, although residential users can choose to pay to receive higher service levels.

2.18 Openreach offers two rental products at the wholesale level: *WLR Basic* and *WLR Premium*. Their prices were set at the time of the last market review based on the differentiation between the products when we last set prices in 2005. However, the majority of these differences have diminished over time with the key remaining differences being based on service levels and phonebook entries. The basic product includes an entry in the residential phonebook only, whereas premium allows the choice between residential and business. We, therefore, do not consider these to be significant differences, and there is evidence that some businesses (generally small companies) buy the residential product.

2.19 Given that both products are subject to a charge controls which reflected greater product differentiation at that time, the current prices are not necessarily good proxies for those that would prevail in a competitive market. In such a market, we would expect the price differential between services that have limited differentiation of value to users to reflect more closely the relatively low difference in costs of the services. In other words, if a hypothetical monopolist provider of *WLR Premium* lines increased its prices by 5-10% above the competitive level, it is likely that, given the minimal difference in service levels, a relatively substantial number of customers (the small firms in particular) would find it more attractive to switch to the *WLR Basic* product. A relatively substantial substitution from the (more highly priced) premium lines to basic lines is likely to render the SSNIP unprofitable even in the case where the hypothetical monopolist of premium lines would also be the main supplier of basic lines.

2.20 Having made the proposal to define a single wholesale analogue exchange lines market, we proposed that BT had SMP in that market with particular reference to BT's high market share (c 81%) and the high barriers to entry.

SMP Remedies

2.21 In the Wholesale Review we also considered what remedies would be appropriate to impose in order to remedy the identified market failure. We proposed that BT should be required to provide a wholesale analogue WLR product. We proposed this remedy in order to directly address BT's SMP in the relevant access market by requiring it to provide a product that allows CPs to compete with BT's downstream businesses on an equivalent basis.

2.22 The review did not specify how the product should be provided, nor did it propose that separate business and residential products should be maintained, although it was noted that WLR was now a mature product and that the "growth of WLR lines suggests that the products generally meet the requirements of third party providers and customers alike”.[9]

2.23 In addition to the requirement to supply an analogue WLR product it was also proposed that the product be charge controlled. It was stated that in the absence of such regulation BT would have incentives to “set prices … higher than could be expected in a competitive market.”[10] A charge control also provides incentives for BT to improve its efficiency as would be expected if the market was competitive, which would ultimately be to the benefit retail consumers.

2.24 We did not propose in the Wholesale Review how that remedy should be implemented. We recognised that the mechanism for any charge control should be considered in a separate consultation, i.e. this document.

Related SMP Conditions

2.25 Although the scope of what services should be subject to a charge control was left open, a basis of charges condition was proposed for BT to provide products in the wholesale analogue markets on the basis of long run incremental costs plus an appropriate return. We discuss the meaning and application of the basis of charges obligation with respect to WLR Rentals in Section 4.

Scope of this review

2.26 We have considered the proposals made under the Wholesale Review and are mindful that those proposals provide us with the authority to consult on a new analogue WLR charge control.

2.27 BT currently offers two analogue WLR products, *WLR Basic* and *WLR Premium*, which correspond to the existing residential and business markets defined in 2003. We therefore have to consider what the effect of the proposal to define a single market has in relation to how a charge control may be defined.

2.28 The choice of what core product or products should be subject to a charge control is discussed in section 3 below. We also consider what services should be included in the control, in Section 4 below, where we discuss additional services.

2.29 We are also mindful that the Wholesale Review is currently in its consultation phase, and therefore the proposals are subject to review in light of any comments received from stakeholders or the European Commission. Any proposals that we make are, and by necessity have to be, made on the basis that the proposals in the Wholesale Review will be adopted. If the outcome of the Wholesale Review differs in relation to any matter that affects this review, we will consider the implications for the proposals set out in this consultation.

Openreach Pricing Framework

2.30 In the Openreach Pricing Framework review, we undertook a detailed review of the underlying costs for the copper based services provided by Openreach. This included cost allocations between services and the determinations of key

[9] Paragraph 13.20 of the Wholesale Review
http://www.ofcom.org.uk/consult/condocs/review_wholesale/fnwm.pdf
[10] Paragraph 16.8 of above

assumptions on future asset prices, appropriate cost of capital and cost allocations to Openreach from other parts of BT (eg BT Group).

2.31 We used this analysis in the Openreach Pricing Framework statement to support the determination of the local loop unbundling charges. As WLR and LLU share a large common cost base this model is directly applicable to the establishment of the unit cost for WLR charges.

2.32 In addition, the use of a common model has direct policy advantages. In Annex 4 of the Openreach Pricing Framework Statement, we set out that we considered there were important efficiency reasons why the differential between (a) the sum of the WLR and SMPF charges and (b) the MPF charge should reflect the difference in the long run incremental cost of providing the two sets of services. It is, therefore, important that as far as possible we have a consistent approach in terms of the underlying cost assumptions. This helps to ensure that the differentials are not driven by changes in underlying cost assumption that should affect both sets of charges. We consider that the LLU charges set in the Openreach Pricing Framework Statement and the proposals made here for WLR are broadly consistent with achieving an appropriate differential between the two sets of charges.

2.33 We are aware that the time lag between the setting of the LLU charges (May) and the WLR charges (September) may give rise to particular issues.

2.34 We will, of course, consider changes impacting on any underlying assumptions prior to the final establishment of the WLR charge. However, we will only modify the assumptions in the underlying model to the extent that such modification are appropriate and required to ensure a robust outcome for the control. In particular, we will take into account the impact on the relativity of the WLR and LLU charges in the first 1.5 years of the charge control (the period of overlap with the LLU charge control) in any modification.

2.35 The Openreach Pricing Framework highlighted the fact that the WLR charges were largely recovering costs. The table below lists the actual and projected returns on capital employed for the aggregate WLR rental charges in the absence of any adjustment to the existing WLR rentals. This is based on the costs set out in the Openreach Pricing Framework statement.

	2007/08	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**
ROCE%	14%	8%	10%	11%	9%	9%

2.36 As can be seen from the table, WLR rental is expected to earn a return near or above its regulated cost of capital (of 10.1%) for the next two years with some decline from 2011/12.

2.37 This suggests that the current fixed control requires only a relatively minor adjustment over the period of the control.

Legal Framework

2.38 In setting any SMP Service condition, Ofcom has to ensure that the proposed condition complies with the various tests set out in the Communications Act (“the Act”), informed by the EC Communications Directives. The legal framework within which our proposals sit is set out in full at Annex 8.

2.39 As stated in the Summary at Section 1 and explained further above , the scope of this review derives its authority from the proposed market definitions and SMP findings made in the Wholesale Review, the consultation for which was published on 19 March 2009. That review discussed whether charge controls should be applied as an appropriate remedy to SMP in various markets. It proposed that the imposition of a charge control on analogue WLR services was an appropriate remedy, and discussed the legal tests justifying that proposal at Section 16 of the consultation document. This review makes proposals about how a charge controls on analogue WLR services, as an appropriate remedy, should be imposed.

2.40 In setting out how we consider the charge controls should work, we have been mindful of the need to ensure that our methodology remains consistent with the various obligations in the Act. Our proposals have to meet various requirements, and we have to ensure that we are acting consistently with our duties under sections 3 and 4 of the Act.

Section 47

2.41 Section 47 of the Act requires that any condition set must be:

i) objectively justifiable;

ii) not such as to unduly discriminate;

iii) proportionate;

iv) transparent.

2.42 Section 47 is primarily considered in the Wholesale Review, as to whether a charge control is an appropriate remedy and whether it passes the tests set out in section 47 based upon the identified market failures. This review concentrates on the mechanics of the control, but we are mindful as to how they fit with section 47 and the proposed reasoning set out in the Wholesale Review.

Section 88

2.43 Charge Controls, as a remedy, are authorised under section 87(9)(a) of the Act, which refers to price controls. Where a s87(9) remedy is proposed it must be compliant with section 88 of the Act.

2.44 Section 88(1) requires that such conditions must only be set where there is a relevant risks of adverse effects arising from price distortion and where the condition is appropriate for the purposes of:

i) promoting efficiency;

ii) promoting sustainable competition; and

iii) conferring the greatest possible benefits on end users.

2.45 In addition, under section 88(2), we must take account of the extent of the investment made by the Dominant Provider. Section 88 is of particular importance when designing a charge control as the choices that are made in determining how the control shall operate will affect how we are able to justify the tests. It is important to ensure that the proposals made are such that the control remains appropriate for the purposes set out in s88(1)(b), and 88(2).

Sections 3 and 4

2.46 It may be that charge controls could be set in a number of ways, all of which meet the requirements of sections 47 and 88. It is therefore important to consider the impact of any proposals against our general duties under section 3 of the Act and our obligations under the Community requirements, as set out in section 4.

2.47 Section 3 is set out in more detail at Annex 8, but the principle duty requires us to further the interests of citizens in relation to communication matters and to further the interests of consumers, where appropriate by promoting competition.

2.48 Section 4 obliges us to act in accordance with the six Community requirements. Article 8 of the Framework Directive sets out policy objectives and regulatory principles which member states shall take all reasonable measures to achieve. Where there is conflict between our section 3 general duties and our obligations under section 4 the latter has precedence.

Other duties

2.49 Section 7 of the Act imposes a duty on Ofcom to carry out an impact assessement (“IA”) where we propose to do anything for the purposes of or in connection with, the carrying out of our functions, where that proposal is important.

2.50 The proposal made in the Wholesale Review that a charge control for analogue WLR services was subject to an impact assessment set out that consultation document. The proposals made in this document relate to how a control should be implemented. This review is part of our duties and will be an important proposal, having a significant impact on BT and other CPs who are customers of BT’s WLR product, we will therefore undertake an impact assessment as part of our review. The discussion of the options available to us in proposing a charge control, how they meet our statutory obligations and how they impact on competition and stakeholders will be an integral part of this review as a whole. We therefore consider this document in its entirety to constitute the impact assessment, noting that Sections 3 and 4, in particular deal with the assessment of options.

Relationship to Wholesale Review consultation

2.51 Further, should any responses to the Wholesale Review consultation contain information or views that are relevant to our proposals made in this document, then we will consider those representations in the context of this review and our duties under section 80(6) of the Act.

Section 3

Setting a charge control on WLR rentals

Introduction

3.1 This section discusses how Ofcom plans to set a charge control for analogue WLR rentals. In Section 5 we examine what (if any) other aspects of WLR require charge regulation. In Section 7, we consider the existing and expected costs and returns for WLR services and in Section 8 we set out our charge control proposals.

3.2 In this section we consider the options and describe our proposals for setting new charge controls on WLR rentals. In summary, we propose:

- to set a single charge control for a core rental service covering all wholesale analogue exchange lines rather than setting separate charge controls for residential and business lines; and
- that Openreach will be required to offer the charge controlled service to all customers, but will also be able to offer it in combination with enhanced service elements to create premium and value-added services.

3.2 We consider that this proposal is consistent with the market review recommendations and the revised structure of service levels proposed for WLR and LLU by Openreach after discussion with Communications Providers.

3.3 In Section 2, we explained that the analysis presented in the Sections and Annexes of this Consultation represents an impact assessment. The analysis in this section is an important part of that impact assessment.

Background

3.4 In the 2003 Review, Oftel identified separate markets for business and residential customers and therefore currently Openreach has separate obligations to provide WLR services in both the business and residential markets[11].

3.5 In the 2009 Wholesale Review[12] we have proposed a single market for wholesale analogue exchange lines on a fixed narrowband network for the UK excluding the Hull area.[13] Hence the proposed new market definition covers services provided to both residential and business customers. Ofcom has further proposed that BT has SMP in this market.

3.6 The analysis supporting the single market definition for business and residential customers is explained fully in the Wholesale Review[14] and is summarised below.

[11] http://www.ofcom.org.uk/static/archive/oftel/publications/eu_directives/2003/fix_narrow0803_1.pdf
[12] http://www.ofcom.org.uk/consult/condocs/review_wholesale/fnwm.pdf
[13] Ofcom has also identified a market for wholesale analogue exchange lines on a fixed narrowband network in the Hull area. There is currently no WLR service in the Hull area and so this consultation does not include any proposals for this market.
[14] http://www.ofcom.org.uk/consult/condocs/review_wholesale/fnwm.pdf. See paras 5.115 – 5.117.

BT's current services

3.7 Openreach currently offers two separate services: *WLR Basic* and *WLR Premium*. These services were previously called *WLR Residential* and *WLR Business* respectively. We have assessed the difference between the services, both in the Wholesale Review and for the purposes of this document to consider what the appropriate form of regulation should be. There are three differences between the *WLR Basic* and *WLR Premium* products:

- *WLR Premium* has a greater quality of service commitments than *WLR Basic*;
- *WLR Basic* only offers a directory listing in the Residential section of the Phonebook; *WLR Premium* offers a choice of a listing in either the Residential or Business section of the Phonebook; and
- *WLR Basic* can be connected to network terminating equipment (NTE); *WLR Premium* can be connected to NTE or network telephony terminating point (NTTP).

3.8 Of these the only substantive difference is the difference in care level. As can be seen from the table below, each of the WLR products has three levels of care.[15] For both *WLR Basic* and *WLR Premium*, there is no incremental charge for Level 1 care, i.e. it is bundled with line rental. However, the commitments in *WLR Basic* Level 1 are lower than those in *WLR Premium* Level 1. Levels 2 and 3 provide enhanced levels of care and involve a charge in addition to line rental.

		Level 1	**Level 2**	**Level 3**
WLR Basic	Repair time	96 hours (Monday to Friday)	72 hours (Monday to Saturday)	24 hours
	Charge	Inclusive	£3.39 / quarter	£9.30 / quarter
WLR Premium	Repair time	48 hours (Monday to Friday)	48 hours (Monday to Saturday)	24 hours
	Charge	Inclusive	£3.39 / quarter	£9.30 / quarter

3.9 BT argues that there is some small additional cost in the provision of a business directory listing (under £1). There is no evidence that the difference between NTE and NTTP affects the cost of providing the services.

Openreach's Service Harmonisation initiative

3.10 A key related development in considering the appropriate regulatory framework for WLR services is the Service Harmonisation initiative currently being undertaken by

[15] See http://www.openreach.co.uk/orpg/pricing/loadProductPriceDetails.do?data=PhBKFq4UU57z6GBPt8DIoSUycYeyp0LS%2FM7XrdsmaHfgP3UPszSry78iVKC0gUAr

Openreach in conjunction with the Office of the Telecoms Adjudicator (OTA) and interested communications providers.

3.11 Openreach intends to rationalise its current set of eight distinct service levels for WLR and LLU and to provide four care levels with (near) identical terms for WLR and LLU – see Annex 7.

3.12 The advantages of the new approach are that it is more transparent and less confusing for Communications Providers, consistent between LLU and WLR, and offers both ‘insurance options’ (i.e. guaranteed service levels for a regular payment) or on-demand care.

Options for regulating WLR rentals

3.13 In the next part of this section we consider how we should regulate WLR rentals. We have identified three main options:

- Option 1 – separate charge controls for *WLR Basic* rentals and *WLR Premium* rentals (i.e. the current situation);
- Option 2 – a single charge control for a core WLR rental service; and
- Option 3 – a basket control containing both *WLR Basic* and *WLR Premium*.

3.14 In considering the most appropriate approach to controlling WLR rentals we have assessed the options above using the following criteria:

- Consistency with the market definitions proposed in the Wholesale Review;
- The desirability of Openreach having the incentive to develop and offer additional services, such as modified or new forms of care level;
- Ensuring that Openreach does not have the ability to price discriminate to the detriment of consumers and competition; and
- The most efficient recovery of costs through prices being set in a manner that provides the greatest benefit to consumers and citizens.

3.15 Set out below we define each option and consider them against the criteria set out above.

Option 1 – separate charge controls on *WLR Basic* and *WLR Premium*

3.16 This option would be a direct continuation of the existing controls on the charges for a business and residential line.

Consistency with the Wholesale Review’s market definition

3.17 As discussed above the current separate controls on a WLR residential and business rental were derived from the previous finding of separate access markets for business and residential customers.

3.18 We need to consider our obligations to institute conditions which are proportionate to the competition problem identified and non-discriminatory. In setting two charge controls we are, in effect, obliging BT to provide two separate services for business and residential customer fixed at a given level of service conditions.

3.19 Our analysis of the market accepts that some purchasers of WLR already substitute *WLR Basic* for *WLR Premium* services. This reflects the fact that there is a very wide level of commonality between the two services differing only in the provision of directory listing and care levels.

3.20 In the absence of any other consideration, it does not appear proportionate to require BT to offer two similar services with specific prices and characteristics to address a competition problem in a single market, i.e. wholesale analogue access.

3.21 We also consider that maintaining two separate charge controls may be considered discriminatory in that it would differentiate the regulatory treatment of similar services, with customers wanting WLR with level 2 or 3 fault repair, being treated differently from customers purchasing *WLR Premium*.

Incentive to innovate

3.22 We consider that the continued imposition of a control on business specific enhancements for WLR risks stifling innovation in this service by Openreach.

3.23 As discussed above, Openreach is currently in discussion with the OTA and other communications providers options for variation in care levels. We consider that this process of innovation should be encouraged and seen as an on-going process. The introduction of charge controls sets in stone a specific care level for a given service. It would be desirable to minimise the number of such services fixed in this way.

Anti-competitive discrimination

3.24 Clearly we are concerned that WLR charges are set in such a way that ensure the services are supportive of a competitive environment, provided that they deliver a ‘fair’ return to BT.

3.25 The setting of charges would ensure that was the case for business and residential lines and thus would meet this criteria.

The most efficient recovery of costs through charges

3.26 Price discrimination for the same or similar services can sometimes enhance consumer welfare. It can allow lower prices to be offered to those customers who do not value the service as highly. This means that more of these customers are prepared to buy the service. This can lead to higher total output and lower average costs than would otherwise be the case.

3.27 This argument suggests that it can be more efficient to have two charges if they can be constructed to ensure that greater demand for one service would allow us to lower the charges for the other.

3.28 Openreach is currently able to price discriminate between *WLR Basic* and *WLR Premium*, in the sense that the current differential between charges is greater than the differential between long-run incremental costs. At the moment, this does not mean that *WLR Premium* is ‘cross subsidising’ *WLR Basic* as both services more than cover their incremental costs. Rather it is that more common costs are recovered from *WLR Premium* than *WLR Basic*.

3.29 However, we believe, that in practice, Openreach's ability to price discriminate in this way is fairly limited. In the current Wholesale market review our provisional finding is that there is a single market, rather than separate business and residential markets. As described in more detail in section 2, this is partly because of substitution by businesses for the cheaper basic product.[16]

3.30 Further, the substitution between the *WLR Basic* and *WLR Premium* services constrains our ability to set prices in advance that ensure that the common costs are allocated to the appropriate proportions in the prices because the relative prices are set based on assumptions about the relative volumes sold.

Option 2 – a single charge control for a core WLR rental service

3.31 This option would involve a control focussed on a single core WLR rental service. The service would be open to provision to both residential and business users and thus would support the minimum level of service for both groups, e.g. including business listing where required.

3.32 Openreach would be free to provide the *WLR Premium* level of care separately as part of the set of enhanced care services.

Consistency with the Wholesale Review's market definition

3.33 A single core WLR rental service clearly is consistent with the Wholesale Review proposals, setting a single regulated service requirement to meet the identified competition requirement. A single charge control would thus appear both proportionate and non-discriminatory.

Incentive to innovate

3.34 By separating the rental charge controls from the care levels, we allow Openreach greater flexibility to adapt and develop the care services it will provide. This will allow Openreach to respond to changes in user demands for this and other care levels and in response to changes in their own structure and system development.

Anti-competitive discrimination

3.35 A single WLR core service control will ensure that there is a 'fairly' priced service available. We consider that the establishment of a core WLR service will also act to constrain the charges Openreach sets for services based on higher care service through a chain of substitution argument.

The most efficient recovery of costs through charges

3.36 In setting a core rental charge, we can still estimate a level of common cost recovery that should be attributed to higher care level packages. This has the effect of reducing the required price for the core service. This estimate is subject to assumptions on volumes for the other services and thus we would need to be cautious in deriving such estimates.

[16] In general, certain conditions need to be satisfied for price discrimination to be possible. In this case, to sustain a higher price for business WLR (than reflects cost differences), BT must firstly be able to identify business customers, and it must be able to prevent resale of residential lines as business lines.

Option 3 – a basket control containing either both *WLR Basic* and *WLR Premium* or both *WLR Basic* and a modified *WLR Premium*

3.37 This option would involve a control for a basket of services containing both *WLR Basic* and *WLR Premium*. This will allow Openreach to price discriminate between residential and business lines, while ensuring any increase in, say, business charges would lead to a decrease in residential rental charges.

3.38 We consider that such a basket should use a modified form of the *WLR Premium* service with care levels set at the same level as WLR Basic. This is because, there is again a risk that the inclusion of the *WLR Premium* service in the basket diminishes the flexibility Openreach has to innovate in its care service delivery. There is no incentive on Openreach to increase or risk increases in costs of the regulated service as the price control will not allow this increase to be recovered. Any additional charges for the *WLR Premium* service will lead to a reduction in charges for *WLR Basic* through the basket mechanism

3.39 Excluding higher care levels, we would still allow Openreach to price discriminate though the directory listing.

Consistency with the Wholesale Review's market definition

3.40 We consider that in this case setting a control on two services for WLR rental could be argued to be proportionate as it will allow price discrimination in a way that would be potentially advantageous to consumers – see discussion below.

Incentive to innovate

3.41 As discussed was a risk that the inclusion of the *WLR Premium* service in the basket diminishes the flexibility Openreach has to innovate in its care service delivery.

3.42 For this reason, we consider that the appropriate basket would remove the enhanced care element of the *WLR Premium* service with the difference in the two services being focussed on discrimination based on the customer type, and hence the directory listing, alone. This should therefore have no significant impact on innovation.

Anti-competitive discrimination

3.43 The basket will ensure that there is a 'fair' charge for an entry WLR service though one which varies between residential and business.

The most efficient recovery of costs through charges

3.44 As noted earlier, price discrimination for the same or similar services can sometimes enhance consumer welfare. The basket would allow this price discrimination to be controlled in a way that ensured the higher prices to one group did lead to a reduction in charges to the other.

3.45 However, the existence of a basket is not cost free. There are management costs and it can lead to less predictability in charges. Also businesses have the option now to purchase a listing in a directory (prices start at £5.50 ex VAT). This retail price must constrain the price differential in a basket. Therefore, for BT to increase the basket differential beyond this retail charge they may need to increase this retail charge, which would have a wide impact on businesses who pay this to spread their listings to multiple directories. This ability to directly purchase a listing is one of the reasons there have been substitution of *WLR Basic* for *WLR Premium* now (ie there is already a chain of substitution though perhaps with greater friction than would be desired in Option 2 as the costs are higher to get a directory listing for business).

Proposed charge control structure

3.46 We consider that the market definitions proposed in the Wholesale Review make the imposition of two separate charge controls for *WLR Basic* and *WLR Premium* disproportionate to the competition concern. Therefore, we do not consider that remaining with the current approach, Option 1, is reasonable.

3.47 We consider the two other options set out above to be the most likely charge control structures for furthering consumers' interests. With both of these options, Openreach would have the ability and an incentive to offer enhanced care services. They would both also allow Openreach some flexibility over the nature of the enhanced care services, consistent with their Service Harmonisation initiative.

3.48 It is possible that by making price discrimination between business and residential customers easier, the basket approach may be more efficient. However, our initial view is that this is that the net benefits from this approach are not clear cut and given the additional complexity the approach entails it is not our preferred option.

3.49 We, therefore, favour the single core service rental option. We consider this best meets the criteria and also has the advantage of setting the framework for WLR controls more closely aligned with MPF – ie a single core service not differentiated by business or residential use.

3.50 Our view is, therefore, that it is appropriate to set a single core service rental charge which will cover a service suitable for a basic offering to business and residential customers. Accordingly, the service would need to, at least, include the option of listing in a business directory. Openreach would be free to sell enhanced care products in addition to the core rental service, including its existing *WLR Premium* offering and any new enhanced care offerings. This arrangement should ensure that Openreach has an incentive to develop new enhanced care packages.

Should enhanced care levels be cost oriented?

3.51 As set out above we propose that we should control WLR rentals by setting a single charge control on a core WLR rental service. In this part of the section we consider whether we should impose a cost orientation obligation on the *WLR Premium* care level above that is included in the core WLR rental service.

3.52 Currently, the enhanced care component of *WLR Premium* is not subject to a cost orientation obligation as it is part the *WLR Premium* rental service (see paragraph [3.19] and table) which is directly charge controlled by Ofcom. As such it is explicitly excluded from the cost orientation obligation applied to the business wholesale narrowband analogue exchange line market. Most other WLR charges in this market are subject to a cost orientation obligation.

3.53 In the Wholesale Review, we proposed that a cost orientation obligation should apply to all the elements required to provide the basic level of service required by consumers. These are:

- Rental charges (though we will exempt the rental charges subject to explicit control);
- Connection, rearrangement and termination charges; and
- Network features that comprise the basic service.

3.54 In addition, we asked whether all options for enhanced levels of WLR care should be subject to cost orientation or other SMP remedies. The Wholesale Review did not explicitly include the *WLR Premium* care level in this question. But we consider that the issues are inextricably bound together. It is unlikely that we would propose substantially different approaches to such similar services and, therefore, we need to consider the implications of any one decision for other related services.

3.55 We will, therefore, consider responses to both the Wholesale Review and this consultation in any final determination on cost orientation.

3.56 If we were to introduce a cost orientation obligation, it would be appropriate to provide guidance on what this would mean in the present context. We would anticipate that this guidance would inform any subsequent dispute.

3.57 With respect to the *WLR Premium* care service, there are at least three options:

- Option 1 – applying cost orientation to the *WLR Premium* charge (i.e. the rental of the *WLR Premium* product) in total;
- Option 2 – applying cost orientation to the *incremental* part of the *WLR Premium* charge compared to the core WLR service, i.e. just the difference in charges related to the care level; or
- Option 3 – not applying any cost orientation obligation, but giving guidance on how we might interpret other obligations on Openreach in the event of a dispute.

Option 1 – applying cost orientation to the full *WLR Premium* charge

3.58 With the first option, the whole *WLR Premium* charge would be subject to cost orientation. In assessing cost orientation, we generally apply a first order test which requires that the price of each item or service should be between the distributed long run incremental cost (DLRIC) floor and distributed stand alone cost (DSAC) ceiling. There would be a wide difference between such a cost floor and ceiling for *WLR Premium*. This is consistent with the unaudited figures in BT's 2007/08 regulatory financial statements. For the *WLR Premium* product sold externally, the long run incremental cost floor is around £72 and a stand alone cost ceiling is around £139. The equivalent costs for internal sales of *WLR Premium* are similar.[17] This is because the core WLR charge includes a significant component of common cost above the incremental cost of providing that service. There would be scope to vary significantly the amount of common cost recovered from *WLR Premium* compared to the core WLR service.

17 http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2008/Currentcostfinancialstatements2008.pdf

3.59 Because of the wide range that would result from this interpretation, this approach seems to offer little constraint on pricing. As such, it would appear to offer customers of *WLR Premium* little protection from the risk of significantly higher prices.

Option 2 – applying cost orientation to the care element

3.60 The second option would address the concern of unreasonably high prices by tying the cost orientation obligation explicitly to the increment. Again, while the possible range of charges would be smaller, there would still be considerable uncertainty as to where an appropriate charge would sit.

3.61 In particular, a DLRIC approach would suggest a charge very close to zero which would offer no incentive for Openreach to provide such as service. The DSAC would also offer potentially a largely per event charge.

3.62 Thus, there is a risk that cost orientation could significantly reduce the incentive for Openreach to provide and innovate in the provision of care levels. The Service Harmonisation initiative discussed above shows the value of flexibility in the development of care levels.

Option 3 – no cost orientation

3.63 The argument for the third option of not having any cost orientation obligation rests partly on the fact that customers have the option of buying a core WLR service. Provided there are enough customers who would switch to buying core WLR service if the price of *WLR Premium* were to rise, then Openreach would find it unprofitable to increase the price of *WLR Premium*.

3.64 Our existing proposal for a single market for Wholesale Analogue Access is premised on that fact that substitution is strong at least between the existing *WLR Basic* and *WLR Premium* services. The extent of such a chain of substitution is likely to be enhanced by ensuring that the core WLR service is suitable as a base product for business customers. In particular, by ensuring they are able to buy the product freely and are able to list in business directories. We therefore consider that *WLR Premium* is likely to be constrained by a core WLR service. If this substitution is strong enough, a cost orientation obligation for *WLR Premium* may be unjustified.

3.65 The third option needs to be considered in the context of the other obligations on Openreach that would apply to *WLR Premium* even if there were no cost orientation obligation. In particular, Openreach would continue to be subject to obligations on notifying charges (Condition AA6(a)), no undue discrimination (Condition AA2) and providing network access on fair and reasonable terms conditions and charges (Condition AA1(a)).

3.66 We could in principle provide guidance on how we would interpret the fair and reasonable requirement in the event of a dispute. In particular, we could say that we would expect to consider whether the *WLR Premium* was fair and reasonable solely in terms of the incremental charge compared to *WLR Basic*. This would involve considering whether the increment was fair and reasonable given the cost of providing the enhanced services. However, in considering whether the increment was fair and reasonable, we could have regard to factors other than the costs of providing the enhanced care. In particular, we might also consider demand factors as well as the costs. For instance it might be reasonable for Openreach to recover a higher proportion of common costs from the users who place the highest value to some of the enhanced features.

3.67 An advantage of this approach is that it should give Openreach stronger incentives to respond to customer demand for enhanced care services and to innovate, whilst offering customers some backstop protection to prevent Openreach from behaving unreasonably.

3.68 There may be a particular concern that BT will increase the enhanced care WLR charges while not reducing the price of its retail enhanced care products. Competing CPs could then face a margin squeeze. In such instance we would have access to ex post competition law powers to address any margin squeeze, as we did when we examined whether BT's pricing of BT Together constituted a margin squeeze[18].

3.69 We invite stakeholders to respond to the question below on the approach to cost orientation. As noted above, we will consider their response together with responses to the Wholesale Review question on higher care level regulation.

Question 3.1 Do you agree with our preferred option to set a control on a WLR core rental service to be available both to residential and business customers with the option for number entry to residential and business directories? Or do you consider that the alternative use of a basket would be a more appropriate control?

Question 3.2 If we are setting the control on a core WLR rental service are there any other features of the WLR Premium service, other than entry in a business directory, that would be required in the revised core rental service so that it would be suitable as a basic business product?

Question 3.3 Please provide you views on the requirement for and if necessary, duration of any transition period for the implementation of a core WLR service?

Question 3.4 What is your view on the appropriate basis of charges (cost orientation) regime for WLR Premium and other higher care level services? Do you consider that the other obligations on Openreach (perhaps supplemented by guidance on interpretation) are sufficient control on the WLR Premium charge without an addition basis of charge condition? (Responses to these question will be considered in conjunction to the basis of charges (question 13.3) proposed in the Wholesale Review consultation).

18 http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw007/cw_760_dec/

Section 4

Structure of WLR rental charges

Introduction

4.1 In this section we set out our approach to setting the core WLR rental charge.

4.2 The key elements to this are:

- using the analysis in the Openreach Pricing Framework, adjusted as necessary for factors discussed in this consultation;

- setting charges by reference to current cost accounting and full allocated costs (CCA FAC);

- a charge control for 3.5 years, from 1 October 2009 to 30 March 2013 to ensure that that control is consistent with the LLU charges set in the Openreach Pricing Framework and allow a path to aligning the charges.

4.3 The form of the proposed control will require that the underlying costs for the WLR core rental service be determined and separated from any enhanced care component.

4.4 To establish the proposed charge cap, we therefore identify the underlying cost of the basic rental element of WLR excluding the additional costs for enhanced service in *WLR Premium* (including common cost recovery by *WLR Premium*). The financial details for this are set out in Section 5. Our approach to this is explained in detail below. The core line rental service comprises the same rental service which Openreach currently provides for its *WLR Basic* service. This incorporates the basic level of fault repair necessary for line maintenance (i.e. Level 1 of the *WLR Basic* fault repair options). Enhanced levels of support are not included in this service.

4.5 This would not necessarily mean that the charge for the core rental service would need to be billed separately for lines used to serve business customers (or other enhanced packages). However, as discussed in the previous section it would be a natural reference point for CPs wishing to understand the breakdown of costs or service elements which go to make up their total package. By imputing the regulated charge for core rental to a core rental plus enhanced service bundle, it would be straightforward to calculate the charge being levied for the enhanced elements. Ofcom expects that this would be the starting point for any analysis of the costs of WLR service elements – for example, to establish whether they meet applicable basis of charges requirements, or have any anti-competitive effect.

Forecasting efficient cost level for WLR charge control

4.6 Our forecasts of efficient cost in the Openreach Pricing Framework Statement were prepared on the basis of the existing residential and business WLR services. The total cost of these two services together will include the additional costs of providing the higher quality business service. In forecasting an efficient cost level for the core rental service, we need to deduct from the total cost those extra costs related to providing *WLR Premium*. We have therefore estimated the additional costs involved in providing *WLR Premium*. This analysis is set out in Section 5.

4.7 The WLR charge currently recovers some of the costs of line transfer. As we will set out in the next section, it may be appropriate to continue this approach. Should any of the transfer cost be re-allocated to the rental charge this will of course mean that the WLR charge will be slightly higher than it would otherwise be.

Charge controls set using CCA FAC

4.8 We are proposing to set WLR prices based upon CCA FAC costs, forecasting those costs as at 2012/13 and following a glide path to that point for the duration of the control period. We consider that this is the most appropriate way of setting WLR charges under this charge control, for reasons set out below.

4.9 CCA FAC has been used in other regulatory charge setting exercises as an alternative to a long run incremental cost (LRIC) based approach, including in the current WLR charges, the Network Charge Controls and the Leased Lines charge controls. We have concluded that the arguments (in those reviews and in the Openreach Pricing Framework) which we summarise below for favouring CCA FAC over LRIC based approach in setting charge controls equally apply here, this argument was set out in detail in Section 6 of the Openreach Pricing Framework, paragraphs 6.8-6.12. In addition CCA FAC has also been used in determining the appropriate charges for MPF and SMPF rental and services in the Openreach Pricing Framework Statement.

4.10 Our work on the Openreach Pricing Framework initially encompassed both MPF / SMPF and WLR charges. However, for the reasons set out above, it has been necessary to consider WLR charges separately given that they depend on the outcome of the Wholesale Review which is currently in progress.

4.11 We set out in Openreach Pricing Framework Statement why we consider an approach using CCA FAC to be appropriate. Our reasons were:

- it is a widely understood concept and has been the anchor point for many previous price controls; and

- it uses data that can be reconciled to the regulatory financial statements, which are audited and, generally, in the public domain.

4.12 In the Openreach Pricing Framework Statement we explicitly considered whether there are strong objections to CCA FAC on efficiency grounds for setting the MPF charge and we concluded there were not.

4.13 Annex 4 of the Openreach Pricing Framework Statement sets out our consideration of the choice of cost standard in detail. We considered a key issue to be the relative prices of different Openreach services.

Cost differentials

4.14 In response to stakeholder concerns we also considered in the Openreach Pricing Framework the differential between the MPF charge and the sum of the charges for WLR and SMPF. We considered this a key differential because nearly 70% of households that take a fixed line also take broadband, and it is the provision of broadband services that has driven investment in LLU. Setting this differential correctly is instrumental in avoiding the risk of inefficient investment.

4.15 Subject to the assumptions on the cost for WLR in that review, we considered that the differential in FAC derived from the model were sound and consistent with those that would have been derived from a LRIC approach.

4.16 In considering the appropriate differential we considered both static and dynamic efficiency. In terms of static efficiency, we considered distortions to competition to be an important issue. In general, where wholesale products are close substitutes, the choice between them could be distorted if the difference in charges does not reflect the difference in incremental costs. In the case of MPF and WLR+SMPF, these products are not in the same market, but are alternative wholesale inputs in the sense that either WLR+SMPF or MPF plus an LLU operator's own voice platform can be used as wholesale inputs to provide retail voice and broadband services.

4.17 We considered that setting charges so that the differential between MPF and WLR+SMPF is based on the difference in LRIC would remove or largely avoid these distortions. We determined that setting charges based on CCA FAC is broadly consistent with doing this. We also examined Ramsey pricing arguments for recovering more costs from WLR than from MPF, but did not consider that these arguments were strong, given that MPF and WLR+SMPF are alternative wholesale inputs for CPs to provide the same retail services.

4.18 We noted in this analysis that we would need to undertake further review of 21CN migration issues to determine whether the WLR charge was soundly based. This is discussed below. However, our assessment is that the cost assumptions set out in the Openreach Pricing Framework remain sound and there is no significant additional migration related costs in the period now under review.

Further efficiency considerations

4.19 As described above, our primary focus in the Openreach Pricing Framework was on the cost differential between MPF and WLR+SMPF. Some of the responses to the Openreach Pricing Framework consultation suggested we should focus also on the differential between MPF and WLR.

4.20 In particular, there was a concern expressed by the TalkTalk Group that the WLR cost stack underestimated the 21CN costs of WLR, and hence the differential between WLR and MPF was too small. The TalkTalk Group proposed an approach that involved setting the WLR charge to include the full combi card cost and also the cost of migration to 21CN. There could be an argument for this approach on the grounds that it would help wholesale competition in voice only services. This is because it would push up the WLR charge significantly and would help CPs using MPF to compete for voice only customers.

4.21 However, consumers of WLR would have to pay higher prices as a result, at least in the short term. There is no clear evidence that this would be promoting effective competition. For such competition to be effective, voice only competition based on MPF would need to develop so as to be sufficient to constraint Openreach's incentive to increase the price of WLR, and ultimately offer consumers better value in terms of lower prices and more choice. It is not clear that this is a likely outcome. As discussed in Annex 4 of the Openreach Pricing Framework Statement, we consider that the dynamic efficiency benefits of wholesale voice only competition are limited.

4.22 Since the Second Consultation for the Openreach Pricing Framework, BT has substantially changed its plans for the roll-out of 21CN. It is currently proposing to continue with the PSTN network for voice service for the next 10 years. This means that BT will not be incurring significant migration costs for the period for which we are setting charges.

4.23 We consider that we should not include 21CN migration charges or the full cost of combi cards in WLR charges. We consider the unit costs calculated on the basis described in the Second Consultation for the Openreach Pricing Framework continue to provide a reasonable basis for estimating line card costs for inclusion in the WLR cost stack, and for excluding migration costs.

Consumers' interests

4.24 Our proposed charge control will result in broadly flat WLR charges in real terms over the period as a whole.

4.25 We consider this is in consumers' interests as it protects them from excessive prices that might otherwise result from an abuse of significant market power. We propose to set the change at a level that also gives Openreach an incentive to invest and maintain the network, which we consider is ultimately in consumers' interests.

Three and a half year duration for the charge control

4.26 We intend the new WLR charge control to run from 1 October 2009 to 31 March 2013.

4.27 We consider this duration provides a good balance between different objectives. On the one hand, we want to provide incentives for Openreach to reduce its costs via efficiency gains. But, on the other hand, we want to pass those gains to customers and encourage efficiency by bringing prices into line with costs. The longer the duration of the control, the greater the risk of prices moving out of line with costs due to forecasting error.

4.28 Another important consideration is that the proposed duration would allow us to set charges on a consistent basis with those set for LLU in the Openreach Pricing Framework. The LLU charges were based on a glide path to CCA FAC full cost recovery by March 2013. As discussed in Section 2, there is a clear relationship between LLU and WLR charges in terms of market demand and use of common costs which should not be distorted by difference in glide path determinations. An advantage of this approach is that it would ensure that the differential between WLR and MPF reflected costs. Much of the cost base for the WLR and MPF charges is the same. And the differential between the two charges is relatively small compared to the common components. When the two charges are set at different times, there is a risk that the differential between the two charges may not reflect the difference in the cost of providing the two services. This is an issue we have had to specifically consider in this consultation. This is because the forecasts of the efficient level of the common components of the two charges could change over time.

4.29 Setting a charge control with a three and one half year duration, ie to March 2012, would also allow us to coordinate future LLU and WLR charge controls more easily as they would both then be set on a BT financial year basis.

4.30 Finally a three and one half year duration also has the benefit of consistency with Ofcom's proposals for network charge controls (NCC).[19] Ofcom is proposing a four-year duration for the NCC, starting from 1 October 2009. Since both the NCC and

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[19] http://www.ofcom.org.uk/consult/condocs/review_bt_ncc/reviewbtncc.pdf

WLR charge control are remedies proposed by Ofcom as a result of the proposals of the Wholesale Review, Ofcom believes there is merit in having controls which finish in a similar timeframe to fit with the likely timing of future narrowband market reviews.

4.31 We are considering the long term alignment of Market Reviews for fixed line communications and charge controls to ensure such controls are closely coordinated in the future.

4.32 The most significant risk with the proposed approach is that if exogenous factors changed significantly between now and when the MPF charge was re-set in April 2011 (assuming it remains appropriate to retain a charge control for MPF), the differential between WLR and MPF charges might not fully reflect the changed circumstances because WLR charges would not have been re-set to reflect them. An example of such a significant change in an exogenous factor might be the price of copper, which affects both charges and can be volatile. Such changes could mean that after April 2011 the differential between MPF and WLR could be greater than or less than what would be implied by the costs.

4.33 If the differential between MPF and WLR/WLR+SMPF does not reflect costs, this could distort the choice of wholesale inputs for CPs. It could also lead to distortions to competition through the retail market. We have described the potential types of costs that could result from this in the Openreach Pricing Framework Statement.

4.34 However, such a distortion would only arise if there were a material change in the forecasts of efficient costs between now and when the future MPF charge is set, by March 2011. Also, it would only last for the two remaining years of the WLR charge control, until March 2013.

Question 4.1 Do you agree that it is important to ensure consistency between the WLR and LLU charge controls? In this context, do you agree that we will need to consider consistency in considering the impact on any challenges to assumptions when we are setting the final controls?

Question 4.2 Do you agree with Ofcom's analysis on the relative charges for WLR and MPF set out here, in Annex 5 of this document and in the Openreach Pricing Framework?

Question 4.3 Do you agree with Ofcom's proposal to set a three and a half year period charge control for WLR?

Section 5

Ancillary services controls

Introduction

5.1 This section describes our proposed approach to the other WLR analogue services aside from the core rental. The key assumptions employed in our analysis, and a detailed explanation of the cost base, are set out in Section 6.

Summary of proposals

5.2 The specific services that we propose to impose price ceilings on are:

- Existing line transfer; and
- New line connection.

5.3 In relation to the existing line transfer charge, we propose to continue with our current approach of recovering a portion of the transfer costs (largely related to systems allocations) through the line rental. We believe a low transfer charge is an important factor in promoting competition in the retail market. Our analysis however suggests there is scope to increase the transfer charge from £2 to £3.

5.4 We propose to implement a one-off adjustment to the connection charge to reduce it from the current level of £88 to £67 in the first year, with further reductions to be realised through a glide path approach. By the end of the control period the charge will be in line with FAC costs of c£40. We consider that a one-off adjustment is necessary due to the large discrepancy between the current charge and the FAC cost.

Services covered by the charge control

5.5 As discussed, we believe that it is appropriate to consider some service set-up and migration charges, specifically existing line transfer and new line connection charges, as falling within the scope of the charge control.

5.6 We believe it is necessary to ensure that BT's charges for these services are based on its reasonably incurred costs as charges associated with migration can be particularly sensitive to pricing. The higher the migration charges the higher the risk the receiving company is taking on in terms of recovering these charges.

Existing line transfer charge

5.7 The current charge ceiling for existing line transfers is set at £2. In the 2006 Statement[20], Ofcom considered that it was appropriate to continue with the approach adopted in 2002 by Oftel when the original charge ceiling was set. There was a concern that high transfer charges might act as a barrier to switching, which resulted in some of the costs of a transfer being recovered from the line rental charge. While our proposal is to continue with this approach, we discuss different options below.

[20] Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services, 24 January 2006, paragraph 3.65 and 3.66, http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

Necessity of a charge ceiling for the transfer charge

5.8 In the recently published fixed narrowband retail services markets consultation[21], we proposed that the retail market for analogue (and ISDN) lines and calls is largely competitive (i.e. while BT still has a high market share we do not propose to find that it has SMP). Therefore, it could be argued that the development of effective competition in the retail market means that it is no longer necessary to continue with a policy of a low upfront transfer charge with the recovery of the remaining costs through the line rental charge. However, we consider that it is critical that the wholesale environment continues to support the competitiveness in the retail space.

5.9 In this context we consider that the current transfer charge has contributed to developing this competitive retail environment. The key question is whether it should remain an important factor in continuing to support this environment in the future.

5.10 SMP assessments are forward-looking in their evaluation. Changes to the current arrangements for the transfer charge need to be assessed against the potential impact they could have on competition in the market and therefore the SMP assessment. This is particularly the case because BT retains a market share of approximately 67 per cent, so any increases in switching costs, which may act as a barrier to consumer switching, and could, therefore, have a significant impact on the SMP assessment.

5.11 At present, service providers do not directly pass on the £2 transfer charge to consumers by way of an additional charge when they switch providers. CPs rely on recovering this cost through their retail line rental margin and additional revenue streams such as calls outside of retail bundles. In the absence of a charge ceiling and if the full cost of the transfer charge was passed to CPs at the point of gaining a new customer, it is possible that we may see either the introduction of an upfront transfer charge recovered directly from the customer or low-cost providers who do not currently require customers to sign on for 12 or 18 month contracts, may see a need to introduce contracts containing Minimum Contract Period (MCPs) or Early Termination Fees (ETCs).[22] Low upfront charges incurred by a gaining CP creates an environment where CPs can compete on terms and conditions other than price. Several CPs active in the retail market offer customers no contract tie-in periods and therefore those customers are not currently subject to MCPs or ETCs. A low transfer charge is an important aspect in maintaining this level of choice for consumers.

5.12 On the other hand, it is also important to consider the impact of the transfer charge level on consumer switching. A low transfer charge in an effectively competitive market may have the potential to cause an inefficient level of switching, whereby consumers are unaware that each time they switch they generate costs, which they will ultimately end up paying for as the cost is spread in the line rental. We consider that this risk is somewhat mitigated by the fact that a large proportion of the costs

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[21] Fixed Narrowband Retail Services Markets: Consultation on the identification of markets, and determination of market power, 19 March 2009, http://www.ofcom.org.uk/consult/condocs/retail_markets/fnrsm.pdf

[22] The Ofcom review of additional charges statement published in December 2008, outlined Ofcom's view on minimum contract periods (MCPs) and early termination charges (ETCs), amongst other charges. Ofcom stated that while it did not disagree that there were legitimate reasons why service providers might require customers to adhere to MCPs and ETCs, we do consider MCPs to be core terms (which means they must be transparent and prominent at point of sale) and ETCs to be non-core terms (which means they are subject to the fairness test as outlined in the statement). http://www.ofcom.org.uk/consult/condocs/addcharges/statement/

associated with a transfer are fixed costs (i.e. system costs) and therefore will not vary with fluctuations in switching levels.

5.13 Finally it is also appropriate to consider the apparent cost of the transaction and what that implies about the efficient charge level. The costing model sets a CCA FAC unit cost for the transfers costs of approximately £9 in the first year (i.e. from October 2009), though increasing to c£13.50 by the final year of the charge control. It is also worth noting that approximately two thirds of the transfer costs are due to allocations of system development costs and, therefore, a product of system cost allocation methodologies rather than real incremental activity. Economic efficiency requires only incremental cost of transactions to be covered by the cost of the activity. Accordingly it is consistent with efficiency considerations to recover some of these cost though other related charges – in this case the WLR line rental.

Conclusion

5.14 While we acknowledge changes in the retail market since the last review by way of increased competitiveness, on balance, we consider that there is still a role for a low transfer charge to support this environment. We believe we can set such a charge without impact on static efficiency. Therefore, our proposal is to continue with the current methodology of setting a low transfer charge and recovering the remaining costs through the line rental, taking account of volumes and churn rate.

Charge ceiling for the transfer charge

5.15 The next consideration as part of our proposal to continue with a transfer charge ceiling is whether we maintain the existing charge of £2 or if we should vary the charge, and if so to what level.

5.16 Given our preference is for some support for transfer costs, the options are:

- Reduce the existing charge;
- Maintain the £2 charge; or
- Increase the charge (but below full cost).

5.17 There is no evidence that a reduction in the transfer charge is required to support competition. The existing charge allows competitor CPs to offer services without MCPs or ETCs and thus provides the competitive support that we have argued is still required.

5.18 In considering whether the existing £2 charge should be maintained it is worth considering the relative cost of that charge to CPs since it was introduced. We consider a key factor to be the size of the transfer charge as a proportion of the monthly line rental charge.

5.19 Our estimates suggest this proportion has decreased over time[23] and we would expect this to continue as retail prices increase in line with general price movements. This would imply that the support for market entry and competition provided by the transfer charge has increased over time and will continue to do so if it is left unchanged. In line with our earlier argument we do not consider that this is required.

[23] The £2 charge was c20% of a typical retail monthly rental charge in 2006 but is now c17%. A £3 charge would be slightly over 20%.

5.20 Accordingly, we consider that it would be reasonable to increase the transfer charge at least to a level equivalent to when it was originally set in 2005 (ie an equivalent proportion of the retail price). This would imply a charge of £3.

5.21 Further, we consider that it is appropriate to allow this charge to increase over time in line with the increase in charges for the WLR rental which should ensure that the relative support to competition over the period of the control should remain stable. The implications for the charge for the WLR rental service are set out in Section 6 but it is below 1% of the total charge.

New line connection

5.22 The current charge ceiling for new line connections is £88. In the 2006 Statement[24], we calculated this figure using the costs and volumes for all analogue new line installations (i.e. BT's own new line installations and WLR new line installations), on the basis that the work involved should be the same regardless of whether it is carried out for BT Retail or a third party CP. This initially set the charge ceiling at £90, however, the methodology of recovering transfer costs in the rental charge was applied to new line connections, which resulted in the charge being reduced by £2 to the current £88 figure.

Necessity of a charge ceiling for the connection charge

5.23 The new line connection charge is paid by customers who have no telephone line connected to BT's network at a premise. In these circumstances the provision of a new line usually requires a site visit by a BT engineer. Third party CPs are not able to self-provide this service as any work that requires changes to the physical aspects of BT's network can only be completed by Openreach. This means that third parties cannot place any competitive pressure on the price of new connections.

5.24 Customers must pay the new line connection charge in order to take-up a WLR service, regardless if they choose BT Retail or a third party CP as their service provider. A possible outcome of there being no competition for the provision of the service is the potential for Openreach to set wholesale prices above the level we could expect to see in a competitive market. We need to make sure that consumers pay a fair price for the service, while at the same time allowing Openreach to recover its reasonably incurred costs for providing these services. We consider that the best way to ensure both of these outcomes is to set a charge ceiling for new line connections.

Proposed charge ceiling for the connection charge

5.25 As discussed, the current new line connection charge set in 2006 is £88. Our recent analysis suggests that the FAC for connections is c£36, which is £52 below the current charge ceiling.

5.26 The fall in underlying costs is driven by efficiencies within Openreach and a re-assessment of common cost apportionment since the 2006 review. Similar factors have lead to the revision in the cost base and charges of the new provide charge for MPF noted in the Openreach Pricing Framework Statement .

[24] Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services, 24 January 2006, paragraph 3.69, http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

5.27 Acknowledging this is a significant differential, we discuss below our proposal for a one-off adjustment and glide path to bring this cost down to FAC by the end of the control period.

5.28 Ofcom's approach to setting charge ceilings, both in the instances where costs either increase or decrease over time, is to apply a glide path. We generally consider that smooth adjustments to prices over time is a preferable outcome than introducing shocks into the market by radically increasing or decreasing prices.

5.29 However, in this case, given the scale of adjustment required for the charge, we consider that there is a strong argument for an initial one-off reduction in the charge followed by a glide path. We consider that this in an appropriate approach in situations where the proposed FAC is substantially different to the current charge ceiling. If we did not apply a one-off adjustment to set the ceiling for the first year, prices would need to fall much more sharply over the course of the control. This approach is again consistent with our treatment of other charge ceilings, most recently with LLU, which was implemented by the Openreach Pricing Framework Review. [25] We stated in that review that '*employing a methodology consistent with our previous practice, our approach would give investors confidence in the predictability of the regulatory regime in the future*'.[26]

5.30 In considering the scale of any proposed adjustment we are conscious of the relationship between new line provision for WLR and MPF customers. The Openreach Pricing Framework Statement imposed a substantial one off adjustment to the MPF new provide charge from £99.95 to £76. We do not consider that there is any argument to adjust charges in a manner that would increase the incentive to connect a WLR line compared to an MPF line or the converse.

5.31 We, therefore, propose that the initial adjustment broadly maintain the pre-existing relative differential between WLR and MPF new line provision.

5.32 A reduction of the WLR new provide charge at a similar rate to the MPF charge would suggest a revised first year charge of £67. Subject to the views of stakeholders this would appear to be a reasonable initial reduction, representing about 50% of the total differential with the FAC. We would then propose to reduce the charge to its FAC cost level over the remaining period of the control. The basis for this is set out in more detail in Annex 5.

5.33 We will need to review the relative charges for LLU and WLR at the next LLU charge control though we would expect Openreach to consider the relative prices in setting their LLU charge within the MPF ancillary services basket.

5.34 As discussed in Annex 5, there is some uncertainty over the appropriate volumes for new connections in the final year of the control. The BT estimated volumes drop by over 50% from c760,000 to around 230,000. It is possible that this reflects uncertainty caused by changes to the 21CN timetable. Our proposed range set out later in the consultation incorporates either volumes remaining at the 2011/12 level in 2012/13 or dropping to the BT estimate in 2012/13. We are seeking stakeholder views on the potential outlook with respect to volumes.

[25] ibid
[26] Ibid, paragraph 5.9.

Services excluded from the charge control

MPF to WLR conversion

5.35 Currently the charge for converting a line using MPF to WLR is £34.86. This was, until the recent LLU charge changes, the same as the equivalent charge in the other direction, that is, the transfer charge for converting a line using WLR to MPF.

5.36 In the Openreach Pricing Framework Statement, we have included the connection charge for converting a WLR line to an MPF line in the MPF ancillary services basket. This basket includes more than a dozen other MPF ancillary service charges, including: cease charges; new connections; cancellation; and amend charges. The MPF transfer charge is also subject to a sub-cap within that basket, so there is a limit on the extent that charge can increase. In recognition of the below FAC position of that LLU charge an initial adjustment of the charge up to £38 was instituted.

Consideration of options

5.37 We believe there are two options open for consideration as part of this review in relation to the WLR conversion charge.

5.38 The first of those is the direct imposition of a charge ceiling for this service.

5.39 We are concerned that the relatively small volumes in this service would make it difficult to determine a reliable and robust estimate of the underlying units costs.

5.40 An alternative option would be to rely on the cost orientation obligation, which is the existing level of regulation for this charge. Our analysis suggests that the charge to date has been applied broadly in line with FAC costs and currently matches the charge for the reverse conversion of WLR to MPF. This would appear appropriate given the engineering effort involved and the nature of the service provided.

5.41 We consider that reliance on cost orientation is proportionate, but we also consider that the existing relative level of charges for the WLR to MPF new connection and the MPF to WLR transfer is appropriate.

5.42 We propose to rely on the support of Communications Provider to monitor the level of the WLR conversion charge relative to the MPF transfer charge. In the event that there emerges a significant differential between the charges then we may need to consider a review of the basis of the charges to see if the differential is justified.

Calling and network features

5.43 We do not consider that it would be appropriate to include calling and network features within the scope of the proposed charge control.

5.44 Unlike the core line rental charge, calling and network features are add-ons to the core service. Therefore, take-up is largely driven by individual consumer choice on the value of the additional feature to their overall service. Like any features linked to a core service, CPs must market them to consumers in terms of the additional value they provide and the important factor might be the ability of retailers to offer these services in order to be seen to be comparable with their competitors from a consumers' perspective, despite a low level of interest in subscribing to these services initially.

5.45 Additionally, Openreach significantly reduced prices for calling and network features effective from 1 February 2009, presumably in the expectation that the likely increase in demand would be profit-maximising. The initial intention was for this to be a trial price reduction. However we understand this is expected to be implemented on a permanent basis.

5.46 Given the significant reduction in prices implemented by Openreach, there does not seem to be a compelling reason for Ofcom to consider increasing regulation of these services by introducing a charge control. One argument for imposing a charge control is to encourage an incumbent to reduce its costs over time by becoming more efficient in the provision of services. With regards to calling and network features, it is difficult to see how further efficiencies would be realised given the nature of the system that supports the service delivery. It is also important to acknowledge in this context that BT's network is constrained by the capacity of the equipment in place which delivers calling and network features. A significant increase in consumer take-up may ultimately put pressure on Openreach's ability to meet this demand with the existing equipment in place.

5.47 Therefore, we propose to exclude calling and network features from the WLR analogue charge control.

Other charges

5.48 The remaining charges that we have not discussed so far are prevalidation, conversion from ISDN to WLR and cancellation charges.

5.49 The prevalidation charge applies to all WLR lines and enables a CP to confirm prior to a 'like for like' order being placed, how the end user's line is configured and whether there are products connected that are incompatible to the WLR offering. The current prevalidation charge is £2. While this charge does apply to all service requests and must be performed by Openreach to facilitate a request, we do not propose to include this charge within the scope of the charge control. The £2 charge has remained unchanged since 2006 and is subject to a cost orientation obligation. It appears that the cost orientation obligation has been a sufficient control for this charge to date and is therefore likely to continue to be an appropriate approach going forward.

5.50 The conversion charge applies when customers who currently purchase an ISDN line wish to convert to a single analogue line. The current ISDN to analogue conversion charge is £70. The level of conversions from ISDN to analogue is very low and it would seem disproportionate to the frequency of these conversions to impose regulation beyond the cost orientation obligation. Furthermore, Ofcom is not aware of any issues with regards to the provision of or the price of this conversion charge. It therefore appears that the cost orientation obligation has been a sufficient framework for this charge to date and that it is likely to be an appropriate approach going forward.

5.51 We sought clarification from Openreach on the costs it incurs when an order is cancelled. Openreach stated that engineering and systems work is performed the day prior to the order completion date and that the full cancellation charge only applies if an order is cancelled after 4pm on the day prior. The 4pm time is referred to as the 'Point of No Return' where Openreach is almost guaranteed to have incurred costs in preparing to deliver a service. If an order is cancelled before 4pm on the day prior, while work is likely to have been performed, Openreach only charges much smaller fee (either £2 or £3.50 depending on the type of order cancelled), therefore, potentially is not fully recovering the full cost of the work it has performed.

5.52 Where Openreach has incurred costs involved in preparing to deliver a service, we do not consider that it is unwarranted for Openreach to recover these costs through reasonable cancellation charges. As a vast majority of a cancellation charge is likely to include costs related to engineering work and Openreach will need to potentially 'reverse' some of the work completed to cancel an order, we do not propose to include these charges within the scope of the charge control.

Question 5.1 Do you agree that Ofcom should continue with its current approach to setting the transfer charge ceiling, recovering the transfer costs primarily through the line rental? If not, please explain why.

Question 5.2 If we do continue with a low transfer charge do you agree that Ofcom should increase the transfer to £3 with an index? If not, please explain why.

Question 5.3 Do you agree that Ofcom should continue to set a charge ceiling for new connections? Do you agree that it is appropriate to impose of one off adjustment in this case given the difference between existing charges and the CCA FAC cost? Do you agree it is appropriate to consider the relative charge of new line for LLU and WLR in making this adjustment?

Question 5.4 Do you agree that Ofcom should exclude the remaining migration charges and calling and network features from the scope of the charge ceiling? If not, please explain why.

Section 6

Unit cost determination

Introduction

6.1 This section sets out our view of Openreach's cost stacks for *WLR Basic* line rental (and ancillary services) to be used as the basis of determining the controlled charge from October 2009 to March 2013.

6.2 Annex 5 sets out in detail how we have calculated the cost of providing *WLR Basic*. Starting from the cost estimates set out in the Openreach Pricing Framework statement, we summarise in this section how we:

- Ensured the assumptions set out in the Openreach Pricing Framework Statement remained appropriate for the calculation of our proposed *WLR Basic* charge;
- Estimated the additional cost of providing the enhanced service; and
- Provide the estimated cost of providing *WLR Basic* line rental, after deducting the cost of providing the enhanced care and for pricing purposes adding the additional transfer costs.

6.3 We also set out the cost stacks for Ancillary services.

Approach to cost calculations

6.4 As we set out in Section 4, our approach to the determination of the costs for the WLR services is based on CCA FAC estimates of cost.

6.5 As we explained in the Openreach Pricing Framework Statement, we consider that it is appropriate to use a four year period as the basis for the modelling of forward costs. We consider that the four year period allows us to take a medium term view of the impact of changes in costs, volume and efficiency levels. In this case, the model starts in April 2009 to ensure consistency with the LLU charges.

6.6 We consider that it was appropriate to use cost estimates provided by Openreach (at our request) as the starting point for our own financial analysis undertaken in the Openreach Pricing Framework. As explained previously, we have drawn extensively on the same cost analysis in undertaking the review of WLR costs and the associate charge controls.

6.7 In the Openreach Pricing Framework, we

- Set out Openreach's cost estimates at an aggregate and unit cost level;
- Described Openreach's approach to the estimate of its costs, which includes the calculation of its costs 2007/08 and projected cost estimates to 2012/13;
- Set out the key assumptions made by Openreach to project future costs;
- Demonstrated that the base year costs were consistent with audited financial data; and

- Provided Openreach's explanations for the main movements in its cost estimates between 2008/09 and 2012/13.

6.8 We explained in the Openreach Pricing Framework Statement why we considered that Openreach's cost projections are based on a logically sound approach and provided a sensible basis for the modelling of future costs. Specifically, we:

- Obtained, on a confidential basis, functional versions of the financial models used by Openreach for forecasting purposes;

- Spent significant time with Openreach and its consultants to ensure that we fully understand the mechanics of the model;

- Reviewed model user manuals and obtained thorough explanations of key aspects;

- Tested the interaction of volumes, task times, FTE assumptions, average salaries, fault rates and visit ratios to ensure the models produced predictable outputs that could be understood;

- Reviewed the allocation basis, to ensure that they were reasonable and were applied as described;

- Reconciled the base year forecasts back to audited financial data;

- Ensured that all movements in costs during the period could be explained by simple analysis based on an understanding of future changes in demand and cost behaviour;

- Prepared our own estimates of future costs on a CCA FAC basis, by rolling forward audited financial data from the 2008 current cost financial statements and ensured that the outputs from Openreach's model were consistent with these estimates.

6.9 We believe the analysis and assumptions set out in the Openreach Pricing Framework Statement continues to provide an appropriate basis for estimating the cost of providing WLR services. Specifically we have reviewed the assumptions in the light of changes to BT's 21CN plans and their impact on WLR. These related to the use and allocation of the combi card replacement of PSTN lines cards. As explained in Annex 5, we are satisfied that the costs allocated to WLR remain reasonable in respect of the combi card

6.10 As discussed in Section 2, given that LLU and WLR products are competitive substitutes and share a broad range of common costs it is essential that costs should be calculated on a consistent basis to avoid competitive distortions.

6.11 Given the nature of the costs and the allocation underlying allocation bases means that – by deriving the cost estimates from a common source and on a consistent basis - an assessment of the costs of one service informs an view of the reasonableness of the costs of the other.

6.12 Finally, given the relatively short period that has passed since the Openreach Pricing Framework Statement was published it is unlikely that the underlying competitive or costs assumptions would have changed significantly. We have reviewed the

Openreach Pricing Framework Statement assumptions in Annex 5, below is a summary of the key ones.

6.13 On this basis, we consider that the analysis set out in the Openreach Pricing Framework Statement provides a robust and appropriate starting point for our estimate of the cost of WLR.

Table 6.1 Key assumptions (a full list is set out in Annex 5)

Parameter	Ofcom conclusion in Openreach Pricing Framework Statement
Aggregate Volumes	Demand for fixed lines to fall by 7% by 2012/13. See Annex 7 of the Openreach Pricing Framework Statement
Inflation	Annual inflation to be 0% in 2009/10 then 2.5% thereafter. Specific adjustments to costs – such as reduced Cumulo rates – should also be taken into account.
Scope for efficiency gains	Efficiency gains of 4% in 2009/10 (excluding fault rates) on compressible costs and declining thereafter. See Annex 9 of the Openreach Pricing Framework Statement.
Reduction in fault rates	Fault rates to fall by 2% each year.
Commodity prices	Assets are valued by reference to the cost of replacing the copper assets at March 2009.
Line cards	Openreach's estimate of costs per line appears reasonable. Further discussion is set out in Annex 5.
Cost of capital	We set out our estimate for Openreach cost of capital in the Openreach Pricing Framework at 10.1% in nominal terms

The costs for the core WLR service

6.14 In Annex 5, we explained that for the purposes of analysis in the Openreach Pricing Framework, we calculated unit costs for WLR Residential (Basic) and WLR Business (Premium) rentals.

6.15 The aggregate costs estimates for the two services are set out below (additional details are provided in Annex 5):

Table 6.2: CCA costs and revenues for WLR Residential, assuming prices remain fixed in nominal terms

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**1,774**	**1,688**	**1,631**	**1,599**	**1,381**	**1,267**
Pay	310	309	271	254	234	214
Line card and Tams	194	192	193	198	179	152
Accommodation	161	159	146	148	134	126
Stores, contractors, Service centre etc	84	78	71	69	59	52
Corporate Overheads	62	61	55	50	45	42
IT (ex depn)	84	84	73	68	61	56
Fleet	58	57	51	50	43	38
Other	14	7	6	7	6	6
Operating Cost	**967**	**948**	**865**	**844**	**761**	**685**
EBITDA	807	740	765	755	620	582
Depreciation inc Holding gains	161	438	363	288	279	277
EBIT	**647**	**302**	**403**	**467**	**341**	**305**
ROCE%	13%	6%	9%	10%	8%	8%
Mean Capital Employed	**5,044**	**4,760**	**4,670**	**4,751**	**4,247**	**3,969**
Volumes	**17,596**	**17,007**	**16,196**	**15,880**	**13,715**	**12,585**

Table 6.3: CCA costs and revenues for WLR Business, assuming prices remain fixed in nominal terms

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**646**	**641**	**579**	**483**	**549**	**539**
Pay	93	95	79	63	76	75
Line card and Tams	64	65	62	54	65	59
Accommodation	50	51	44	38	45	46
Stores, contractors, Service centre etc	26	25	21	18	20	19
Corporate Overheads	19	19	16	13	15	15
IT (ex depn)	25	26	22	17	20	20
Fleet	18	18	15	13	15	13
Other	5	3	2	2	2	3
Operating Cost	**300**	**302**	**262**	**218**	**259**	**249**
EBITDA	346	339	317	265	291	290
Depreciation inc Holding gains	74	163	130	89	111	116
EBIT	**272**	**176**	**187**	**176**	**180**	**175**
ROCE%	17%	12%	14%	14%	13%	12%
Mean Capital Employed	**1,554**	**1,537**	**1,433**	**1,241**	**1,461**	**1,459**
Volumes	**5,853**	**5,814**	**5,261**	**4,391**	**4,995**	**4,900**

6.16 The key difference in the costs relates to the assumption of different copper pair line length.

6.17 As we have set out in Section 3, we do not now propose to set separate charge controls for residential and business lines. It is, therefore, necessary to aggregate the cost and revenue estimate for WLR Residential and Business as follows:

Table 6.4: CCA costs and revenues for WLR rentals, assuming prices remain fixed in nominal terms before adjustment for enhanced service costs

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**2,420**	**2,329**	**2,209**	**2,082**	**1,930**	**1,806**
Pay	403	404	350	317	310	289
Line card and Tams	258	257	255	253	244	211
Accommodation	211	210	190	187	179	172
Stores, contractors, SMC and misc.	110	103	92	87	79	71
Corporate Overheads	81	80	71	63	60	56
IT (ex depn)	109	110	95	85	81	75
Fleet	76	75	66	63	58	51
Other	18	9	9	9	8	9
Operating Cost	**1,266**	**1,250**	**1,127**	**1,062**	**1,020**	**934**
EBITDA	1,154	1,079	1,082	1,020	911	872
Depreciation inc Holding gains	235	601	493	377	390	393
EBIT	**918**	**478**	**590**	**643**	**521**	**479**
ROCE%	14%	8%	10%	11%	9%	9%
Mean Capital Employed	**6,629**	**6,298**	**6,103**	**5,992**	**5,708**	**5,428**
Volumes	**23,449**	**22,821**	**21,457**	**20,271**	**18,710**	**17,485**

6.18 It is, therefore, possible to derive an aggregate unit cost estimate below. This cost includes the provision of the core service we are proposing plus the enhanced care elements in *WLR Premium*.

Table 6.5: Aggregate unit cost of WLR rental

	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Operating unit cost	75.48	70.97	75.32	75.88
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	97.10	100.83	106.14	107.24

Estimating the cost of providing the enhanced service

6.19 As set out in section 3 we propose that the charge control for WLR rentals, will be focussed on a core WLR service which is able to meet the minimum needs of both business and residential customers. This requires us to estimate a cost for the core service which excludes any associated direct costs linked to the provision of the higher care level provided by *WLR Premium* and, as discussed below, any common costs which should be carried by the service offering enhanced care.

6.20 As enhanced care services are already provided by Openreach, the associated costs are already reflected in the aggregate cost stacks set out above. It is therefore necessary to deduct these costs to leave the underlying cost of providing the basic service.

6.21 As set out in Annex 5, to determine the appropriate charge for the WLR core service, we have determined the aggregate costs for *WLR Basic* and *WLR Premium* and then identified *WLR Premium* specific cost which should be subtracted from the total costs.

6.22 We have considered three possible approaches to estimating the cost of providing *WLR Premium* care support, as follows:

- An "incremental savings" approach. Under this approach, the costs that would be saved if the current service levels were reduced back to the level to be provided with *WLR Basic*. This might include the pay costs that could be saved if the fewer engineers were required as a result. This approach results in the smallest deduction; and

- An "incremental cost" approach. This is similar to the incremental saving approach but, rather than looking at the costs that might be saved if Openreach ended the provision of the higher service levels, it considers the additional costs it incurs to be able to provide those services. For example, in addition to extra pay costs, this might also include the cost of higher-specification IS (which would be incurred to deliver enhanced service levels but would not be avoided if such service levels were withdrawn, as under the incremental saving approach).

- A Fully Allocated Cost approach. In addition to the incremental cost/savings of providing the higher service levels, this approach includes a share of Openreach's overheads related to the enhanced services. This approach results a larger deduction

6.23 As set out in Annex 5, we consider that the third approach provides the most appropriate basis for estimating the cost of the enhanced care.

6.24 However the financial models provided during the Openreach Pricing Framework or Openreach's own model do not identify explicitly the incremental cost of providing the Premium Product nor the common costs to be included within the FAC cost.

6.25 In Annex 5 we set out Openreach's estimate of the incremental savings associated with the enhanced service and our estimate of the common costs which could be attributed to the provision of the service. They total £0.91 to be deducted from the basic rental. We invite comment on both these estimates. The estimation of incremental costs in this context is inherently difficult and we welcome views of respondents.

6.26 With respect to the allocation of common costs we also accept that this is dependent on assumptions of take up volumes for the Premium service which may be impacted on by the proposed changes to the regulatory regime. We consider that we will, therefore, need to be cautious in the use of this estimate.

6.27 On the basis for the estimates set out in Annex 5, we have derived a cost estimate for the WLR rental service excluding the enhanced care costs. The unit costs are set out below:

Table 6.6: Adjusted aggregate unit cost of WLR rental removing higher care costs

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	74.57	70.04	74.37	74.90
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	96.19	99.89	105.18	106.26

WLR Transfer adjustment

6.28 As discussed in Section 5, we are proposing one further adjustment to the basis for charges. We do not consider that it is appropriate for full CCA FAC costs to form the basis for the price of the WLR transfer. Accordingly, we need to ensure that those costs not covered by the proposed transfer charge are recovered through the *WLR Basic* rental charge.

6.29 Consistent with the previous treatment of the WLR transfer charge we propose to spread the cost recovery for each transfer over a five year period. The resultant cost stack (for pricing purposes) of the WLR Core service, therefore, is as follows;

Table 6.7: Unit cost for recovery by WLR core rental, after adjustment for enhanced service costs and WLR transfer

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	75.94	71.49	75.93	76.58
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	97.55	101.34	106.75	107.93

6.30 Given that this estimate includes a number of recent assumptions (since the Openreach Pricing Framework) we set out our sensitivity analysis of these assumptions in Annex 5.

WLR Connection charge

6.31 As discussed in Section 5, the WLR connection charge of £88 appears to be substantially in excess of FAC CCA costs.

6.32 As this cost is sensitive to volume assumptions we reviewed the volumes estimates for 2012/13, the key year for the price determination. The Openreach volume estimates for this year, sees a substantial drop in volumes for connections from the 2011/12 of c760,000 to the 2012/13 estimate of c230,000.

6.33 We are concerned that this estimate does not fully take into account the impact of recent changes to the 21CN plans. We, therefore, propose to set a range for our estimate of the WLR Connection to include the possibility that the volumes for 2012/13 are the same as the estimate for 2011/12. An estimates of what the unit cost is for WLR connections if volumes are in line with BT estimate or remain constant in 2012/13 are shown below. The shows there is a small impact from this change which we reflect in the range we are proposing for the control.

Table 6.8: Ancillary services – WLR Connections – unit costs BT volume estimate

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	35.25	35.49	36.77	36.01
ROCE unit cost	1.09	1.74	2.01	2.08
Total unit cost	36.34	37.23	38.78	38.09

Table 6.10: Unit cost of WLR connection if 2012/13 volumes are the same as 2011/12.

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	35.25	35.49	36.77	37.88
ROCE unit cost	1.09	1.74	2.01	2.02
Total unit cost	36.34	37.23	38.78	39.90

Sensitivity analysis

6.34 In Annex 5 we examine the impact of alternative allocation assumptions for the combi card and the level of common cost recovery for the *WLR Premium* service. However, we conclude that the results are not highly sensitive to these assumptions.

Question 6.1 Do you agree with the approach we have taken to derive the core WLR rental? In particular do you consider the estimates for the cost of the WLR Premium care levels to be reasonable?

Question 6.2 Do you agree with an allocation of common costs to the WLR Premium care level service?.

Question 6.3 Do you have any comments on the likely change in transfer or connection volumes in the latter part of this charge control period?

Section 7

Proposals

Introduction

7.1 The earlier sections of this document set out the case for restructuring the charge controls for WLR and the cost evidence supporting the case for changes in the charges for *WLR Basic* and some of the related services.

7.2 Our proposals are also informed by the need to ensure consistency between WLR and LLU charges and as such have been based on the model developed in the Openreach Pricing Framework review.

7.3 Informed by these considerations, this section summarises our proposals

Prices should move towards the underlying FAC by 2012/13

7.4 Our decision on the appropriate pricing regime will be informed by responses to this consultation. We will take account of these responses in determining the appropriate assumptions to be made in our cost calculations. We expect that these assumptions, in particular, will drive our final assessment of the efficiently incurred costs of providing the regulated services. We propose to attach significant weight to this assessment of costs in determining whether and, if so, how much prices need to change. We will also take account of stakeholder responses in respect of the impact of price changes to inform our assessment of how quickly prices may need to change.

7.5 As set out in Section 6, based on the assumptions set out in Section 6, our unit cost estimates for core WLR service are as set out in table below.

Table 7.1: Unit cost for recovery by WLR core rental, after adjustment for enhanced service costs and WLR transfer

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	75.94	71.49	75.93	76.58
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	97.55	101.34	106.75	107.93

Prices should move by reference to a glide path

7.6 In the Openreach Pricing Framework Statement we considered a number of options for phasing in the price change for MPF. In general, we considered there was a strong case for setting charges by reference to a glide path. Glide paths offer stability and predictability and give stronger cost efficiency incentives. This means that in the long term, they can be expected to result lower prices than adjusting prices rapidly to cost.

7.7 However, specifically for MPF, we also considered that there was a case for a price path that involves a larger increase in the charge in the first year. In particular, this would avoid distorting the choice of wholesale inputs for CPs and avoid distortions to competition in the retail market.

7.8 Our preferred option was to set the appropriate starting charge for MPF in 2009/10 giving weight to both a four year glide path and full cost recovery. We adopted a value close to the middle of this range.

7.9 We consider that the general case for glide paths applies to the WLR charge.

7.10 We have also considered the case for an initial step reduction in the WLR charge, to reflect the fact that it is currently above efficiently incurred costs. However, unlike for the MPF charge, we do not think there are strong reasons for moving away from a glide path approach. Moving away from a glide path approach would be inconsistent with our normal practice and risks undermining both cost minimisation incentives and confidence in the regulatory regime. Therefore, although there would be potential short term consumer benefits of a small reduction in the WLR charge (if it was passed on to consumers), we consider that this would not be in consumers' long term interests.

7.11 Given that we have set the MPF with a first year adjustment to reduce the differential between the MPF and WLR+SMPF charges, we do not consider that it is necessary to also adopt such an approach for the WLR charge.

RPI adjustment

7.12 There are advantages to price controls that take account of anticipated movements in the costs of providing the underlying services. The use of an inflation index within a control provides some protection - to both the supplier and the buyer of the services – against changes in the underlying rate of inflation, which, over time, could cause prices – in real terms - to diverge from their intended level.

7.13 Traditionally, we have linked the control to RPI (in the form of an "RPI- X" adjustment), applied to a starting charge over a number of years. RPI has been used because it is a published - and widely understood - measure of inflation.

7.14 To provide the desired protection against changes in the underlying rate of inflation, the RPI data needs to provide a relevant measure of the cost pressures facing the supplier during the period in which the price control is to apply.

7.15 For obvious practical reasons, the RPI data used in such price controls is historical, published data. For the reasons set out in the Second Openreach Pricing Framework Consultation, we propose to use October 2009 RPI data for the purposes of applying the indexation in the 2010/11 controls, and have drafted the Condition accordingly.

7.16 Although there are limitations to the relevance of RPI data as a measure of the input cost pressure facing BT or Openreach it has generally provided a reasonable basis on which to consider movements in costs. To the extent that it might lead to an inconsistent or distorted measure of inflation in a particular year, the impact of these distortions might be expected to even out over a long control period.

7.17 However, we noted in the Openreach Pricing Framework that we did not consider that the October 2009 RPI statistic is likely to provide a particularly reliable estimate of inflation for 2010/11. While, as discussed above, this would not normally be a problem as the impact would even out over the period the circumstances were different in this case, as the LLU charge controls are of two years duration balancing out over the longer term was not feasible.

7.18 With respect to the charges proposed in this review we are very conscious of the need to ensure that there is no substantial avoidable distortion in the relative charges between WLR and MPF in the period of overlap between the controls. For this reason we consider it is appropriate to use the same adjustment for the October 2009 RPI outcome in setting the charges for 2010/11 as used for the LLU controls.

7.19 The impact of this adjustment can be illustrated by considering how a glide path based on published RPI data might look for WLR. The RPI inflation statistic for October 2008 was +4.2%. As explained below, in October 2009, it could be around -1.5%. A price control that added a constant X to both RPI statistics would therefore result in a large increase in 2009/10 followed by a small increase – or even a reduction- in prices in 2010/11. This approach would therefore result in an erratic glide path that has had more to do with the timing and basis of the RPI statistic than movements in Openreach's underlying costs. Our preferred approach, therefore, is to set Xs for 2010/11 which adjust for the inconsistencies in the expected level of inflation compared to the average inflation for the period.

7.20 However, we recognise that this approach will lead to nominal increases in a year in which we expect Openreach's returns to already exceed their cost of capital. We accept that stakeholders could argue that in these circumstances that it would not be appropriate to undertake adjustment to RPI that would deliver nominal increase. As set out in the graphs below we demonstrate that there are periods of under-recovery by Openreach in the period under review and therefore do not think it is appropriate to modify move away from a straight line path.

Implications for WLR prices

7.21 Given that we will be resetting the WLR charge half way through 2009/10 year and the charge is expected to rise in nominal terms from 2010/11 to 2012/13, we propose to retain the current ceiling for the WLR core charge for the rest of 2009/10, that is, at £100.68.

7.22 We propose to determine the appropriate glide path over the remaining three years, based on our estimate of the 2012/13 costs and the expected rate of RPI inflation over the remaining period.

7.23 However, for the reasons given above, we propose to define the value of X in 2010/11 to reflect the fact that the RPI statistic that will be used in the control does not reflect our assessment of the relevant underlying rate of inflation for the period in question. Our assumption on the underlying rate of inflation is 0% in 2009/10 and 2.5% in 2011/12 and 2012/13.

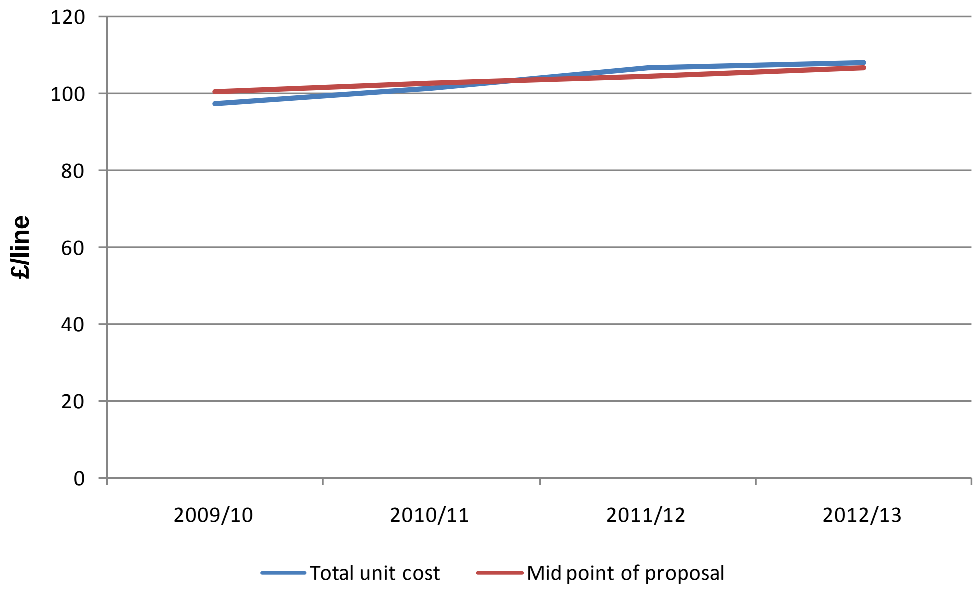
7.24 Our analysis suggests that a 'true' real terms decrease of 0% to - 1% per annum is needed to allow prices to move towards full cost recovery by 2012/13. The difference between the high and low points in the range represent the uncertainty in the level of allocation of common costs between the core WLR service and *WLR Premium* and the decision on the level of transfer costs to be supported by the rental charge.

7.25 However, in order to deliver this real terms decrease in 2010/11 we have adjusted the X to allow for the expected difference between the reported RPI in October 2009 and the actual RPI for 2010/11.

7.26 The difference is significant – approximately 4%. On this basis, we consider that an X of between +3% and +4% is appropriate for 2010/11 would allow a constant increase.

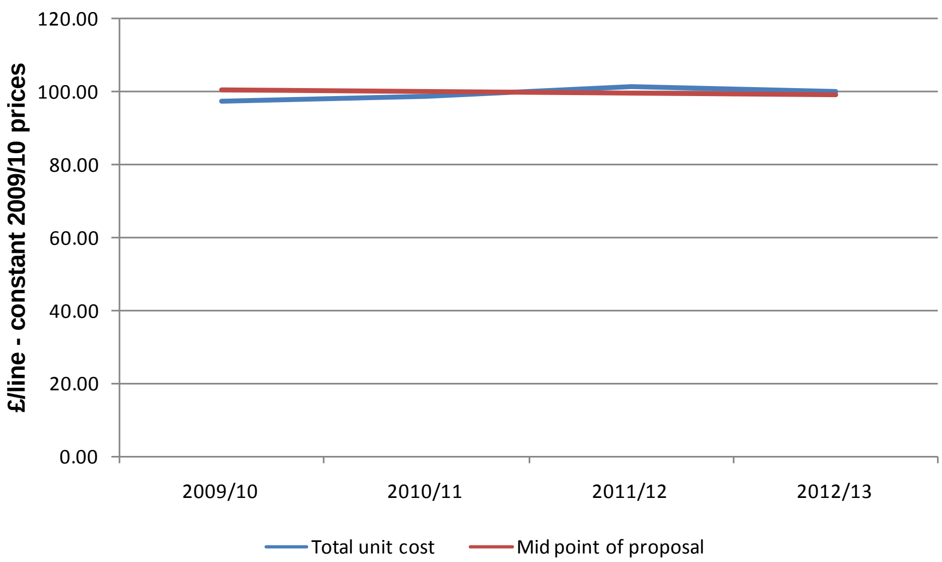
7.27 Figure 7.1 below shows the mid-point of our proposal for the core WLR rental charge in nominal terms, together with our assessment of total unit costs.

Figure 7.1: WLR core service – nominal terms



7.28 Figure 7.2 shows the equivalent mid point proposal and total unit cost in constant 2009/10 prices, based on our assumption of underlying inflation.

Figure 7.2: WLR core service – constant 2009/10 prices



Other charges

WLR Transfer

7.29 As discussed in Section 5 we propose to continue to support competition in exchange line by maintaining the policy of a low WLR transfer charge.

7.30 We propose that this will increase from £2 to £3 in the first year with an annual increase of between RPI+1.5 and RPI +4 in 2010/11 and between RPI-1 and RPI-0 for years 2011/12 and 2012/13.

WLR New Connection charge

7.31 We noted earlier the substantial over-recovery of the existing WLR new connection charge. Consistent with the changes to the LLU new line charge we propose that the WLR new connection charge be reduced from £88 to £67 in the first year with a subsequent control of between RPI-16.0 and RPI-15.0 in 2010/11 and between RPI-20 and RPI-19 for years 2011/12 and 2012/13.

7.32 The range represents the alternative assumptions on volumes set out in Section 6.

Summary of proposals

	Current price	**2009/10**	**2010/11**	**2011/12**	**2012/13**
New WLR Core Rental Service	£100.68	£100.68	RPI +3 to RPI +4	RPI - 1 to RPI - 0	RPI – 1 to RPI - 0
WLR transfer charge	£2.00	£3.00	RPI +3 to RPI +4	RPI - 1 to RPI - 0	RPI - 1 to RPI - 0
WLR new connection	£88.00	£67.00	RPI -16 to RPI-15	RPI - 20 to RPI - 19	RPI - 20 to RPI - 19

Implementation of the controls

7.33 Our proposal is that the new controls to take effect from 1 October, though this would be subject to when the statement will be finalised as we would wish to ensure sufficient, notice for the change. Subject to stakeholder views we propose that 28 days prior notice is sufficient to allow implementation of the changes given the limited range of changes under consideration .

7.34 In proposing a 28 day notice period we recognise that the considerations for how quickly changes to the rental services and the ancillary service can be made are different.

7.35 In proposing a move from two charge controlled rental services (*WLR Premium* and *WLR Basic*) to a single Core rental service which does not discriminate between residential and business customers, we acknowledge that this may require Openreach to adapt to this requirement. We do not consider that the period should be longer than 28 days as the new Core service that we are proposing is based upon Openreach's current *WLR Basic* service with the additional requirement that a business directory entry is provided. We note that Openreach already offer enhanced business entries as standalone products that can be purchased by CPs (along with either *WLR Basic or Premium*) at an extra charge. We do not, therefore, consider that the requirement to offer the single line business entry currently included in the *WLR Premium* service should involve any significant re-engineering of Openreach's currents services and therefore propose, subject to consultation, that a 28 day notice period should be appropriate. It is also important to note that we are not proposing any change to the price of the new Core service from that of the current *WLR Basic* product. Further, our proposals allow Openreach to continue to market *WLR Premium* as an enhanced product if they so choose. This price and product stability also suggest that our proposed notice period of 28 days is appropriate to allow for the changes required to be made.

7.36 Our proposal to set controls for the two identified ancillary services, transfer and new connection, only relate to a change of price for the services and therefore we consider that the required change in pricing is different in nature to the changes proposed for the rental service. We are proposing that the transfer charge be increased, initially by £1 to £3, and that the new connection charge be decreased, initially from £88 to £67. Given the nature of the proposed price changes we consider that it is appropriate to propose a 28 day notice period to allow both Openreach and other CPs to adapt to the changed prices.

7.37 Recognising the difference in changes that occur between the rental and ancillary services, we have invited stakeholders to comment on the appropriateness of the period. Specifically we recognise that some stakeholders may wish to comment separately on the appropriateness of the proposed notice period in relation to the rental and ancillary service.

7.38 In order that we may be able to set differing periods of notice for the two sets of services, if on review of any consultation responses we feel that this would be appropriate, we have drafted the proposed SMP condition AA4(A) in such a way that the effective dates for rental and ancillary services can be set differently. Further, as we are proposing that the 2006 WLR Charge Ceiling direction be withdrawn, we have drafted the proposed withdrawal of the direction in order to allow a staged withdrawal for the controls relating to rental and ancillary services to be removed at different times.

7.39 In drafting the proposed SMP condition and proposed withdrawal of the direction in this way we will still be able to set identical notice periods for the two services, but we consider that it is important to allow flexibility in order that we can properly consider and, if appropriate, react to consultation responses in setting an appropriate notice period.

Consultation Period

7.40 We have set a six weeks consultation given the technical nature of these proposals and their relationship to the Openreach Pricing Framework which was the subject of extensive public consultation.

Proposed conditions and statutory tests

Communications Act Tests.

7.41 To give regulatory effect to the policy proposals summarised above, we have proposed a new SMP condition (AA4(A)) and proposed a modification to an SMP condition (AA3). The text of those conditions are attached in Schedules 1 and 2, respectively, to the statutory notification published under 48(2) of the Act at Part 1 of Annex 9 to this document.

7.42 Linked to the setting of the SMP conditions is the proposal to withdraw the Direction that sets the current WLR price ceilings. The text of the withdrawal is annexed at Part II of Annex 9 to the document.

Proposed SMP service condition AA4(A)

Aims and Effects

7.43 The proposed SMP condition AA4(A) requires Openreach to ensure that its charges for WLR Core rental, transfer charges and new line provide charges do not increase by more than RPI -/+ X that varies according to each service. The range of proposed values of X are set out in the proposed condition.

7.44 Ofcom's reasons for imposing this particular form of control and the values of X are set out above. It is proposed that the first year for the control will run from 1 October 2009 to 31 March 2010, with the control period lasting for a further 3 years (the final year ending on 31 March 2013). Our current proposal is that prices should move towards FAC CCA in the final year of the control.

7.45 The proposed condition is designed to ensure that where the percentage change in a control year is more or less than the controlling percentage in question this can be adjusted in the following year's control.

7.46 The proposed condition contains mechanisms to deal, by means of directions, with any material changes (other than to a charge) made by Openreach to any product or service subject to the charge control.

7.47 We have also drafted the proposed condition to require Openreach to record, maintain and supply data to Ofcom in relation to the performing the percentage change calculation. Such data is required to be provided within three months of the end of each control year. It is essential for this information to be supplied *ex ante* to ensure that we can effectively monitor compliance with the controls.

Our duties and policy objectives

7.48 Our opinion of the likely impact of these proposals (as discussed throughout this document) is that the performance of our general and specific duties under sections 3 and 4 of the Act is secured or furthered by the way we have designed the proposed charge control.

7.49 In particular, we consider that the proposed charge control is designed to ensure that charges for wholesale line rental services can be set at a level that will enable other CPs to compete in the provision of downstream services. We have had particular regard to the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers, which are relevant to both sections 3 and 4 of the Act.

7.50 We have also borne in mind the need to seek the least intrusive regulatory measures to achieve our policy objectives.

7.51 In addition we have taken into account further objectives, including

Prices – to ensure that retail services are available at prices that are reasonably related to the efficient costs of supply, preferably as a result of effective competition

Investment and innovation – to promote efficient investment in the development of new and innovative services by BT, Openreach and other communications providers

Powers under sections 87 and 88 of the Act

7.52 The wholesale review proposed that BT held SMP in an identified market, wholesale exchange lines. Section 87(1) of the Act provides that, where Ofcom has made a determination that a person has SMP in an identified services market, they shall set such SMP conditions authorised by that section as they consider it appropriate to apply to that dominant provider.

7.53 Section 87(9) authorises the setting of SMP service conditions, including price controls and the setting of rules in relation to recovery of costs and cost orientation.

7.54 Where Ofcom seek to set an SMP condition falling within section 87(9) we are also required to comply with the conditions in section 88.

7.55 Having made the proposal that BT held SMP in the wholesale exchange lines market, the wholesale review proposed a number of SMP conditions that were considered appropriate given the market failures identified. Section 88 also requires us to take into account the extent of the investment made by Openreach in relation to the WLR services to which the proposed SMP condition relates. These included:

a) a requirement to provide WLR; and

b) that the WLR service / product be subject to a charge control.

7.56 The review identified the need for a charge control as an appropriate remedy to be proposed including identifying a risk of adverse events arising from price distortion. The wholesale review did not consider how the charge control should operate, and confirmed that this would be the subject of a separate consultation. This consultation fulfils that purpose.

7.57 In setting an appropriate control we need to ensure that it operates so that it

i) promotes efficiency;

ii) promotes sustainable competition; and

iii) confers the greatest possible benefits on end users.

7.58 We consider that the proposed conditions are appropriate for the purposes of promoting efficiency, sustainable competition and conferring the greatest possible benefits on end users. In proposing a four year charge control we are using an RPI +/- X formulation so that Openreach is encouraged to achieve greater efficiency in the provision of. This provides an incentive by allowing Openrach to keep any returns associated with efficiency gains over and above those forecast when the control is set. The benefits of lower costs can then be passed onto customers.

7.59 This structure of charges also ensures sustainable competition as charges are set at a level to allow the incumbent to make are ‘fair’ level of return yet ensure that purchases of the wholesale products are able to enter the market with a product priced competitively.

7.60 We have in this document, and in the associated cost analysis from the statement *A Pricing Framework for Openreach*, looked at a range of evidence when coming to a view on Openreach's efficiency. We have also had regard to the appropriate cost accounting methodology to be adopted.

7.61 We also consider that a single core control will allow Openreach to offer a variety of services, either as bundled offerings or by way of developing further "value added" services in order to respond to any particular demand in the market, thus allowing greater flexibility and therefore potentially greater choice of service by end users.

<u>The section 47 test</u>

7.62 Ofcom must also be satisfied that the proposed condition AA4(A) satisifies the test in section 47 of the Act, namely that any SMP service condition be objectively justifiable, not unduly discriminatory, proportionate and transparent.

7.63 Our proposed charge control has been structured to deliver the lowest possible charges to competitors for the wholesale services, while ensuring that Openreach is able to recover costs, including a reasonable return on investment.

7.64 The structure of the controls is such that BT has an incentive to continue to seek efficiency gains and is able to benefit from efficiencies achieved that are in excess of those anticipated in the review.

7.65 The controls are also objectively justifiable in that the benefits of RPI-X price controls are widely acknowledged as an effective mechanism to reduce prices in a situation where competition does not act to do so.

7.66 Further the proposal to charge control a single Core rental service (rather than to maintain separate controls for business and residential services) reflects the analysis undertaken in the wholesale review which proposed a single market for analogue exchange lines, based upon an analysis of the market and the services currently available within that market.

7.67 Secondly, the charge controls will not discriminate unduly against a particular person or particular persons because any CP (including BT) can access the services at the regulated charges. The proposed controls are designed to ensure fair returns and price levels for all customer groups. In addition, Ofcom considers that they do not discriminate unduly against Openreach as the controls address BT's dominant position in the relevant market , including its ability and incentive to set excessive charges for services falling within the controls.

7.68 Thirdly, the charge controls are proportionate because BT's obligations apply to the minimum set of charges required for the delivery of the bottleneck services. In particular we have proposed that only a single Core rental service needs to be charge controlled, and that this price can then inform the cost of other "bundled" services that Openreach may choose to offer, including, for example enhanced care provisions. The proposed controls are focussed on ensuring that there are reasonable prices for those access services which are critical to the development of a competitive market, whilst allowing a reasonable return on investment. Openreach will also have incentives to continue to invest and develop its access network. Moreover, the maximum charges Openreach is allowed to set over the period of the control has been formulated using information on BT's costs and a consideration of how these costs will change over time.

7.69 We therefore consider that the proposed charge controls would further our policy objectives of ensuring the WLR charges are consistent with LLU charges during the period of overlap in the controls and that they represent a level which encourages sustainable competition and the means employed to achieve those aims are both necessary and the least burdensome to address effectively the concerns we have set out.

7.70 Finally we consider that the charge controls are transparent. Their aims and effect are clear and they have been drafted so as to secure maximum transparency. The texts of the proposed Conditions themselves have also been published in the Notification. Their intended operation are also aided by our explanations in this document.

Proposal to amend SMP Service Condition AA3

7.71 As described above, the wholesale review has proposed a basis of charges condition, AA3. This condition will apply to all services within a market unless it is specifically disapplied.

7.72 A separate issue to the consideration of “value added” services discussed above, is the treatment of services that are subject to specific charge control conditions. The proposed AA3 makes it clear that services subject to SMP service condition AA4 remain subject to the basis of charges requirement. We consider that AA3 should be amended to include a similar statement relating to the services subject to the proposed SMP service condition AA4(A).

7.73 However, it is not appropriate for WLR Core Rental charges to be subject to the basis of charges condition set out in AA3. That requirement should not apply to those charges for reasons similar to why the LRIC+ cost orientation requirement was excluded in relation to the WLR rental charge ceiling in 2005. Namely, for reasons discussed in the Openreach PricingFramework Statement, one of our assumptions taken into account in assessing the cost bases that applied to copper access products (MPF and WLR) was the Regulated Asset Value (RAV) adjustment. Given that BT’s pre-1 August 1997 copper access network assets account for a significant proportion of the costs that make up the WLR rental charge ceiling in the first control year (and then followed by indexation of that ceiling in subsequent years), the charge ceiling itself cannot be said to be ‘based’ on LRIC+. On the face of it, the charge ceiling is therefore not consistent with SMP Condition AA3, proposed in the wholesale review which requires charges for Network Access to be ‘based’ on LRIC+.

7.74 This was recognised when the current price ceilings were set in 2006. The statement *WLR: reviewing and setting charge ceilings for WLR services*, discussed this in relation to the existing basis of charges condition and included a specific provision in the Direction setting the price ceilings disapplying the condition to WLR rental services.

7.75 We are therefore proposing an amendment to the currently proposed basis of charges condition. It is important to explain the significance of the timing of this review process and the related wholesale review in understanding why we consider it necessary for a currently draft condition to be subject to a proposed amendment.

7.76 We consider it appropriate to consult on the proposed amendment to AA3, with a view that if the condition is confirmed in the wholesale final statement, then the proposed amendment can, subject to consultation, take effect at the time of the WLR

Charge Control final statement. We recognise that, should the proposal for AA3 not be adopted in its current form in the wholesale review final statement, then we would have to consider what effect that would have on the amendment proposed here.

7.77 The proposed amendment is to insert a paragraph into the condition that has a similar effect to the current paragraph AA3.2, confirming that charge controlled services remain subject to the basis of charges requirement, but excluding WLR rental services from that obligation.

7.78 The proposed modified condition also needs to satisfy the section 47 test. We consider that the amendment by way of inserting an additional paragraph does satisfy those tests as we remain consistent with our approach to the pricing of copper access services taken in previous reviews and in the Openreach Financial Framework. Such an amendment is therefore objectively justifiable, proportionate and does not discriminate. Further the condition adds clarity to exactly which services are subject to the basis of charges condition and therefore the amended condition is transparent in what it seeks to achieve.

Proposal to withdraw current WLR Ceiling Direction

7.79 The prices for WLR services are currently regulated by fixed price ceilings that were set under a Direction (the 2006 Direction) made in the statement *Wholesale Line Rental : Reviewing and setting charge ceilings for WLR Services* published on 24 January 2006.

7.80 For the reasons set out above we consider that the current charge ceilings as imposed by the 2006 Direction are no longer the appropriate remedy by which WLR prices should be regulated. We, therefore, propose to withdraw the 2006 Direction.

7.81 In order to withdraw a Direction we have to comply with section 49 of the Act. We must be satisfied that the withdrawal is objectively justifiable, not unduly discriminatory, proportionate and transparent.

7.82 We have set out above that it would not be appropriate to continue with the current price ceilings as they do not reflect the ongoing costs of WLR services. Further the controlling of two separate services, whilst consistent, with the previous market analysis conducted in 2003, is no longer consistent with the proposed market analysis set out in the wholesale review. We consider that as the 2006 Direction gives effect to a remedy that is no longer appropriate, its withdrawal is objectively justifiable.

7.83 We do not consider that the withdrawal of the direction would be unduly discriminatory as the direction applied to give effect to an SMP remedy which applied to Openreach, and set prices at a consistent level for their customers. Our proposal to withdraw the 2006 Direction is contingent upon the implementation of an alternative, appropriate SMP condition which, equally would apply to BT to ensure prices were set at a consistent level for their customers. In those circumstances the withdrawal of the 2006 Direction will neither be unduly discriminatory, nor disproportionate.

7.84 Finally we are satisfied that the proposal to withdraw the direction in order that the price ceilings can be replaced with a more appropriate price control is transparent.

Proposal to Allow BT to implement price changes with 28 days notice

7.85 The wholesale review has proposed SMP Service condition AA6(a) which requires BT to give notice of amendments to prices in certain circumstances. This provision does not apply to cases where such changes are required by a Notification.. Therefore Openreach would not be bound by a requirement to give notice before any initial price changes that they would be required to make in consequence of any final Notification in this review. However, we consider that BT should give CPs 28 days notice when initially amending its prices for WLR services to align with any charges as set out in the Notification.

7.86 We consider that this can be achieved by ensuring that the proposed SMP Condition AA4(A) does not come into effect for at least 28 days after the publication of our final statement and Notification.

7.87 We have, in the draft SMP condition AA4(A).1, set a fixed charge ceiling for a period to run to the start of the first full year ("Relevant Year") of the control (April 2010 – March 2011). This period could start, at the earliest, on 1 October 2009, however, the dates have not be fixed in our proposals in order to specifically allow for a different period of notice (should we publish our Notification less that 28 days before the 1 October 2009) where we consider that to be appropriate, balancing responses from stakeholders suggesting a longer period and the need to ensure that the proposed controls take effect promptly to ensure that WLR services are appropriately regulated. We have also drafted the condition in order that different notice periods can be set for the proposed rental service and the ancillary services, should we consider it appropriate for different periods to apply. The need to allow for this is discussed in detail at paragraphs 7.32 to 7.38 above.

Question 7.1 Please set out your views on the proposals set out in Section 7, together with the potential implications of the those proposals for CPs and for consumers, and the factors you consider we should take into account when determining the final pricing regime.

Question 7.2 Do you agree with our treatment of the first year RPI adjustment to ensure consistency with the LLU proposals?

Question 7.3 Do you agree with the proposed 25 days implementation period? If not please state your reasons and a preferred period?

Question 7.4 Do you agree with our assessment that the proposed changes to conditions and directions meet the tests set out under the Act?

Question 7.5 Please provide any other comments you may have in response to the proposals set out in this document.

Annex 1

Responding to this consultation

How to respond

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 14 August 2009**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/wlrcc/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email markham.sivak@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Markham Sivak
Floor 4
Competition Policy
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 77834109

A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Markham Sivak on 020 77834659.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.11 Following the end of the consultation period, Ofcom intends to publish a statement in March 2009.

A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom’s consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom’s ‘Consultation Champion’ will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	☐	Name/contact details/job title	☐
Whole response	☐	Organisation	☐
Part of the response	☐	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name | Signed (if hard copy)

Annex 4

Consultation questions

A4.1 A summary of the questions set out in the consultation is listed below:

Question 3.1 Do you agree with our preferred option to set a control on a WLR core rental service to be available both to residential and business customers with the option for number entry to residential and business directories? Or do you consider that the alternative use of a basket would be a more appropriate control?

Question 3.2 If we are setting the control on a core WLR rental service are there any other features of the WLR Premium service, other than entry in a business directory, that would be required in the revised core rental service so that it would be suitable as a basic business product?

Question 3.3 Please provide you views on the requirement for and if necessary, duration of any transition period for the implementation of a core WLR service?

Question 3.4 What is your view on the appropriate basis of charges (cost orientation) regime for WLR Premium and other higher care level services? Do you consider that the other obligations on Openreach (perhaps supplemented by guidance on interpretation) are sufficient control on the WLR Premium charge without an addition basis of charge condition? (Responses to these question will be considered in conjunction to the basis of charges (question 13.3) proposed in the Wholesale Review consultation).

Question 4.1 Do you agree that it is important to ensure consistency between the WLR and LLU charge controls? In this context, do you agree that we will need to consider consistency in considering the impact on any challenges to assumptions when we are setting the final controls?

Question 4.2 Do you agree with Ofcom's analysis on the relative charges for WLR and MPF set out here, in Annex 5 of this document and in the Openreach Pricing Framework?

Question 4.3 Do you agree with Ofcom's proposal to set a three and a half year period charge control for WLR?

Question 5.1 Do you agree that Ofcom should continue with its current approach to setting the transfer charge ceiling, recovering the transfer costs primarily through the line rental? If not, please explain why.

Question 5.2 If we do continue with a low transfer charge do you agree that Ofcom should increase the transfer to £3 with an index? If not, please explain why.

Question 5.3 Do you agree that Ofcom should continue to set a charge ceiling for new connections? Do you agree that it is appropriate to impose of one off adjustment in this case given the difference between existing charges and the CCA FAC cost? Do you agree it is appropriate to consider the relative charge of new line for LLU and WLR in making this adjustment?

Question 5.4 Do you agree that Ofcom should exclude the remaining migration charges and calling and network features from the scope of the charge ceiling? If not, please explain why.

Question 6.1 Do you agree with the approach we have taken to derive the core WLR rental? In particular do you consider the estimates for the cost of the WLR Premium care levels to be reasonable?

Question 6.2 Do you agree with an allocation of common costs to the WLR Premium care level service?.

Question 6.3 Do you have any comments on the likely change in transfer or connection volumes in the latter part of this charge control period?

Question 7.1 Please set out your views on the proposals set out in Section 7, together with the potential implications of the those proposals for CPs and for consumers, and the factors you consider we should take into account when determining the final pricing regime.

Question 7.2 Do you agree with our treatment of the first year RPI adjustment to ensure consistency with the LLU proposals?

Question 7.3 Do you agree with the proposed 25 days implementation period? If not please state your reasons and a preferred period?

Question 7.4 Do you agree with our assessment that the proposed changes to conditions and directions meet the tests set out under the Act?

Question 7.5 Please provide any other comments you may have in response to the proposals set out in this document.

Annex 5

Wholesale Line Rental cost stacks

Introduction

A5.1 This Annex sets out our assessment of the costs of providing the proposed core WLR line rental. The starting point of our assessment is the analysis in the Openreach Pricing Framework Statement. In the Openreach Pricing Framework Statement we set out cost calculations for the Core Rental Services for the five years to March 2013, including the costs for Business and WLR Residential, together with the underlying assumptions. We explained in that Statement that these would be relevant to the Charge Controls being proposed in this Consultation Document.

A5.2 As set out in Section 3 of this consultation, we intend to set a charge for a single core WLR service, in the period to March 2013. Openreach may also choose to charge a premium for enhanced levels of service requested by customers.

A5.3 This annex sets out how we have calculated the cost of providing the core WLR service. Specifically this section sets out

- Our cost estimates for residential and business WLR for the five years to March 2013, as set out in the Openreach Pricing Framework Statement;
- How we have reviewed the assumptions;
- How we used have the estimates for residential and business WLR derived estimates of the cost of an aggregated WLR service;
- How we have adjusted these estimates to deduct the costs of providing services that may now be charged separately and hence derived the cost for the core WLR service
- How we have derived the additional costs that need to be recovered by the core WLR service rental charge to cover the remaining WLR Transfer costs not covered by that charge

Cost Estimates for residential and business WLR

A5.4 Our approach to the determination of the costs for the WLR services is based on CCA FAC principles.

A5.5 As we explained in the Openreach Pricing Framework statement, we consider that it is appropriate to use a four year period as the basis for the modelling of forward costs. We consider that the four year period allows us to take a medium term view of the impact of changes in costs, volume and efficiency levels. In this case, the model starts in April 2009 to ensure consistency with the LLU charges.

A5.6 We consider that it was appropriate to use cost estimates provided by Openreach at our request as the starting point for our own financial analysis undertaken in the Openreach Pricing Framework review and extended for the WLR charge review now.

A5.7 In the Openreach Pricing Framework, we

- Set out Openreach's cost estimates at an aggregate and unit cost level;
- Described Openreach's approach to the estimate of its costs, which includes the calculation of its costs 2007/08 and projected cost estimates to 2012/13;
- Set out the key assumptions made by Openreach to project future costs;
- Demonstrated that the base year costs are consistent with audited financial data; and
- Provided Openreach's explanations for the main movements in its cost estimates between 2008/09 and 2012/13.

A5.8 We considered that Openreach's cost projections are based on a logically sound approach and provided a sensible basis for the modelling of future costs and have used Openreach's model to inform our estimate of unit costs. Specifically, we:

- Obtained, on a confidential basis, functional versions of these models;
- Spent significant time with Openreach and its consultants to ensure that we fully understand the mechanics of the model;
- Reviewed model user manuals and obtained thorough explanations of key aspects;
- Tested the interaction of volumes, task times, FTE assumptions, average salaries, fault rates and visit ratios to ensure the models produced predictable outputs that could be understood;
- Reviewed the allocation basis, to ensure that they are reasonable and are applied as described;
- Reconciled the base year forecasts back to audited financial data;
- Ensured that all movements in costs during the period could be explained by simple analysis based on an understanding of future changes in demand and cost behaviour;
- Prepared our own estimates of future costs on a CCA FAC basis, by rolling forward audited financial data from the 2008 current cost financial statements and ensured that the outputs from Openreach's model were consistent with these estimates

A5.9 Set out below are our estimates of the costs for the individual WLR residential and premium services as derived from the Openreach Pricing Framework model.

Table A5.1: CCA costs and revenues for WLR Residential, assuming prices remain fixed in nominal terms

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**1,774**	**1,688**	**1,631**	**1,599**	**1,381**	**1,267**
Pay	310	309	271	254	234	214
Line card and Tams	194	192	193	198	179	152
Accommodation	161	159	146	148	134	126
Stores, contractors, Service centre etc	84	78	71	69	59	52
Corporate Overheads	62	61	55	50	45	42
IT (ex depn)	84	84	73	68	61	56
Fleet	58	57	51	50	43	38
Other	14	7	6	7	6	6
Operating Cost	**967**	**948**	**865**	**844**	**761**	**685**
EBITDA	807	740	765	755	620	582
Depreciation inc Holding gains	161	438	363	288	279	277
EBIT	**647**	**302**	**403**	**467**	**341**	**305**
ROCE%	13%	6%	9%	10%	8%	8%
Mean Capital Employed	**5,044**	**4,760**	**4,670**	**4,751**	**4,247**	**3,969**
Volumes	**17,596**	**17,007**	**16,196**	**15,880**	**13,715**	**12,585**

Table A5.2: Unit WLR Residential Operating costs and depreciation

	2007/08 £	2008/09 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Revenue	**100.84**	**99.26**	**100.68**	**100.68**	**100.68**	**100.68**
Pay	17.64	18.19	16.74	15.98	17.05	17.04
Line card and Tams	11.04	11.31	11.89	12.49	13.06	12.08
Accommodation	9.13	9.36	9.01	9.33	9.74	10.01
Stores, contractors, Service centre etc	4.76	4.59	4.36	4.33	4.32	4.15
Corporate Overheads	3.53	3.61	3.38	3.18	3.31	3.30
IT (ex depn)	4.76	4.94	4.51	4.26	4.44	4.42
Fleet	3.31	3.37	3.12	3.16	3.16	2.98
Other	0.78	0.39	0.40	0.43	0.41	0.47
Operating Cost	**54.95**	**55.77**	**53.42**	**53.15**	**55.48**	**54.45**
EBITDA	45.89	43.49	47.26	47.53	45.20	46.23
Depreciation inc Holding gains	9.14	25.74	22.40	18.12	20.32	22.04
Operating Cost inc depn	64.08	81.51	75.82	71.27	75.79	76.48

Table A5.3: CCA costs and revenues for WLR Business, assuming prices remain fixed in nominal terms

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**646**	**641**	**579**	**483**	**549**	**539**
Pay	93	95	79	63	76	75
Line card and Tams	64	65	62	54	65	59
Accommodation	50	51	44	38	45	46
Stores, contractors, Service centre etc	26	25	21	18	20	19
Corporate Overheads	19	19	16	13	15	15
IT (ex depn)	25	26	22	17	20	20
Fleet	18	18	15	13	15	13
Other	5	3	2	2	2	3
Operating Cost	**300**	**302**	**262**	**218**	**259**	**249**
EBITDA	346	339	317	265	291	290
Depreciation inc Holding gains	74	163	130	89	111	116
EBIT	**272**	**176**	**187**	**176**	**180**	**175**
ROCE%	17%	12%	14%	14%	13%	12%
Mean Capital Employed	**1,554**	**1,537**	**1,433**	**1,241**	**1,461**	**1,459**
Volumes	**5,853**	**5,814**	**5,261**	**4,391**	**4,995**	**4,900**

Table A5.4: Unit WLR Business Operating costs and depreciation

	2007/08 £	2008/09 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Revenue	**110.32**	**110.21**	**110.00**	**110.00**	**110.00**	**110.00**
Pay	15.85	16.32	15.02	14.32	15.30	15.27
Line card and Tams	10.93	11.19	11.77	12.36	12.93	11.95
Accommodation	8.53	8.74	8.42	8.72	9.10	9.35
Stores, contractors, Service centre etc	4.45	4.30	4.08	4.06	4.05	3.88
Corporate Overheads	3.20	3.27	3.07	2.88	3.01	2.99
IT (ex depn)	4.34	4.49	4.11	3.88	4.04	4.02
Fleet	3.06	3.10	2.87	2.91	2.91	2.73
Other	0.81	0.45	0.46	0.48	0.46	0.53
Operating Cost	**51.17**	**51.86**	**49.79**	**49.61**	**51.80**	**50.73**
EBITDA	59.15	58.35	60.21	60.39	58.20	59.27
Depreciation inc Holding gains	12.72	28.12	24.65	20.29	22.24	23.61
Operating Cost inc depn	63.89	79.98	74.45	69.90	74.03	74.34

Review of Key Assumptions

A5.10 We believe the analysis and assumptions set out in the Openreach Pricing Framework Statement continues to provide an appropriate basis for estimating the cost of providing WLR services.

- We specifically have reviewed the assumptions in the light of changes to BT's 21CN plans and their impact on WLR. This related to the use and allocation of the combi card replacement of lines cards.

- As explained in Annex 5, we are satisfied that the costs allocated to WLR remain reasonable.

A5.11 As discussed in Section 2, given that LLU and WLR products are competitive substitutes and share a broad range of common costs it is essential that costs should be calculated on a consistent basis to avoid competition distortion.

A5.12 Secondly, the nature of the costs and the allocation underlying allocation bases means that – by deriving the cost estimates from a common source - an assessment of the costs of one service informs an assessment of the reasonableness of the costs of the other.

A5.13 Thirdly, given the relatively short period that has passed since the Openreach Pricing Framework Statement was published it is unlikely that the underlying competitive or costs assumptions would have changed significantly. Below is our assessment of the key assumptions.

A5.14 We believe the analysis set out in the Openreach Pricing Framework Statement continues to provide an appropriate basis for estimating the cost of providing WLR services.

A5.15 Nevertheless, as set out below, we have reviewed the key assumptions set out in the Openreach Pricing Framework Statement below in table A5.5, to ensure that they remain appropriate.

Table A5.5: Key assumptions

Parameter	Ofcom conclusion in Openreach Pricing Framework and assessment now
Aggregate Volumes	Demand for fixed lines to fall by 7% by 2012/13. See Annex 7 of the Openreach Pricing Framework Statement – still valid
Change in mix- internal demand for MPF	Internal demand for MPF lines to increase but remain below 0.5m lines – still valid
Change in mix- external demand for MPF	External demand for MPF lines to increase to around 5m lines by 2012/13 – still valid
Change in mix - other	Total demand for SMPF to fall to around 11m lines by 2012/13 – still valid
Inflation	Annual inflation to be 0% between 2008/09 and 2009/10 then 2.5% thereafter. Specific adjustments to costs – such as reduced Cumulo rates – should also be taken into account – still valid but may need to be reviewed prior to final charge setting

Pay costs	Long term average real wage inflation of 1% pa – still valid
Pension costs –deficit	Regulated charges will not include any contribution to the funding of the pension deficit. However, our long term approach to the funding of pension deficits should be considered in a separate consultation – still valid
Pension costs – future costs	Annual charges to meet future liabilities should be included in our assessment of recoverable costs and recent cost-reduction plans should be taken into account – still valid
Energy costs	Recent reductions in energy costs must be taken into account, but we accept that actual costs based on forward looking contracts effected prior to 2009/10 should be recovered. See Annex 9 of the Openreach Pricing Framework Statement – still valid
Commodity prices	Assets are valued by reference to the cost of replacing the asset at March 2009 prices – basis for current estimate but will be reviewed prior to final statement
Scope for efficiency gains	Efficiency gains of 4% in 2009/10 (excluding fault rates) on compressible costs and declining thereafter. See Annex 9 of the Openreach Pricing Framework Statement – still valid
Reduction in fault rates	Fault rates to fall by 2% each year – still valid
Cost allocation	Costs of £88m should be reallocated away from the Core Rental Services – still valid
Group Costs	Other than the specific exceptions noted elsewhere, no adjustment to Group costs is necessary – still valid
IS costs	No adjustment to Openreach’s estimate of IS costs – still valid
Line cards	Openreach’s estimate of costs per line appears reasonable. Further discussion is set out in below
SLG payments	Openreach should recover efficiently incurred costs. Openreach’s adjusted cost estimates look reasonable – still valid
Light User Scheme	None of the cost of the LUS should be recovered through the regulated services, including administration costs – still valid
Regulatory Asset Value (“RAV”)	Openreach’s assessment of the RAV adjustment appears reasonable – still valid
Dropwire costs	To be consistent with our previous approach, a proportion of capital costs relating to residential dropwires installed between

	2000/01 and 2004/05 should be excluded – still valid
Line length adjustment	Openreach's approach provides a reasonable basis for determining the line length adjustment. No further adjustment is proposed – still valid

BT's 21CN Programme and the impact on line card and migration costs

A5.16 There was a concern expressed by the TalkTalk Group that the WLR cost stack underestimated the 21CN costs. The TalkTalk Group's proposed approach would be to set the WLR charge to include the full combi card cost which replaces the existing lines cards and also the cost of migration to 21CN.

A5.17 Line cards are the electronic equipment that sit at the local exchange and assign the phone numbers to copper lines; they represent the end of the access network. They represent an important input for WLR but are not required for the provision of MPF.

A5.18 BT currently uses PSTN line cards which only recognise voice traffic. These have a ten year life span and are no longer manufactured. As a result these have become obsolete in exchanges where BT replaces its legacy PSTN and broadband network with a single IP based network, BT termed this NGN '21CN'. In the traditional PSTN network, as the line card exclusively supports voice services, the cost is directly attributable to WLR services.

A5.19 At the time of the Second Consultation on the Openreach Pricing Framework, 21CN was expected to be largely complete by 2013. As part of this migration, BT planned to replace most of PSTN line cards with 'combi cards', which can be used by multiple products or services in three ways:

- To generate a voice only service, using the voice only capability of the card (currently WLR);
- A data only service (not currently available); or
- A voice and data service (currently WLR and SMPF).

A5.20 Openreach had provided forecasts of both PSTN and 21CN line cards. In aggregate, total costs fell by 25% as expected, as an old technology was replaced by a newer one. Of greater impact to the unit cost of WLR is how these costs are allocated to products and services, which we discussed in the Openreach Pricing Framework Statement.

A5.21 The cost of a combi card is the same however it is used. As with the existing PSTN line cards, combi cards will be owned by BT Wholesale, who pass the cost on to Openreach.

A5.22 We explained in the Second Consultation for the Openreach Pricing Framework that Openreach had estimated the line card cost to be recovered via the WLR charge on the basis of the number of services provided.

A5.23 On this basis, WLR and internal SMPF would both be treated as one service each and internal MPF would be treated as two services (i.e. Voice and Broadband). The result is that that the combi card cost is divided by the total number of services forecast.

A5.24 We explained that we considered that this approach resulted in a reasonable unit cost for line cards that includes both legacy PSTN and voice-related costs relating to BT's next generation access network (known "21CN"). This was partly because it resulted in a line card cost that is broadly constant in real terms over time.

A5.25 However, since the Second Consultation for the Openreach Pricing Framework, BT has suspended its plans for the roll-out of 21CN. They are currently proposing to continue with the PSTN network for voice service for the next 10 years. This means the most migration costs are not now relevant for the control period.

A5.26 However, determining what the cost of continuing with PSTN line cards would be in the future is not straightforward. The cards are no longer manufactured. This makes this approach difficult to implement.

A5.27 Whilst potentially there could be cost savings by not installing combi cards, PSTN line cards are reaching the end of their life and must be replaced or refurbished. Delaying replacement past their useful life or refurbishing will result in higher maintenance costs which could increase overall costs.

A5.28 It is unclear whether there is a more reliable, practicable basis for determining line card costs for WLR than the basis described in the Second Consultation for the Openreach Pricing Framework. While the underlying justification has changed, we believe that the unit costs calculations continue to look reasonable.

A5.29 If alternative allocation methodologies are used, the cost of a line card could rise or fall. One alternative methodology is that 21CN line card costs are recovered across all line, regardless as to the number of services provided on that line. This would make a single service line such as WLR relatively expensive compared to a dual service line. The impact on line cards is as follows:

	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13
On a per line basis	12.01	21.49	18.38	19.31	20.18	18.86
Current approach	11.01	11.28	11.86	12.46	13.02	12.04

A5.30 We do not consider that there is a strong argument for the per line allocation given the multiple services supported by the line cards.

Estimating the aggregate WLR costs

A5.31 For the reasons given above, we consider that the WL:R cost stacks set out in the Openreach Pricing Framework Statement continue to provide an appropriate starting point for our assessment of the costs of the core WLR service.

A5.32 However, the cost analysis in the Openreach Pricing Framework Statement was prepared on the basis that the historical distinction between residential and business WLR would continue. Separate cost projections were therefore prepared for the two services.

A5.33 However, as set out in Section 3, we propose that the two WLR services will be replaced with a single service available to all customers with a specified level of service. Customers would then be able to specify enhanced levels of service at additional cost (*WLR Premium*).

A5.34 To estimate the cost of the *WLR Basic* service, it is therefore necessary to aggregate the costs of the residential and business WLR services and deduct any costs that relate to the delivery of incremental services that will be charged separately via the Premium product.

A5.35 The aggregate WLR rental costs, blended unit opex cost stacks are set out in the tables below.

Table A5.6: CCA costs and revenues for WLR rentals, assuming prices remain fixed in nominal terms before adjustment for enhanced service costs

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**2,420**	**2,329**	**2,209**	**2,082**	**1,930**	**1,806**
Pay	403	404	350	317	310	289
Line card and Tams	258	257	255	253	244	211
Accommodation	211	210	190	187	179	172
Stores, contractors, SMC and misc.	110	103	92	87	79	71
Corporate Overheads	81	80	71	63	60	56
IT (ex depn)	109	110	95	85	81	75
Fleet	76	75	66	63	58	51
Other	18	9	9	9	8	9
Operating Cost	**1,266**	**1,250**	**1,127**	**1,062**	**1,020**	**934**
EBITDA	1,154	1,079	1,082	1,020	911	872
Depreciation inc Holding gains	235	601	493	377	390	393
EBIT	**918**	**478**	**590**	**643**	**521**	**479**
ROCE%	14%	8%	10%	11%	9%	9%
Mean Capital Employed	**6,629**	**6,298**	**6,103**	**5,992**	**5,708**	**5,428**
Volumes	**23,449**	**22,821**	**21,457**	**20,271**	**18,710**	**17,485**

Table A5.7: Unit WLR Operating costs and depreciation before adjustment for enhanced service costs

	2007/08 £	2008/09 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Revenue	**103.20**	**102.05**	**102.97**	**102.70**	**103.17**	**103.29**
Pay	17.20	17.72	16.32	15.62	16.58	16.54
Line card and Tams	11.01	11.28	11.86	12.46	13.02	12.04
Accommodation	8.98	9.21	8.86	9.20	9.57	9.82
Stores, contractors, SMC and misc.	4.68	4.52	4.29	4.28	4.25	4.07
Corporate Overheads	3.44	3.53	3.31	3.11	3.23	3.21
IT (ex depn)	4.66	4.82	4.41	4.17	4.33	4.30
Fleet	3.25	3.30	3.06	3.10	3.09	2.91
Other	0.79	0.40	0.42	0.44	0.42	0.49
Operating Cost	**54.01**	**54.77**	**52.53**	**52.39**	**54.49**	**53.40**

EBITDA	49.20	47.27	50.44	50.31	48.67	49.89
Depreciation inc Holding gains	10.03	26.35	22.95	18.59	20.83	22.48
Operating Cost inc depn	64.04	81.12	75.48	70.97	75.32	75.88
EBIT	**39.17**	**20.93**	**27.48**	**31.72**	**27.85**	**27.41**
ROCE%	14%	8%	10%	11%	9%	9%
Mean Capital Employed	**282.7**	**276.0**	**284.4**	**295.6**	**305.1**	**310.4**
Volumes	**23,449**	**22,821**	**21,457**	**20,271**	**18,710**	**17,485**

Estimating the cost of the enhanced service

A5.1 As set out in section 3 we propose that the charge control for WLR rental products, will be focussed on a core WLR product. This is a departure from the current *WLR Basic* and *WLR Premium* services which have been controlled through charge ceiling for WLR Residential and WLR Business respectively.

A5.2 To determine the appropriate charge for a core WLR service we have determined the aggregate costs for *WLR Basic* and *WLR Premium* and then identified *WLR Premium* specific cost which should be removed.

A5.3 The table below sets out the aggregate unit cost for *WLR Basic* and *WLR Premium*.

Table A5.8: Unit cost of WLR rental, before adjustment for enhanced service costs

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	£	£	£	£	£	£
Operating unit cost	64.04	81.12	75.48	70.97	75.32	75.88
ROCE unit cost	28.55	27.87	21.62	29.85	30.81	31.35
Total unit cost	92.59	108.99	97.10	100.83	106.14	107.24

A5.4 However, as enhanced care services are already provided by Openreach the associated costs are already reflected in the cost stacks set out above. It is therefore necessary to deduct these costs to leave the underlying cost of providing the basic service.

A5.5 We have considered three possible approaches to estimating the cost of providing *WLR Premium*, as follows:

- An “incremental savings” approach. Under this approach, the costs that would be saved if the current service levels were reduced back to the level to be provided with *WLR Basic*. This might include the pay costs that could be saved if the fewer engineers were required as a result. This approach results in the smallest deduction; and

- An “incremental cost” approach. This is similar to the incremental saving approach but, rather than looking at the costs that might be saved if Openreach ended the provision of the higher service levels, it considers the additional costs it incurs to be able to provide those services. For example, in addition to extra pay costs, this might also include the cost of higher-specification IS (which would be incurred to deliver enhanced service levels but would not be avoided if such service levels were withdrawn, as under the incremental saving approach).

- An approach that assumed some additional common costs are recovered from *WLR Premium*. In addition to the incremental cost of providing the higher service levels, this approach includes a share of Openreach's overheads. This approach results in the largest deduction

A5.6 The incremental cost approach requires an assessment of the cost of providing the Basic WLR product as if the enhanced service levels had never been offered. As such it is difficult to quantify. The result is unlikely to be significantly different from the second incremental approach given the minimal impact of system modification.

A5.7 The incremental savings approach can be readily reconciled with existing activity and is straightforward, by starting from the current aggregate WLR cost stack. It is therefore the most practical given the Openreach Pricing Framework methodology.

A5.8 To inform our view, we asked Openreach to provide an estimate of the costs that could be avoided if the enhanced levels of service were no longer provided. These estimates were adjusted to make them consistent with the Openreach Pricing Framework.

A5.9 The two incremental cost saving Openreach provided information on were for Jeopardy Management and Faster Contractual Repair.

A5.10 Jeopardy Management is the labour activity carried out to improve provision and repair performance. Openreach argue that BT Jeopardy management is focussed on more complex jobs, where an engineering visit is required. *WLR Premium* new provides usually require an engineering visit and *WLR Premium* repairs are 'more likely' to require a visit. Openreach consider a 70:30 split of Jeopardy Management activity between *WLR Premium* and *WLR Basic* appropriate.

A5.11 Based on the Openreach Pricing Framework, Openreach have identified Jeopardy management costs of £19m. Openreach assume 70% of Jeopardy management costs are attributed to the premium product. If *WLR Premium* had the same cost characteristics of *WLR Basic*, then these costs would fall by £0.8m.

A5.12 Faster contractual repair is the cost of serving WLR Business customers in priority to WLR Residential customers even where it causes inefficiency – e.g. an Engineer's route would be scheduled to attend WLR Business customer in priority to Residential customers even where it might impose additional travelling distances. Openreach have provided evidence which shows removing the need to carry out faster contractual repairs would reduce the current aggregate repair cost on residential lines by 3.2%. This is equivalent to a £10m saving.

A5.13 We agree that the costs of faster response times are a legitimate cost differential. The resultant 47p average comparable to the 53p differential in service cost we identified when we set the current Charge Control.

A5.14 The third approach of including some common costs in the additional costs of *WLR Premium* would be more consistent with the fully allocated cost approach taken to determining the costs of the rental services in the Openreach Pricing Framework.

A5.15 The problem is that as the Openreach Pricing Framework did not identify the incremental cost of providing the Premium Product, it did not identify the common costs to be included within the fully allocated cost. It is therefore difficult to determine how much common cost should be included.

A5.16 However we consider it reasonable to including some common costs. Assuming there is reasonably strong demand for the *WLR Premium* services, users of *WLR Premium* are likely be prepared to pay more than the incremental costs to receive these services. It may be a more efficient way of recovering common costs to recover more from *WLR Premium* and correspondingly less from the core WLR service. Given the current differentials in charges, this seems possible.

A5.17 In considering the appropriate amount of common cost to include, we took as a starting point the fully allocated cost methodology used in the Openreach Pricing Framework. From the work carried out by ourselves and KPMG in the second Consultation on the Openreach Pricing Framework we identified that one of the main drivers for the allocation of common costs is labour cost.

A5.18 The incremental cost of for faster contractual repair is a labour cost. If we assume that the proportion of common cost included for *WLR Premium* is the same as a proportion of labour as with *WLR Basic* rental, then on the basis that the 47p saving is mostly labour related then the additional common cost included would be 40p (compared to the average WLR charge).

A5.19 This assumes the incremental labour savings on *WLR Premium* attracts common cost in the same proportion as overall labour on WLR rentals. A 50% lower proportion would deliver a cost saving of £0.20 whilst a 50% higher proportion would deliver a cost saving of £0.61. On the basis that the common cost apportionments are the same, the unit cost saving to *WLR Basic* of removing the elements relating to the provision of the premium product are as follows:

	Difference
	£
Jeopardy Management	0.04
Faster Contractual Repair	0.47
Overhead Allocation	0.40
	0.91

A5.20 This results in a relatively modest reduction in the aggregate WLR charge. However, we believe that it is appropriate to be cautious about the additional common costs that are assumed to be recovered through *WLR Premium*. This is because we believe that that the level of the *WLR Premium* charge is likely to be constrained by *WLR Basic*, as customers have the option of buying the cheaper product. And the extent of such substitution is likely to be enhanced in the future because we propose to ensure that *WLR Basic* is suitable as a base product for business customers. In particular, we propose to ensure customers are able to buy the product freely and are able to list in business directories. We therefore consider that the relatively modest differential resulting from the above calculation is appropriate.

Core WLR Costs

A5.21 Based on the proposed approach above, the cost differential between the average WLR charge and the *WLR Premium* equates to a £0.91p reduction from the aggregate WLR charge. We have assumed over time that the deduction is to operational cost and inflates with general inflation.

A5.22 Assuming the reduction to the aggregate WLR charge of £0.91 tracks general inflation, we have the following cost stacks;

Table A5.9: Unit cost of WLR rental, before adjustment for enhanced service costs

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	75.48	70.97	75.32	75.88
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	97.10	100.83	106.14	107.24

Table A5.10: Unit cost of aggregate WLR rental, after adjustment for enhanced service

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	74.57	70.04	74.37	74.90
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	96.19	99.89	105.18	106.26

Cost of transfer above the proposed charge

A5.23 As set out in Section 5, we propose that, for pricing purposes only, we make a cost transfer from Transfers to the core WLR service for those costs not covered by the regulated charge. Given average churn rates this suggests that the cost of any transfer should be split over five years. This would increase the core WLR cost stack as follows.

Cost of transfer above the proposed charge

A5.24 As set out in Section 5, we propose that, for pricing purposes only, we make a cost transfer from WLR transfers to the WLR Basic rental service for those costs not covered by the regulated charge. Given average churn rates this suggests that the cost of any transfer should be split over five years.

A5.25 There are many possible ways to calculate the cost transfer, we modelled three. The first assumed that price stayed at £2 and cost transfers, amounting to one fifth of each year's unrecovered cost, start in 2007/8 so that by 2012/13, the cost transfer is at 'steady state'. This methodology does not take account of the price increase in 2009/10 however and results in a slight over-recovery. The second methodology assumes the transfer price is £3 indexed with WLR Rental through the period and on the same basis leads to a slight under-recovery. However, the difference between these methodologies is not great <£1m.

A5.26 The third and simplest methodology was to assume that 2012/13 under recovery represented a steady state position, with prices at the actual/proposed rate. The cost transfer was set to ensure costs equalled revenues. The result sits between the other two methodologies with a transfer of costs, for pricing purposes of £29m, to WLR Basic rentals of £29m in 2012/13 and the preceding three years. The impact on the WLR Basic rental cost stack is as follows;

Table A5.11: Unit cost of WLR rental, after adjustment for enhanced service costs and cost transfer (for pricing purposes) from WLR transfer

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	75.94	71.49	75.93	76.58
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	97.55	101.34	106.75	107.93

Annex 7

Wholesale Line Rental Ancillary cost stacks

A6.1 Set out below are the aggregate cost stacks for WLR Connections and Transfers (for residential and business lines) and their related unit costs.

A6.2 The assumptions underlying the cost stack are as set out in Annex 5.

Table A6.1: Ancillary services – WLR Connections – Aggregate costs

	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m
Revenue	110	101	62	39
Operating Cost	41	37	22	14
EBITDA	69	64	40	26
Depreciation	3	4	4	3
EBIT	66	60	36	23
ROCE (%)	368%	305%	257%	253%
Mean Capital Employed	**18**	**20**	**14**	**9**

Table A6.2 Ancillary Services – WLR Transfers – Aggregate costs

	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m
Revenue	9	6	6	6
Operating Cost	27	20	19	18
EBITDA	-18	-14	-13	-13
Depreciation	9	9	13	14
EBIT	-27	-23	-26	-27
ROCE (%)	-54%	-50%	-51%	-54%
Mean Capital Employed	**50**	**45**	**51**	**50**

Table A6.3: Ancillary services – WLR Connections – unit costs

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	35.25	35.49	36.77	36.01
ROCE unit cost	1.09	1.74	2.01	2.08
Total unit cost	36.34	37.23	38.78	38.09

Table A6.4: Ancillary services – WLR Transfers – unit costs

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	8.06	9.05	10.80	11.67
ROCE unit cost	0.85	1.43	1.73	1.82
Total unit cost	8.91	10.48	12.53	13.49

A6.3 The current ROCEs for services vary widely. For Connections they are currently very high, remaining high throughout the period – from 366% falling to 255%. This suggests the need for a high RPI-X control.

A6.4 For rentals as discussed in Section 5 and in Annex 5, we are proposing an adjusted charge of £3 per transaction. This means an additional £5 of costs (in 2009/10) need to be will be recovered through the line rental charge. Consistent with our approach to the line rental charge, we propose to phase in subsequent increases in the charge with an RPI+X control. We propose that costs associated with the transfer would be recovered through the WLR rental charge (taking account of volumes and churn rates).

Annex 7

Service Harmonisations proposals

Introduction

A7.1 A key related development in considering the appropriate regulatory framework for WLR services is the service harmonisation initiative currently being undertaken by Openreach in conjunction with the OTA and interested Communications Providers.

A7.2 The aim of this initiative is to rationalise the existing set of 8 distinct service levels for WLR and LLU to 4 levels with (near) identical service terms for WLR and LLU – see charts below:

Existing Services

Existing service	**Key Services terms**
WLR Basic Standard Care	96 hr clear fault (Monday to Friday)
WLR Basic Prompt Care	72 hr clear fault (Monday to Saturday)
WLR Premium Standard Care	48 hr clear fault (Monday to Friday)
WLR Premium Prompt Care	48 hr clear fault (Monday to Saturday)
LLU Standard Care	40 hr clear fault (Monday to Sunday)
WLR Total Care / WLR expediate	24 hr clear fault (Monday to Sunday)
LLU enhanced care	20 hr clear fault (Monday to Sunday)
LLU enhanced care+ on demand	5 hrs clear fault (reasonable endeavour)

Service Harmonisation proposals

Level	Description	Standard Engineer Working Times
1	End of next working day + 1 working day	Monday – Friday 08:00 – 18:00
2	End of next working day	Monday – Saturday 08:00 – 18:00
3	In by 13:00 fix same day, in after 13:00 fix by 13:00 next day (incl bank holidays)	Monday – Sunday 08:00 – 18:00
4	X-Hour repair	Monday – Sunday 24/7
Bolt-ons		
Saturday	Applies to levels 1	08:00 – 18:00
Sunday	Applies to levels 1 & 2	08:00 – 18:00
On demand	Applies to levels 1, 2 & 3	Outside of above times (TRC)
Temporary increases in the service level for a line/ fault		
Just as Levels 1– 4 above will be available as rental options, a suite of multi-level expedites, or on demand temporary increases in the service levels, will be available to purchase. These will take a line from its current service level to any higher level.		

A7.3 The advantages of this approach are its simplification of the care options, parity between LLU and WLR and the free choice between prepay services (ie regular payments for guaranteed care) or on demand.

Annex 8

Legal Framework for Charge Controls

Introduction

A8.1 The present regulatory framework for electronic communications networks and services entered into force on 25 July 2003. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers. The basis for the regulatory framework is five EU Communications Directives (together "the Directives"):

- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services ("Framework Directive");
- Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities ("Access Directive");
- Directive 2002/20/EC on the authorisation of electronic communications networks and services ("Authorisation Directive");
- Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services , ("Universal Service Directive"); and
- Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector ("Privacy Directive").

This framework is currently being reviewed, but the Community legislation has yet to adopt legislative proposals.

The Communications Act 2003

A8.2 The Framework Directive, the Access Directive, the Authorisation Directive and the Universal Service Directive were implemented in the United Kingdom on 25 July 2003 via the Communications Act 2003 ("the Act"). The Privacy Directive was implemented by separate regulations which came into force on 11 December 2003.

A8.3 In particular part 2 of the Act sets out the majority of that Act's provisions that implement the Directives. Sections 32, 45-50 and 78-90 are of particular importance. Ofcom is required to act in accordance with its general and specific duties in sections 3 and 4 of the Act, respectively.

A8.4 Under section 3, Ofcom must, in carrying out its functions further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition.

A8.5 Section 3(3) requires that Ofcom has regard to the principles of transparency, accountability, proportionality, consistency, the need to target cases where action is needed and any other principle representing best regulatory practice.

A8.6 Section 3(4) lists criteria to which Ofcom must have regard where they appear relevant in the particular circumstances. The list includes:

the desirability of promoting competition in relevant markets

d) the desirability of encouraging investment and innovation in relevant markets

I, k and l) the needs, interests and opinion of consumers, members of the public, especially in vulnerable categories and recognising geographic and ethic differences.

A8.7 Section 3(5) confirms that in furthering the interests of consumers Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money. This corresponds with the policy objective in Article 8(2) of the Framework Directive.

A8.8 Section 4 of the Act requires that Ofcom acts in accordance with the six Community requirements set out at sections 4(3) to 4(9). Where it appears to Ofcom that its general duties conflict with its section 4 duties, priority must be given to the latter.

A8.9 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives including where they conflict. In doing so, Ofcom will take all relevant considerations into account, including consultation responses. Sections 4 and 5 of this document consider the application of duties relevant to our proposals in more detail.

Market Reviews

A8.10 The Directives require National Regulatory Authorities ('NRA') to carry out reviews of competition in communications markets to ensure that regulation remains appropriate and proportionate in the light of changing market conditions.

A8.11 Each market review normally has three stages, namely:

- definition of the relevant markets;
- assessment of competition in each market, in particular whether any undertakings have SMP in a given market; and
- assessment of appropriate regulatory obligations where there has been a finding of SMP.

A8.12 On 19 March 2009 Ofcom published a consultation document Review of the fixed narrowband services wholesale markets ('the Wholesale Review'), where each of those three stages has been carried out and proposals made in relation to market definition, market power assessment and appropriate remedies.

Relationship between this review and the wholesale market review

A8.13 Charge Controls are a specific remedy that Ofcom can impose upon a market once a finding of SMP has been made in that market.

A8.14 We do not propose to set out in further detail the legal framework for the market review process in this document, and will concentrate on the framework that allows the imposition of a Charge Control regime. A detailed discussion of the underlying legal framework for the market review process is set out in the Wholesale Review.

A8.15 The Wholesale Review has proposed the analogue wholesale exchange line market is a markets in which BT holds SMP.

A8.16 That market was further analysed and appropriate remedies to address the competitive concerns in it were proposed. Under the proposals, for that market, made in the Wholesale Review, BT would be required to provide an analogue WLR product and that product would be subject to a charge control in order to ensure that BT could not set prices at a an inappropriate level.

A8.17 The scope of this review is required to consider in detail the proposed remedy of a charge control for analogue WLR services and put forward proposals as to its implementation. It is therefore important to set out the framework within which consideration of a Charge Control will be considered as a specific SMP remedy.

SMP Remedies

Subject matter of the SMP remedies

A8.18 The third and final market review stage concerns remedies. Article 16 of the Framework Directive dictates the imposition or removal of SMP remedies depending upon whether or not a finding of SMP in an identified services market has been made. Where an SMP finding has been made, Ofcom will consider what appropriate SMP remedies are available. This process has been completed (to the point of consultation) in the Wholesale Review.

A8.19 Under section 45 of the Act, Ofcom is empowered generally to set SMP services conditions authorised or required by sections 87 to 92. The latter implement Articles 9 to 13 of the Access and Interconnection Directive and Articles 17 to 19 of the Universal Service Directive. In addition, Ofcom’s power to set such conditions includes additional powers specified in section 45(10), such as powers to include provisions in SMP services conditions for Ofcom to make directions in respect of specified markets.

A8.20 Specifically, section 87(9)(a) empowers Ofcom to set :

> “such price controls as Ofcom may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities”

A8.21 This allows the imposition of a Charge Control regime.

A8.22 Section 46 of the Act provides that SMP services conditions set under section 45 may only be applied if the person to whom they are to apply is a communications provider (or a person who makes associated facilities available) and is a person whom Ofcom has determined to be a person having SMP in a services market. It is therefore important to consider the precise identity of the regulated entity on whom it is appropriate to impose obligations.

Regulated entity

A8.23 As noted above, section 46 provides that a person to whom an SMP services condition is applied must be a ‘communications provider’ or a ‘person’ who makes associated facilities available and a 'person' who Ofcom has determined to have SMP in a specific market for electronic communications networks, electronic communications services or associated facilities (i.e. the 'services market').

A8.24 Article 16 of the Framework Directive requires that, where an NRA determines that a relevant market is not effectively competitive, it shall identify "undertakings" with SMP on that market and impose appropriate specific regulatory obligations. For the purposes of EC competition law, "undertaking" includes companies within the same corporate group (Viho v Commission Case C-73/95 P [1996] ECR I-5447), for example, where a company within that group is not independent in its decision making.

A8.25 Ofcom considers it appropriate to prevent a dominant provider to whom a SMP service condition is applied, which is part of a group of companies, exploiting the principle of corporate separation. The dominant provider should not use another member of its group to carry out activities or to fail to comply with a condition, which would otherwise render the dominant provider in breach of its obligations. The only dominant provider on whom Ofcom propose to set charge controls for the purpose of this review is BT.

The legal tests

A8.26 However, before Ofcom can set or modify SMP services conditions on such a regulated entity, it must be satisfied that certain legal tests have been satisfied in imposing the SMP condition in question.

A8.27 In Section 3 of this document, Ofcom sets out its reasons explaining why those tests would be satisfied based on evidence presently before Ofcom. The Wholesale Review proposed appropriate remedies in accordance with the legal tests set out below, however it remains important to apply the tests to the specific mechanics of how we propose each remedy should be applied, to ensure that they remain consistent with the requirements of the Act.

A8.28 In addition to need of satisfying the general and specific duties, the appropriateness of the remedy and identifying the nature of the competition problem mentioned above, Ofcom must satisfy a number of additional tests.

A8.29 First, under section 47(2) of the Act, Ofcom must show for each and every SMP services condition that it is:

- *objectively justifiable* in relation to the networks, services, facilities, apparatus or directories to which it relates;
- *not such as to discriminate unduly* against particular persons or against a particular description of persons;
- *proportionate* to what the condition or modification is intended to achieve; and
- in relation to what it is intended to achieve, *transparent*.

A8.30 Secondly, each of the tests set out in section 87(4) of the Act which Ofcom considers relevant must be satisfied. That section requires that Ofcom:

> "…must take into account, in particular, the following factors—

(a) the technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed network access unnecessary;

(b) the feasibility of the provision of the proposed network access;

(c) the investment made by the person initially providing or making available the network or other facility in respect of which an entitlement to network access is proposed;

(d) the need to secure effective competition in the long term;

(e) any rights to intellectual property that are relevant to the proposal; and

(f) the desirability of securing that electronic communications services are provided that are available throughout the member States."

A8.31 It is to be emphasised that this list is not exhaustive and other reasons can therefore be added by Ofcom for imposing the obligation(s) in question.

A8.32 Thirdly, in addition to the above-mentioned tests, Ofcom must also satisfy the tests set out in section 88 of the Act in relation to price controls, authorised as a remedy by section 87(9)

A8.33 Section 88 only allows Ofcom to impose such obligations where:

- it appears to Ofcom from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion (see below for the meaning of this term); and

- it also appears to Ofcom that the setting of the condition is appropriate for the purposes of promoting efficiency, promoting sustainable competition, and conferring the greatest possible benefits on the end-users of public electronic communications services. In considering these matters, Ofcom may have regard to the prices at which services are available in comparable competitive markets and may determine what they consider to represent efficiency by using such cost accounting methods as they think fit.

A8.34 There is a relevant risk of adverse affects arising from price distortion if the SMP designated undertaking might fix and maintain some or all of its prices at an excessively high level, or impose a price squeeze, so as to have adverse consequences for end-users of public electronic communications services.

A8.35 In addition, Ofcom must show that in setting the network access pricing obligation it has taken account of the extent of the SMP provider's investment in the matters to which the condition relates.

A8.36 It is to be noted that the term "price control" has not been defined in the EC Communications Directives. The 20th recital to the Access and Interconnection Directive suggests that it could cover a range of obligations concerning prices:

> "Price control may be necessary when market analysis in a particular market reveals inefficient competition. The regulatory intervention may be relatively light, such as an obligation that prices for carrier selection are reasonable as laid down in Directive 97/33/EC, or much heavier such as an obligation that prices are cost oriented to provide full justification for those prices where competition is not sufficiently strong to prevent excessive pricing. In particular, operators with significant market power should avoid a price squeeze whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services is not adequate to ensure sustainable competition. When a national regulatory authority calculates costs incurred in establishing a service mandated under this Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits."

A8.37 Article 12 of that Directive, however, expressly empowers NRAs to impose obligations on operators to meet reasonable requests for access to, and use of, specific network elements and associated facilities, inter alia in situations where the NRA considers that denial of access or unreasonable terms and conditions having a similar effect would hinder the emergence of a sustainable competitive market at the retail level, or would not be in the end-user's interest, and that NRAs may attach to those obligations conditions covering fairness, reasonableness and timeliness.

A8.38 In the light of the potential interplay between these provisions, Ofcom has addressed the section 88 test also under the requirement to provide network access on fair and reasonable terms and conditions, including charges.

ERG Common Position on Remedies

A8.39 At a plenary meeting on 18/19 May 2006, the European Regulators Group ("ERG") adopted a revised version of its document entitled 'Revised ERG Common Position on the approach to Appropriate remedies in the new regulatory framework', ERG (06) 33, (the "Common Position on Remedies").

A8.40 That document sets out NRAs' views on imposing remedies in a manner that contributes to the development of the internal market and ensures a consistent application of the new regulatory framework under the EC Communications Directives.

A8.41 Ofcom has therefore taken into account those views in considering Charge Controls as an appropriate remedy.

Annex 9

Legal Instruments

PART 1 – PROPOSED SETTING OF AND MODIFICATION TO, SMP CONDITIONS

NOTIFICATION OF PROPOSALS UNDER SECTION 48(2) OF THE COMMUNICATIONS ACT 2003

Proposals for the setting of and modification to SMP services conditions to be imposed upon BT as a result of the proposed market power determinations made by Ofcom in its Review of the fixed narrowband services wholesale markets as published on 19 March 2009.

Background

1. On 28 November 2003, the Director General of Telecommunications ("the Director") published a *Review of the fixed narrowband line, call origination, conveyance and transit markets*[27]*,* the Notification to which set SMP Service Condition AA4, imposing a charge control on (amongst other services) Wholesale Line Rental ('WLR') Services;

2. On 29 December 2003, Ofcom took over the functions and responsibilities under the Communications Act 2003 relating to the EC Communications directives from the Director.

5. On 10 February 2005, Ofcom published *Modifications to BT's SMP services conditions AA4, BA4 and PA1*[28]

6. On 24 January 2006, Ofcom published *Wholesale Line Rental : Reviewing and setting charge ceilings for WLR services*[29]. SMP Service condition AA4 was disapplied to WLR services and price ceilings were introduced.

7. On 19 March 2009, Ofcom published a consultation document entitled *Review of the fixed narrowband wholesale markets*[30] ("the Wholesale Review"). The Wholesale Review proposed, amongst other matters:

- that wholesale analogue exchange line services be defined as a market;
- that BT hold SMP in that defined market;
- that BT be subject, as an appropriate SMP service condition, to an obligation to supply a wholesale analogue WLR service; and
- that the required wholesale analogue WLR service be subject to a charge control.

8. The Wholesale Review further proposed that the method as to how that charge control should be applied, should be considered in a separate consultation.

[27] http://www.ofcom.org.uk/static/archive/Oftel/publications/eu_directives/2003/fix_narrow0803_1.pdf
[28] http://www.ofcom.org.uk/consult/condocs/bt_smp/amend_ccc/btsmp_amend_ccc.pdf
[29] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf
[30] http://www.ofcom.org.uk/consult/condocs/review_wholesale/

Proposals

9. Ofcom hereby proposes, in accordance with section 48(2) of the Communications Act 2003, to set SMP service condition AA4(A), set out in Schedule 1 to this Notification implementing charge controls be set for analogue WLR as identified and proposed by the wholesale review.

10. The effect of, and Ofcom's reasons for making, the proposals to set the SMP conditions set out in Schedule 1 to this Notification are contained in Sections 3 and 4 of the consultation document accompanying this Notification.

11. Ofcom hereby also proposes, to modify, as set out in Schedule 2 to this Notification SMP Service Condition AA3 if adopted as proposed, in the Notification to the *Review of the fixed narrowband wholesale markets* dated 19 March 2009.

12. The effect of, and Ofcom's reasons for making, the proposals to modify the proposed SMP conditions set out in Schedule 2 to this Notification are contained in Section 7 of the consultation document accompanying this Notification.

Ofcom's duties and legal tests

12. In considering whether to make the proposals set out in this Notification, Ofcom are proposing SMP conditions by reference to the proposed market power determinations made in relation to the identified services markets made in the Notification to the *Review of the fixed narrowband wholesale markets* dated 19 March 2009. Further Ofcom consider that the proposed new and modified SMP service conditions referred to in paragraphs 9 and 11 of this Notification comply with the requirements of sections 45 to 47, 87 and 88 of the 2003 Act as appropriate and relevant to each of those SMP service conditions.

13. In making all of the proposals referred to in paragraphs 9 to 12 of this Notification, Ofcom has considered and acted in accordance with its general duties set out in section 3 of the Act and the six Community requirements in section 4 of the Act.

Making representations

14. Representations may be made to Ofcom about any of the proposals set out in this Notification and the accompanying explanatory statement by no later than **14 August 2009.**
.
15. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State for Business, Enterprise and Regulatory Reform in accordance with section 50(1)(a) of the Act, as well as the European Commission and to the regulatory authorities of every other member State in accordance with section 50(3) of the Act.

Interpretation

18. Save for the purposes of paragraph 7 of this Notification and except as otherwise defined in paragraph 18 of this Notification, words or expressions used shall have the same meaning as they have been ascribed in the Act.

18. In this Notification:

(a) **"BT"** means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985 as amended by the Companies Act 1989;

(b) **"The Act"** means the Communications Act 2003 c21

(c) **"The Wholesale Review"** means the consultation document entitled **"***Review of the fixed narrowband wholesale markets; Consultation on the proposed markets, market power determinations and remedies"* and its accompanying Notification published by Ofcom on 19 March 2009.

Gareth Davies

Competition Policy Director

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

[Date]

SCHEDULE 1

[DRAFT] Setting of SMP services conditions AA4(A) as a result of the market power determination [made] by Ofcom in the [final statement Review of the fixed narrowband services wholesale markets] in respect of the services market for wholesale analogue exchange line services in the United Kingdom but excluding the Hull Area in which it has been proposed that BT is a person having significant market power.

1. In Schedule 1 to Annex 8 of the [final statement Review of the fixed narrowband services wholesale markets], there shall be set the following SMP services condition AA4(A), inserting it after Condition AA3.

“Condition AA4(A)

Charge control – Analogue Wholesale Line Rental

AA4(A).1 For the period beginning on [1 October 2009] (the “Rental Effective Date”), and ending on [31 March 2010] the Dominant Provider shall not charge more than, for the charge for Analogue Core WLR rental, the amount of [£100.68];

AA4(A).2 For the period beginning on [1 October 2009] (the “Ancillary Services Effective Date”), and ending on [31 March 2010] the Dominant Provider shall not charge more than:

a. for the WLR transfer charge, the amount of [£3.00];
b. for the WLR new connection charge, the amount of [£67.00].

AA4(A).3 Without prejudice to the generality of Condition AA3, and subject to paragraphs AA4(A).6, AA4(A).8 and AA4(A).9, the Dominant Provider shall take all reasonable steps to secure that, at the end of each Relevant Year, the Percentage Change (determined in accordance with paragraphs AA4(A).) in:

a. the charge for Analogue Core WLR rental;
b. WLR transfer charge;
c. WLR new connection charge;

in each of the three categories of products and/or services specified in paragraphs AA4(A).3 (a) to (c) above is not more than the Controlling Percentage (determined in accordance with paragraph AA4(A).4).

AA4(A).4 For the purpose of complying with paragraph AA4(A).3, the Dominant Provider shall take all reasonable steps to secure that the revenue it accrues as a result of all individual Charge Changes during any Relevant Year shall be no more than that which it would have accrued had all of those Charge Changes been made at 1 April in the Relevant Year in question. The Dominant Provider shall be deemed to have satisfied this obligation where, by example in the case of a single Charge Change in the Relevant Year in question, the following formula is satisfied:

$$RC(1 - D) \leq TRC$$

where:

RC is the revenue change associated with the single Charge Change made in the Relevant Year in question, calculated by the relevant Percentage Change immediately following the Charge Change multiplied by the revenue accrued during the Relevant Financial Year;

TRC is the target revenue change required in the Relevant Year in question to achieve compliance with paragraph AA4(A).3, calculated by the Percentage Change required in the Relevant Year in question to achieve compliance with paragraph AA4(A).3 multiplied by the revenue accrued during the Relevant Financial Year; and

D is the elapsed proportion of the Relevant Year in question, calculated as:

(i) for any Relevant Year other than the Leap Year the date on which the Charge Change takes effect, expressed as a numeric entity on a scale ranging from 1 April = 0 to 31 March = 364, divided by 365.

(ii) for the Leap Year, the date on which the Charge Control takes effect expressed as a numeric entity on a scale ranging from 1 April = 0 to 31 March = 365, divided by 366.

AA4(A).5 The Percentage Change for the purposes of each of the products and/or services specified in paragraphs AA4(A).3(a) to (c) shall be calculated for the purposes of complying with paragraph AA4(A).3 by employing the following formula:

$$C_t = \frac{(p_t - p_0)}{p_0}$$

where:

C_t is the Percentage Change in charges for the specific product and/or service in the single charge category in question at a particular time *t* during the Relevant Year;

p_0 is the published charge made by the Dominant Provider for the specific product and/or service at the beginning of the Relevant Year excluding any discounts offered by the Dominant Provider; and

p_t is the published charge made by the Dominant Provider for the specific product and/or service at the time *t* during the Relevant Year excluding any discounts offered by the Dominant Provider.

AA4(A).6 Where the Percentage Change in the Relevant Year in question is less than the Controlling Percentage (the “Excess”) then the Controlling Percentage for the following Relevant Year shall be determined in accordance with paragraph AA4(A).8, but increased by the absolute value of the Excess.

AA4(A).7 Where the Percentage Change in the Relevant Year in the Relevant Year in question is more than the Controlling Percentage (the “Deficiency”) then the Controlling Percentage for the following Relevant Year shall be determined in accordance with paragraph AA4(A).8, but decreased by the absolute value of the Deficiency.

AA4(A).8 Subject to paragraphs AA4(A).6 and AA4(A).7, the Controlling Percentage in relation to any Relevant Year in question means:

a. for Analogue Core WLR Rental:

for the First Relevant Year [RPI increased by 3 to 4 percentage points]; and

for the Second and Third Relevant Years [RPI decreased by 0 to 1 percentage points];

b. for the WLR transfer charge:

for the First Relevant Year [RPI increased by 3 to 4 percentage points]; and

for the Second and Third Relevant Years [RPI decreased by 0 to 1 percentage points];

c. for the WLR new connection charge:

the First Relevant Year [RPI decreased by 15 to 16 percentage points]; and

for the Second and Third Relevant Years [RPI decreased by 19 to 20 percentage points];

AA4(A).9 Where:

(a) the Dominant Provider makes a material change (other than to a Charge) to any Charge Controlled Service for which a Charge is charged;
(b) The Dominant Provider makes a change to the date on which its financial year ends; or
(c) there is a material change in the basis of the Retail Prices Index,

paragraphs AA4(A).1 to AA4(A).8 shall have effect subject to such reasonable adjustment to take account of the change as Ofcom may direct to be appropriate in the circumstances. For the purposes of paragraph AA4(A).9, a material change to the Charge Controlled Service includes (but is not limited to) the introduction of a new product and/or service wholly or substantially in substitution for an existing Charge Controlled Service.

AA4(A).10 The Dominant Provider shall, no later than three months after the end of each Relevant Year, supply to Ofcom, in writing, the data necessary to perform the calculation of the Percentage Change. The data shall include:

(a) pursuant to Condition AA4(A), the calculated percentage change relating to Analogue WLR Services;
(b) pursuant to Condition AA4(A).4, calculation of the revenue accrued as a result of all relevant individual charge changes during any Relevant Year compared to the target revenue change;
(c) All relevant data the Dominant Provider used in the calculation of the percentage change C_t pursuant to Conditions AA4(A).5;
(d) All relevant revenues accrued during the Relevant Financial Year in respect of Analogue WLR Services;
(e) Published charges made by the Dominant Provider at time *t* during the Relevant Year excluding any discounts offered by the Dominant Provider;
(f) The relevant published charge at the start of the Relevant Year;
(g) Other data necessary for monitoring compliance with the charge control.

AA 4(A).11 If it appears to Ofcom that the Dominant Provider is likely to fail to secure that the Percentage Change does not exceed the Controlling Percentage for the last relevant year beginning on 1 April 2012 and ending on 31 March 2013, the Dominant Provider shall make such adjustment to any of its charges for the provision of Analogue WLR Services and by such day in that Relevant Year (or if appropriate in Ofcom's opinion, by such day that falls after the end of that Relevant Year) as Ofcom may direct for the purpose of avoiding such a failure.

AA4(A).12 Paragraphs AA4(A).1 to AA4(A).10 shall not apply to such extent as Ofcom may direct.

AA4(A).13 The Dominant Provider shall comply with any direction Ofcom may make from time to time under this Condition.

AA4(A).14 In this Condition:

(a) "Analogue Core WLR Rental" means the rental of an analogue narrowband access line for control and billing purposes;
(b) "WLR transfer charge" means a charge for the transfer of control of an analogue access line;
(c) "WLR new connection charge" means a charge for the connection of a new analogue line to a premises;
(d) "Charge" means for the purposes of paragraph AA4(A).7, the charge (being in all cases the amounts offered or charged by the Dominant Provider) to a Communications Provider for the Charge Controlled Service;
(e) "Charge Change" means a change to any of the charges for the provision of Analogue WLR Services;
(f) "Charge Controlled Service" means a product or service which forms part of or is comprised in) the provision of Analogue WLR Services;
(g) "Controlling Percentage" is to be determined in accordance with paragraph AA4(A).6;
(h) "Leap Year" means the Relevant Year beginning on 1 April 2011 and ending on 31 March 2012;
(i) "Ofcom" means the Office of Communications;
(j) "Percentage Change" has the meaning given to it in paragraph AA4(A).3;
(k) "Relevant Financial Year means the period of 12 months ending on 31 March immediately preceding the Relevant Year in question;
(l) "Relevant Year means any of the three periods of 12 months beginning on 1 April starting on 1 April 2010 and ending on 31 March 2013;
(m) "Retail Prices Index" means the index of retail prices compiled by an agency or a public body on behalf of Her Majesty's Government or a governmental department (which is the Office of National Statistics at the time of publication of this Notification) from time to time in respect of all items;
(n) "RPI" means the amount of the change in the Retail Prices Index in the period of twelve months ending on [date] immediately before the beginning of a relevant year, expressed as a percentage (rounded to two decimal places) of that Retail Prices Index at the beginning of that first mentioned period;
(o) "Rental Effective Date" means [1st October 2009], which is the date on which the Dominant Provider shall be required to comply with paragraph AA4(A).1
(p) "Ancillary Services Effective Date" means [1st October 2009], which is the date on which the Dominant Provider shall be required to comply with paragraph AA4(A).2

SCHEDULE 2

[Draft] Modification to SMP condition AA3

1. SMP Condition AA3 shall be modified by inserting the following new paragraph AA3.2(a) after paragraph AA3.2 of Condition AA3 in the [Notification to the *Review of the fixed narrowband wholesale markets*] -

AA3.2(a) For the avoidance of doubt, except for the charge for WLR Core Rental, where the charge offered, payable or proposed for Network Access covered by Condition AA1(a) is for a service which is subject to the charge control under Condition AA4(A) the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirements of paragraph AA3.1 above.

PART II – PROPOSED WITHDRAWAL OF A DIRECTION

NOTIFICATION UNDER SECTIONS 49 OF THE COMMUNICATIONS ACT 2003

Proposal for withdrawing a Direction dated 24 January 2006 setting charge ceilings for Wholesale Line Rental Services under SMP services condition AA3.1, AA10.3(a)(ii) and AA10.3(f) imposed on British Telecommunications plc as a result of a market power determination made by the Director General of Telecommunications that British Telecommunications plc has significant market power in the markets for wholesale residential analogue exchange line services and wholesale business analogue exchange line services in the United Kingdom excluding the Hull Area.

Background

1. The Wholesale Line Rental Charge Ceiling Direction dated 24 January 2006 set charge ceilings for the following WLR products / services:

a. WLR rental (residential quality of service);

b. WLR rental (business quality of service);

c. WLR transfer charge (residential quality of service);

d. WLR transfer charge (business quality of service);

e. WLR new line provide (residential quality of service); and

f. WLR new line provide (business quality of service).

2. Ofcom have proposed, in Part 1 of Annex 9 to the accompanying explanatory document, to set SMP service condition AA4(A). The proposed SMP service condition AA4(A) sets new price controls in relation to rental, transfer charges and new connection for a WLR Core service, replacing the ceilings set under the Wholesale Line Rental Charge Ceiling Direction.

3. The charge ceilings set under the Wholesale Line Rental Charge Ceiling Direction require withdrawal when the equivalent product / service is controlled under SMP condition AA4(A).

4. The controls proposed in AA4(A) may not come into effect at the same time for all WLR products / services that are the subject of the proposed control. The withdrawal of the Wholesale Line Rental Charge Ceiling Direction needs to be phased to ensure that only products / services that are the subject of effective control by proposed SMP condition AA4(A) are withdrawn, and products / services which are not yet the subject of control by the SMP condition remain subject to control under the 2006 Direction Wholesale Line Rental Charge Ceiling Direction.

Proposal in this Notification

5. Ofcom hereby makes, in accordance with section 49(4) of the Act, the proposal to withdraw, on the basis described below, the Wholesale Line Rental Charge Ceiling Direction upon the precondition set out in paragraph 6 being satisfied.

6. The precondition referred to in paragraph 5 above is that Ofcom sets a new SMP Condition AA4(A) (as proposed in Part I of Annex 9 of the accompanying explanatory document) to impose a charge control in respect of the annual rental for access to Wholesale Line Rental Services and other specified services, if so, this proposed withdrawal is to take effect as described in paragraphs 7 to 9 below.

7. Ofcom proposes that the Wholesale Line Rental Charge Ceiling Direction shall be withdrawn on the Rental Effective Date (as defined for the purposes of proposed SMP service condition AA4(A) only in so far as and to the extent that it relates to:

g. WLR rental (residential quality of service); and

h. WLR rental (business quality of service);

8. Ofcom propose that the Wholesale Line Rental Charge Ceiling Direction shall be withdrawn to on the Ancillary Services Effective Date (as defined for the purposes of proposed SMP service condition AA4(A) only in so far as and to the extent that it relates to:

i. WLR transfer charge (residential quality of service);

j. WLR transfer charge (business quality of service);

k. WLR new line provide (residential quality of service); and

l. WLR new line provide (business quality of service).

9. For the avoidance of doubt, it is proposed that the entirety of the Wholesale Line Rental Charge Ceiling Direction shall be withdrawn on whichever is the later of the Rental Effective Date and the Ancillary Services Effective Date.

10. The effect of, and the reasons for making, the proposed withdrawal is set out in the accompanying explanatory statement.

Ofcom's duties

11. In making the proposal set out in this Notification, Ofcom has considered the test set out in section 49(2) of the Act and considers that it is:

a. Objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;

b. Not such as to discriminate unduly against particular persons or against a particular description of persons;

c. Proportionate to what it is intended to achieve; and

d. In relation to what it is intended to achieve, transparent

12. Ofcom also consider that, in making this proposal it has acted in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

Making representations

13. Representations may be made to Ofcom about this proposal set out in this Notification and the accompanying explanatory statement by no later than 14 August 2009

14. In accordance with section 50 of the Act, copies of this Notification have been sent to the Secretary of State, the European Commission and to the regulatory authorities of every other Member State.

Interpretation

15. Except for references made to the identified services market in this Notification and subject to paragraph 8 below, words or expressions used in this Notification shall have the same meaning as they have been ascribed in the Act.

16. In this Notification—

(a) **"Act"** means the Communications Act 2003 (c.21);

(b) **"BT"** means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985, as amended by the Companies Act 1989;

(c) **"Hull Area"** means the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc;

(d) **"Ofcom"** means the Office of Communications;

(e) **"Wholesale Line Rental Charge Ceiling Direction"** means the Direction dated 24 January 2006 as set out in Annex 1 to the Statement entitled *Wholesale Line Rental : Reviewing and setting charge ceilings for WLR services* published by Ofcom, which Direction was given to BT under SMP Services Conditions AA3.1, AA10.3(a)(ii) and AA10.3(f) imposed on BT as a result of a market power determination made by Ofcom that BT has significant market power in the markets for wholesale residential exchange line services and wholesale business exchange line services within the United Kingdom, but not including the Hull Area;

(f) **"United Kingdom"** has the meaning given to it in the Interpretation Act 1978 (c.30);

(g) "**Rental Effective Date**" means [1st October 2009], which is the date on which the Dominant Provider shall be required to comply with paragraph AA4(A).1 of the SMP service condition proposed in Part I of Annex 9 of the accompanying explanatory document; and

(h) "**Ancillary Services Effective Date**" means [1st October 2009], which is the date on which the Dominant Provider shall be required to comply with paragraph AA4(A).2 of the SMP service condition proposed in Part I of Annex 9 of the accompanying explanatory document.

17. For the purpose of interpreting this Notification—

(a) headings and titles shall be disregarded; and

(b) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.

Gareth Davies

Competition Policy Director

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 200

[Date]