A NEW PRICING FRAMEWORK FOR OPENREACH – CABLE&WIRELESS RESPONSE

Cable&Wireless

5TH MARCH 2009

EXECUTIVE SUMMARY

Cable&Wireless welcomes the opportunity to respond to Ofcom's second consultation on the pricing framework for Openreach. We welcome the fact that this consultation document contains a lot of detailed information on BT's costs. However, we think that Ofcom has over-estimated Openreach's costs and under-estimated the potential for efficiency gains.

We agree that MPF charges should be rebalanced towards fully allocated current cost on a gradual basis during the period to 2012/13. However, given that we believe Openreach's costs have been overestimated, particularly from 2011/12 onwards, the proposed glide path is too steep and the range of proposed prices for 2009/10 is too high. The rebalancing should not be accelerated.

It is too soon to predict a material shift away from WLR on to MPF-based products, since the timing and nature of 21CN product deployment is now in doubt. Since this is the main rationale for a projected increase in BT's costs, without it the major impetus for a significant increase in the MPF charge falls away. Ofcom expect demand for MPF to increase by between 10m and 14m lines by 2012/13, as against Openreach's prediction of 14m. Ofcom's "low case" is not low enough. If the low case were 6m, for example, this could increase Return On Capital Employed by as much as 2%.

The decline in the overall number of analogue lines is unlikely to be as precipitous as Ofcom and Openreach predict. Moreover, since the end of 2008 we have seen a fall in the price of copper back to a more typical level, along with a dramatic decline in the rate of inflation. All of this means that Ofcom's "low case" proposal of £85 for the 2009/10 MPF charge now looks too high. An increase in the price of MPF which greatly exceeds the rate of inflation could undermine existing LLU investments and lead to a stagnation in further growth *within* existing LLU areas.

Any price increases for 2009/10 should provide the full 90 days' notice. Given the returns on Core Rental Services that Ofcom expects BT to enjoy in the financial year 2009/10 (i.e. 10-12%), there is no urgency to impose a price increase on April 1st.

Openreach should be required to make efficiency gains of between 3 and 6% per annum of total costs, as opposed to Ofcom's proposed target of 1.2-2.4% of total costs. Openreach wages costs should rise in line with inflation, not at a rate of inflation plus 1%. Openreach projected energy costs should be revised downwards in line with recent wholesale price changes. Openreach should not be allowed to allocate costs in respect of the pension fund shortfall or the funding of the Light User Scheme.

We agree with the use of baskets for charge controls on ancillary services and we agree that important services such as Cease, Provide and Transfer should be given their own individual charge controls or "sub-caps". However, we believe Ofcom should give more consideration to the treatment of certain ancillary services which are currently unregulated and which are vital to the provision of service to our customers, and particularly business users.

QUESTION 2.1 DO YOU AGREE WITH THE STATED SCOPE OF THE REVIEW IN THE CONTEXT OF THE PROPOSED MARKET REVIEWS FOR FIXED NARROWBAND AND WHOLESALE LOCAL ACCESS? IF NOT PLEASE PROVIDE YOUR REASONS.

Given the length of time since the last reviews of LLU and WLR pricing, we agree that it is appropriate to review the pricing of these services, pending the outcome of the Narrowband and Wholesale Local Access market reviews. We agree that a charge control period of one year for WLR and two years for MPF and SMPF is appropriate.

We urge Ofcom to undertake a full assessment of MPF and SMPF ancillary services to assess which should be subject to obligation to supply and cost orientation. The basis on which the ancillary services are currently categorised is unclear and apparently arbitrary and, we believe, many currently unregulated services are essential elements of the core services which should be subject to regulation.

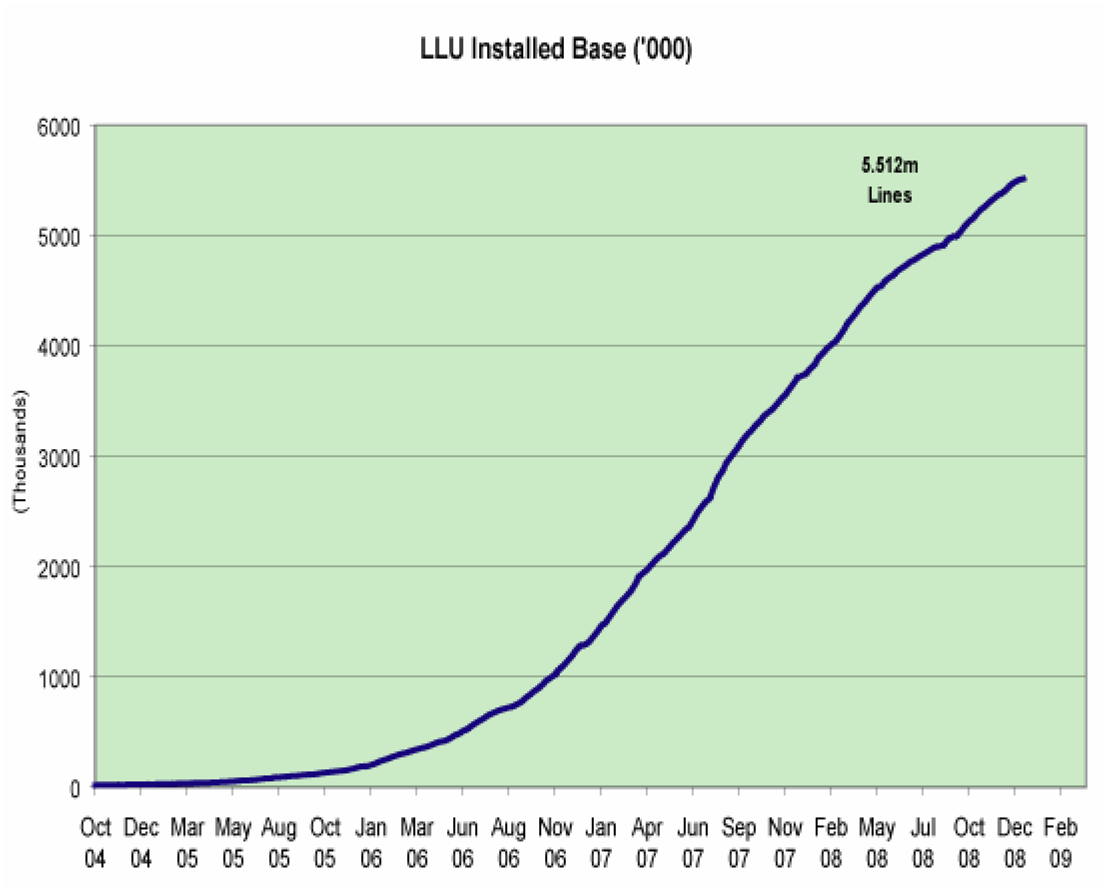
QUESTION 2.2 DO YOU AGREE WITH THE PROPOSED OBJECTIVES FOR THIS REVIEW? IF NOT PLEASE PROVIDE YOUR REASONS.

We agree with Ofcom's objectives as set out in the first consultation. Ofcom's objectives should be to continue to encourage competition at the deepest level which is effective and sustainable and to facilitate the level of competition and choice that UK consumers have come to enjoy. To achieve this, Ofcom will need to undertake a rigorous and realistic assessment of Openreach's costs and projections. If prices for LLU services are allowed to rise significantly, the UK could start to fall behind again in the worldwide broadband rankings.

QUESTION 3.1 WHAT DO YOU CONSIDER TO BE THE KEY DEVELOPMENTS IN ACCESS SERVICE COMPETITION AND HAS YOUR ASSESSMENT CHANGED SINCE THE FIRST CONSULTATION?

Two notable developments in the retail communications market since 2005 have been the market entry of major brands such as Carphone Warehouse and Sky and the emergence of bundled offers of multiple services such as telephony, broadband and television. Ofcom's policy of encouraging access competition was instrumental in enabling this market growth.

The chart below (published by OTA2) shows that competition in access services has taken off since the LLU pricing statement in 2005. Currently more than 1700 exchanges have been unbundled, 802 of which by C&W, and more than 5 million unbundled lines have been installed. The level of competition amongst LLU providers and BT has led to the de-regulation of wholesale broadband access in much of the Great Britain. Since the introduction of competition we have seen the price of retail broadband fall, and the speeds increase.



We note that businesses have not been able to benefit as much from the introduction of broadband as they should have done due to a continued lack of business-grade SLAs from Openreach and due to market pricing structures that have encouraged high contention rates which have impeded the performance of the services provided.

The growth of WLR-based services has probably had more to do with product and process improvements than with pricing.

QUESTION 3.2 HOW SHOULD WE TAKE ACCOUNT OF THESE DEVELOPMENTS AND POSSIBLE FUTURE DEVELOPMENTS WHEN DEVELOPING OUR FINAL PROPOSALS?

Ofcom should not take the success of infrastructure competition thus far as a signal to retreat from its policy of encouraging LLU competition. Those that have acted on the basis of the prevailing regulatory policy and have unbundled exchanges in so-called “LLU areas” should not be penalised by a sudden significant increase in the price of their input product.

Whilst we support Ofcom's view that the price of MPF should move towards fully allocated current costs (and thus increase relative to price of WLR) we are opposed to a rapid or expedited rebalancing of MPF charges. We believe that Ofcom should signal a gradual change by the imposition of an appropriate glide path towards FAC, including allowing 90 days' notice for the starting charge for 2009/10. Investors would then take this well signposted upward trend in the MPF charge as an indication that unbundling further exchanges in less well populated areas is unlikely to be sustainable or profitable.

QUESTION 4.1 TO WHAT EXTENT SHOULD OUR ASSESSMENT OF OPENREACH'S FINANCIAL PERFORMANCE TO DATE INFORM OUR FINAL DECISIONS FOR A NEW FINANCIAL FRAMEWORK?

Ofcom accepts that Openreach has operated profitably to date and has achieved overall rates of return which have exceeded their previously determined cost of capital. An analysis of BT's financial statements shows that profitability and ROCE have been reasonably stable since 2006.

The perceived need for an increase in the price of some of Openreach's regulated products was driven partly by rising inflation until late 2008 and partly by a predicted change in circumstances (i.e. a shift from WLR to MPF) which has now been thrown into doubt by BT's review of its 21CN programme.

In terms of Openreach's ability to make improvements to its efficiency, we believe that Ofcom has taken insufficient account of Openreach's achievements to date. It is true that some of Openreach's costs have risen in line with inflation, but so, too, have those of other communications providers. In the current competitive market, rather than pass on an increase in costs to their customers, other CPs have no choice but to find efficiency gains and other ways in which to maintain their slim margins. We believe that Openreach should therefore be expected to maintain the same pace of efficiency improvements as it has achieved thus far. We discuss this further in our response to Question 5.3 below.

The levels of ROCE on Core Rental Services that Openreach is enjoying now and expects to achieve in 2009/10 (and of course the now lower level of inflation) mean that a significant immediate price increase would be completely unjustified.

QUESTION 5.1 WITH REFERENCE TO ANNEX 11, WHAT ARE YOUR EXPECTATIONS FOR FUTURE LEVELS OF DEMAND FOR FIXED LINES AND THE MIX OF THIS DEMAND BETWEEN MPF AND WLR?

Openreach's cost calculations are based on a volume scenario that includes the following trends:

- A reduction in the aggregate demand for fixed lines, from 24.7 m in 2008/09 to 23.0 m in 2012/13.
- A shift in demand from WLR to MPF, driven by increases in internal and external demand for MPF; and
- A reduction in demand for SMPF, from 10.7 m in 2008/09 to 3.5 m in 2012/13.

Aggregate demand for fixed lines

As explained in Annex 11, Openreach has revised its assumptions since the May consultation, now predicting a steeper decline than before. Openreach now predicts that the number of analogue lines will reduce by 7% between 2008/9 and 2012/13. In the December document, Ofcom proposes instead 1% per annum, or about 3.5% over the period.

The reasons for Openreach's forecast of a more rapid decline in the number of lines are:

- An increase in mobile-only households;
- Increased competition from cable;
- Reduced demand for second lines as a result of broadband take up; and
- More recently concern has been expressed about a decline in the rate of new house builds.

There is no evidence to support a significant increase in mobile substitution. According to Ofcom's figures, the proportion of adults with only a mobile service was 11% in the first quarter of 2008, up only 1% on Q1 2006 and up only 2% on Q4 2004. There has been no significant change to the pricing or products offered by mobile service providers to suggest an increase level of substitution.

We note that the mobile market is now saturated, so we are unlikely to witness a significant increase in take up of mobile services. Moreover, the level of fixed to mobile substitution has been largely due to unfair mobile termination rates. The recent Competition Commission decision and the European Commission work on termination rates point to lower mobile termination rates in the future, giving a better balance between fixed and mobile call charges. There is therefore no reason to predict an increase in the number of mobile-only households.

Ofcom also suggest a steep reduction in the number of new house builds - these have, in recent times, counteracted the decline in lines caused by mobile substitution. Whilst the economic events of 2008 have led to a downward spike in housing development, there is no evidence to suggest that development will remain frozen over the next two to four years. For example, lower interest rates, a downward correction to house prices or a government stimulus package could provide a boost to the sector. A more long term view of housing market trends should be taken.

Much of the decline in the number of analogue lines has been due to the advent of broadband services, reducing the need for second lines. The move to broadband has largely taken place now, which will therefore slow this decline. Similarly, a switch from BT to cable service has mostly already occurred, with Virgin Media not planning any new build, although the introduction of Virgin's Superfast broadband service may encourage growth within their existing footprint.

We also believe that products such as Bonded Copper / Ethernet in the First Mile will counteract some of the decline by increasing the number of copper lines per premises amongst business users.

BT's most recent sets of results appear to indicate a continuation of the slow rate of decline that we have seen in recent years. All of the above factors may counteract the current economic downturn, so we believe Ofcom should apply an annual percentage rate based on long term trends. Ofcom should assume volumes at no more than the low end of the range set out in Table 5.4, i.e. no more than 3.5% by 2012/13.

Shift in demand from WLR to MPF and reduction in demand for SMPF

BT's predicted increase in demand for MPF and MPF-based wholesale products is based on the introduction of new products on BT's 21CN. At the present time, there is clarity on neither the geographic extent to which BT's 21CN will be installed, the timing of such deployment, nor on the features of any voice, line rental or converged broadband products which BT might develop to run on that network.

Openreach's volume estimates in Table A11.1 show a steep decline in WLR in 2010/11 and again in 2011/12 and a concomitant increase in the take up of MPF services in the same years. We believe these projections are now baseless given the current hiatus in the development of 21CN.

BT's 21CN Deployment Strategy Plan of Record, dated 15 January, 2009, stated the following:

"Strategy for Voice Products

The project to develop and launch WBCC/ WVC is currently reported as "red" in BT's reporting against the timetable outlined in this plan, following the pause in development work that we have announced. This means that the dates are unlikely to be achieved. In addition, BT is currently reviewing its voice strategy in general and this may result in changes to the strategy set out here.

WVC and WBCC were previously scheduled for launch in April 2010 and product development has now been on hold since December 2008."

There is also now doubt over the geographic extent of 21CN. There are signs that BT might not roll out 21CN beyond the so-called LLU areas. BT's "Summary of 21CN Product Plans", also dated 15 January, 2009, explains:

"The footprint for Wholesale Broadband Connect is progressively being rolled out across the country. Where end users are connected to a 21CN broadband enabled exchange, communications providers can choose to supply them with products and services based on WBC. We are working towards increasing our planned footprint to 40% by April 2009. Our current Service Availability Schedule is based on a forecast expansion of this to 60% by April 2010. This expansion is now under review, and is likely to change, in the light of demand and the current economic conditions."

We note that BT plans to begin roll-out of its Fibre to the Cabinet upgrade in January 2010, which throws more doubt upon the future of new products based on ADSL2+ technology.

Openreach assumes that a decline in the demand for SMPF would go hand in hand with a decline in demand for WLR. However, this is based on assumptions about the nature of wholesale voice and broadband (and combined) products that might be available on 21CN. Therefore, as above, we believe that these forecasts should be revised.

We also wonder whether Ofcom has taken into account the fact that the cost of SMPF might go down on 21CN, as the copper would become "virtually" shared, with no actual split, with the MSAN taking on the functions of both the DSLAM and the concentrator.

We discuss the implications of these volume predictions further in our response to Questions 5.4 and 5.5 below.

QUESTION 5.2 WITH REFERENCE TO ANNEX 12, DO YOU AGREE WITH OUR APPROACH TO ESTIMATING OPENREACH'S COST OF CAPITAL? IF NOT, PLEASE PROVIDE EVIDENCE TO SUPPORT YOUR VIEW.

We have previously argued that BT's cost of capital is lower than Ofcom estimates suggest and our views on that have not changed. There is one additional point to cover that relates specifically to the current difficult financial climate. BT and Openreach will no doubt argue that the problems in the financial markets has pushed up its cost of capital but it is important to consider the relative effect on those other Communications Providers who are purchasing Openreach inputs as part of their own solutions. These smaller competitors to BT will feel the impact of the economic environment far more severely that BT, their own ability to invest will be reduced far more than BT's. The success of LLU is based upon operator's investment any increase in prices will risk that continued success. If anything the difficult financial environment suggests the use of a lower, not higher, Openreach cost of capital.

QUESTION 5.3 WITH REFERENCE TO ANNEX 14, DO YOU AGREE WITH OUR APPROACH TO ESTIMATING OPENREACH'S ABILITY TO DELIVER FURTHER EFFICIENCY GAINS IN THE FUTURE? IF NOT, PLEASE PROVIDE EVIDENCE TO SUPPORT YOUR VIEW.

Definition of Efficiency

We agree with Ofcom's approach to the definition of efficiency, i.e. that efficiency targets should be considered on a "net" basis and in real terms, allowing for inflation.

Scope for Efficiency Gains

Openreach have estimated that about 30% of the operating costs for core rental services, 20% of cost of sales and 30% of capital expenditure are "non-compressible", i.e. cannot be targeted for future efficiency gains. Ofcom proposes to apply its efficiency targets only to Openreach's "compressible" costs. Ofcom estimates that Openreach's 1% assumed annual efficiency assumption translates into a 0.6% average efficiency target across all costs. Ofcom's proposed target of 2-4% of compressible costs therefore translates into a target of about 1.2 – 2.4% as a percentage of Openreach's total costs for core rental services.

We have analysed the MPF/WLR component unit costs from BT's regulatory financial statements since 2004/5. Over that period they have fallen by RPI – 3.4% but that figure is influenced by some significant CCA adjustments. One they are stripped out the cost has fallen by RPI – 5.7% over that period. This suggests Openreach actual efficiency gains are significantly greater than the Ofcom target. BT Group has said it expects to improve on last years efficiency improvements and we see no reason why the opposite should be the case with Openreach.

We do not agree with the principle of excluding non-compressible costs. It is at odds with the way in which all other businesses must operate and the daily cost/ benefit analyses that businesses must make. We do not believe that Openreach's so-called non-compressible costs are necessarily non-compressible. For example, to the extent that BT pays an incrementally higher network rates charge as it deploys additional infrastructure[1], it would have discretion as to whether or not to install the network and incur a higher rates bill, or not install the network and maintain a lower rates bill. This is the choice that other operators are faced with. Moreover, rates bills set by the Valuation Office are sometimes revised downwards on appeal. BT may have no direct control over their rates bill, but that does not mean they can't take steps in mitigation and one cannot assume that nothing can be done.

We believe that it is more appropriate to set the efficiency target against the total costs for core rental services, and let Openreach itself offset costs which it believes are non-compressible against gains in other areas. For example, if Openreach has entered into a long term property contract, it must decide whether a) to break the contract with the landlord and incur a penalty charge; b) to attempt to negotiate a break clause or the possibility of sub-letting with the landlord; c) to reduce costs by terminating the leases on other properties; or d) to find savings in another area altogether.

Similarly, it seems wrong to deem IT spend "non-compressible" since all businesses are faced with the choice of whether to incur spend on IT or whether to endure the opportunity cost of not doing so. It should not be possible to deem certain costs "non-compressible", since there is always an element of subjectivity and discretion to this.

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[1] As highlighted in Lord Carter's Interim Report on Digital Britain, the Valuation Office have published guidance on the application of business rates to NGA networks (FTTC and FTTH). In this they propose to value NGA residential connections on the same basis as the current cable TV assessments, i.e. on a "per home passed" basis.

Even to the extent that some costs are really non-compressible, we believe this is somewhat of a "red herring". It would be more rational for Ofcom to set an efficiency target based on total costs and let BT decide how it should make those savings. We do not believe it is appropriate for Ofcom to take a view on what is or is not compressible.

In support of its assumption that efficiency gains of 1% are reasonable, Openreach claim that there is no evidence to suggest that they are inefficient, and there is limited scope for further cost savings. C&W suggests the following possible areas for efficiency improvements:

- Streamlined fault reporting processes
- Improvements in the productivity and efficiency of field engineers, such as making sure they have the right tools, making sure they know the "drop dead" date and time and improving their training, such as broadening the scope of what individuals can do.
- Improve quality of data in customer/ end user address databases
- Pro-active fixes of high-risk cables and fibres
- Introduce IT systems to enable "zero touch" processes.
- Time Related Charges – there is a new system to validate TRCs and deliver revenue assurance, which should result in efficiency gains.

KPMG's report completed in November 2008 concluded that Openreach would need to make efficiency gains of 3.2 – 3.5% per annum from 2008 to 2013 on its operating cost base to bring this in line with that of an organisation operating in a competitive environment. We support KPMG's findings.

For example, KPMG found that Openreach's IT costs were 11.5% greater than the benchmark. Not only might savings be made on large scale MIS systems, one would expect this to be an area where there is some discretion on the part of the employer as to how much to spend per employee on workstations, mobile phones, etc..

Another area where room for improvement was found was the allocation of corporate overheads. KPMG note that BT are holding a lot of vacant exchange space, which cannot be justified over a five year period. This contrasts with Openreach's assertion that some or all of its accommodation costs are non-compressible. Perhaps BT's leases and property outsourcing contracts should be re-examined.

So taking into account BT Group targets and KPMG's analysis, we believe that Ofcom's target should be at least 3.2% pa of total operating costs and potentially as much as 6% pa, rather than their current range of 1.2 – 2.4% of total operating costs.

Fault Rates

Openreach predict that fault rates will remain static beyond 2007/8. Ofcom, on the other hand, predict that fault rates will continue to decline by between 4 and 6% per year. We agree with Ofcom's assessment.

As more CPs move from WLR2 to WLR3 and begin to use the EMP platform, we would expect that this will generate a decline in the volumes of faults recorded, as the EMP diagnostic tools will weed out erroneous fault reports, such as customer internal wiring problems, thus reducing the number of faults that are actually passed to Openreach. This has trend has already been demonstrated in statistics produced from recent usage of WLR3.

QUESTION 5.4 AND 5.5 DO YOU HAVE ANY COMMENTS ON THE ABSOLUTE LEVELS OF COSTS OR COST TRENDS PROJECTED IN SECTION 5 AND ANNEXES 9 AND 10? PLEASE PROVIDE ANY COMMENTS AND EVIDENCE YOU MAY HAVE TO INFORM OUR ASSESSMENT OF THE COST PROJECTIONS AND KEY ASSUMPTIONS SET OUT IN SECTION 5 AND IN ANNEX 10

Aggregate Volumes

As discussed above, we do not believe that the decline will be as steep as Openreach and Ofcom predict.

Change in Mix

As previously stated, a significant shift from WLR to MPF is unlikely to happen in the short to medium term and should be discounted or radically adjusted for the period of this review.

Given that these charge controls are to be for a period of two years (albeit with a glide path of four years), we believe that there is no justification for selecting a higher value of X for 2010/11 based on these potentially false assumptions.

Ofcom have set out alternative volume projections in Table 11.2. Although these are more realistic, they still show a precipitous decline in 2011/12 which, on our current understanding of the status of 21CN, is still too aggressive. It would be more appropriate to assume the same volume patterns that we have seen over the last four years and make a further assessment of the impact of 21CN in two years' time.

Alternatively, Ofcom could make further adjustments to the volume predictions to delay the impact of 21CN, thus decreasing the incline of the glide path required to achieve FAC. The problem with choosing this option is that if it becomes apparent at some point that the 21CN roll-out plans are permanently shelved or altered in some radical way, CPs may have overpaid in the short term because of a glide path based on false assumptions. In these circumstances CPs might demand retrospective repayment of MPF charges.

Ofcom might argue that any overpayment would effectively only amount to an expedited rebalancing of the MPF charges towards FAC. However, as previously stated, we are opposed to early rebalancing and would therefore urge caution on Ofcom's part.

Inflation

We note that Openreach have assumed an annual inflation rate of 3% per annum. This may now need to be revised downwards given the changing market conditions since the end of 2008.

Given our assertion that Ofcom's efficiency targets are not challenging enough, we believe that Openreach's target that pay costs should increase at RPI + 1% should be revised downwards and that pay costs should track inflation.

Cost of Copper

Since the document was published, the cost of copper has fallen dramatically and is now close to what it was five or ten years ago. Although this was not discussed in great detail in the consultation document, we would expect this to have a considerable impact on BT's asset base and cost stacks. This is important given the use of current cost accounting.

Energy Costs

Openreach predict a 50% increase in energy costs for 2009/10. Even allowing for the fact that Openreach may have bought ahead at the top of the market, this increase does not reflect our own experience. C&W also bought ahead in 2008 when prices were high, but we did not experience a 50% price increase on the previous year. Moreover, we expect our energy costs for 2010 to be considerably reduced.

We therefore agree with Ofcom that a 50% increase in energy costs is unlikely to be appropriate for 2009/10 in view of recent falls in wholesale prices.

Pension Costs

We agree with Ofcom that payments to cover the pension funding shortfall should be excluded as they do not relate to the forward looking provision of Openreach services.

Line Cards

We are surprised that Openreach is predicting that the line card unit cost will increase over the period. Openreach proposes that line card costs should be recovered on the basis of the number of services provided. This means an increase in price if the overall number of lines per exchange falls.

However, to the extent that lines remain on PSTN equipment, this is mostly mature kit which should have been written down by now. Meanwhile any move on to 21CN equipment should signal a reduction in costs due to the use of "combi-cards" which split the cost between voice and data. Moreover, the number of ports per line card has been increasing in recent years, so that the cost per port has been decreasing.

Light User Scheme

We do not believe that cost should be allocated to Openreach in respect of the Light User Scheme. Any cost, whether in lower retail rates or in administering the system, belongs in BT Retail. And we note that it has long been held that the cost of the universal service obligation is compensated for by the benefits and kudos of being the incumbent operator.

Line Length Adjustment

When Ofcom originally set the MPF charge they excluded 16% of D side copper costs, based on assumptions about the average length of a line used for DSL services. Using a different methodology, Openreach have now calculated that the average cost of an MPF line is 6% less than an average WLR residential line. This compares with a WLR business line which costs 8% less than a WLR residential line.

In our analysis of BT's 2007/8 regulatory financial statements we have found that Residential WLR includes £62.58 of D and E side copper whereas MPF includes £61.18 which is only 2.2% less. It appears that the costs included in those statements do not include the 6% reduction and therefore Ofcom should ensure that the figures it uses in setting the final charge control do apply the line length adjustment correctly.

QUESTION 6.1 DO YOU AGREE WITH OUR ASSESSMENT THAT ON BALANCE IT IS APPROPRIATE TO REBALANCE THE MPF CHARGES TOWARDS CCA FAC? IF NOT PLEASE SET OUT YOUR OWN VIEWS ON THE MOST APPROPRIATE APPROACH.

We believe that there is a case for rebalancing MPF charges towards fully allocated current cost over the four year period. Whilst it remains important for Ofcom to encourage competition at the deepest level that is efficient and sustainable, it is appropriate that this policy can be finessed by signalling a gradual increase in price to discourage further investments in those exchanges that are unlikely to prove profitable on a long term basis.

However, we believe that Openreach have overestimated the future cost of MPF (for the reasons explained above) and that the unit cost in 2012/13 would be at the low end of (if not lower than) the range projected by Ofcom in this consultation. We therefore do not believe that the annual price increase needs to be as significant as currently proposed by Ofcom.

QUESTION 6.2 DO YOU AGREE WITH OUR ASSESSMENT THAT A GLIDE PATH OFFERS THE BEST APPROACH TO THE INTRODUCTION OF ANY NEW CHARGES, SUBJECT TO AN ASSESSMENT OF STARTING POINTS AND THE RETURNS IN A GIVEN YEAR? IF NOT PLEASE SET OUT YOUR OWN VIEWS ON THE MOST APPROPRIATE APPROACH.

We do agree that a glide path is the best approach. In the case of MPF and Residential WLR, however, we think that more consideration should be given to a glide path with a *varying* real annual percentage price change. As described above, if the glide path is set too steep, there is a danger that CPs will over pay during the period. The steepest cost increases are projected to occur in 2011/12 and 2012/13 andthe timing of these cost increases is greatly dependent on 21CN roll out and products and is therefore subject to change and delay. It would be inappropriate to allow Openreach to over recover in 2009/10 unless one could be sure that the projected cost increases would indeed materialise within the charge control period.

Date of Introduction of New Charges

Ofcom are currently proposing that new charges for 2009/10 should be introduced on 1st April 2009. Such an immediate increase in the price of MPF, in particular, would harm those CPs who have invested in LLU for the following reasons.

CPs need to wait until the new charges are announced before completing internal analysis as to whether and how to pass on any increases to its customers (for example whether in headline monthly charges or in usage charges). These decisions cannot be made until the exact quantum of any charge change is known. Internal and Executive approval will then need to be obtained.

Some CPs will need to go through a notification process with their resellers which may require them to give those wholesale customers 30 days' notice or more, so that they, in turn, can pass on price increases to customers if they choose to do so.

End user notifications (whether by LLU operators or by their wholesale customers) may need to coincide with a bill run, so they may need to wait up to a month before being able to notify their customers. The whole process of notifying end users via their reseller providers could therefore take up to 60 days.

In 2007, following its review of mobile termination charges in 2007, Ofcom introduced price reductions in the first year of the charge control period. However, the reductions that were required to be introduced in that first year were adjusted to enable the normal notification period to be used. We believe that the same principle should be applied to any initial charge increases introduced following this review. Should Ofcom choose to impose any higher initial charges, we would request the full 90 day notice period for this.

We discuss this further in the confidential annex attached.

QUESTION 7.1 DO YOU AGREE WITH THE PROPOSED BASKET TREATMENT OF THE NON CORE RENTAL SERVICES SUBJECT TO COST ORIENTATION? DO YOU AGREE WITH THE PRINCIPLES FOR BASKET CONSTRUCTION SET OUT? IF NOT PLEASE SET OUT YOUR PREFERRED APPROACH AND WHY.

We agree that many of the non-core services can be dealt with in a basket of services. We agree it makes sense to organise the baskets on a per-product basis.

QUESTION 7.2 DO YOU HAVE ANY COMMENTS ON OUR PROPOSED SET OF LLU CHARGES SUBJECT TO SPECIFIC OR BASKET CHARGE CONTROLS?

Ideally we would like to see the most important non-core services left out of the basket so that they could be given their own specific charge controls. However, we believe that the application of individual sub-caps to MPF Transfer, New Provide and Cease, and SMPF Transfer and Cease, goes much of the way to offer protection to CPs who purchase those services in high volumes. It is vital that these services are given their own individual charge caps.

Ofcom are proposing that the value of X for ancillary services is between -0.5 and +2.5. We do have some concerns about some of the individual ancillary services. We would ideally like a specific charge cap to be applied to **MPF mass migration** (normal hours) and **SMPF bulk migration** (normal hours). However, we note that this charge would always have to be provided at a discount to the singleton migration charge, which itself is capped. We also note that Openreach may be expected to offer bespoke prices for mass migrations based on a large number of transfers per exchange, according to economies of scale and the principle of cost orientation.

Regarding the “inertia” cap, which has been introduced to prevent BT “gaming” charges within the basket according to volumes and its own retail purchasing patterns, we have expressed some doubt about the need for a “floor” in that cap. However, we note Openreach’s charges for basket services will always be subject to cost orientation in the first instance.

QUESTION 7.3 DO YOU AGREE WITH THE STATEMENTS ON COST ORIENTATION AND THE PROPOSED BASKETS FOR THE SERVICES SET IN ANNEX 7? IS THE LIST COMPREHENSIVE?

We are disappointed that there is no obligation to supply regarding the provision of out of hours bulk and mass migrations. We are particularly concerned that Openreach might refuse to supply these services (we have already encountered this problem with respect to migrations from Datastream to our own LLU platform), which would be of great detriment to our business end-users and those of our customers. However, we will continue to pursue commercial negotiations regarding the supply of these services and will consult Ofcom should any disputes arise.

We note that most of the ancillary services which are <u>not</u> currently subject to regulation (such as out of hours work and enhanced care) are those on which enterprise customers rely. Many of these services are essential for business customers (rather than “nice to have”) and CPs are not able to purchase them from anyone other than Openreach. As MPF will be an input to the new Ethernet in the First Mile product for business users, a business-grade service wrap will become increasingly important.

Services which we would like to see subject to an obligation to supply and/or cost-orientation are:

- SMPF Bulk Migration, out of hours - £30.39
- MPF Mass Migration, out of hours - £32.54
- MPF Tie Pair Modification (next working day re-termination) - £44.74
- Standalone shift of NTP - £95.55
- Additional Network Termination Points - £72.58
- MPF Enhanced Care per annum - £37.54
- Enhanced Care Plus on demand - £164.50
- EvoTam connection for 32 pair (SMPF) - £166.55
- EvoTam connection for 64 pair (SMPF) - £333.11
- Medium Capacity Unit 1 - £3,324.99
- Medium Capacity Unit 2 - £4,059.54
- B-BUSS 3 - £6,305.11
- B-BUSS 7 - £7,465.04
- Escorted MDF Site access, outside normal hours, planned - £51.36
- Contract conversion from RANF to Access Locate, administration charge - £220
- Access Locate Plus

QUESTION 7.4 OTHER THAN THE CORE RENTAL SERVICES AND THE MPF AND SMPF SERVICES IDENTIFIED FOR A SUB-BASKET CAP DO YOU BELIEVE THERE ARE OTHER CHARGES WHICH REQUIRE SPECIFIC ATTENTION?

Please refer to our answer to 7.3 above.

QUESTION 8.1 PLEASE SET OUT YOUR VIEWS ON THE PROPOSALS SET OUT IN SECTION 8, 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.

We agree that the MPF price should be allowed to increase towards the 2012/13 FAC. However, for the reasons outlined above, we believe that Openreach have over-estimated their projected costs and that their actual costs are going to be at the very low end of Ofcom's suggested range. In any event, we do not believe there is any merit in rebalancing "sooner rather than later".

Secondly, we are against an immediate price increase on April 1st as it does not provide CPs with enough notice to pass some or all of the increase on to retail and wholesale customers. We do not object to a price increase at some point in 2009/10 but we expect Openreach to provide the usual and necessary 90 days' notice of any price change. We have elaborated on this point in the Confidential Annex.

Thirdly, we believe that Ofcom should consider a glide path with a variable rate of price increase for MPF which would minimise the increases in 2009/10 and 2010/11 and avoid over-recovery by Openreach in the face of an uncertain product and network roadmap in 2011/12 onwards.

Given the rate of return Openreach is currently enjoying, the fall in the cost of copper, the very low rate of inflation, and the change in the plans for 21CN products and deployment, we do not believe that a price increase of more than £1 or £2 for 2009/10 can be justified for MPF.

For similar reasons, we believe that the percentage rate of change for WLR could be variable, so that prices more closely reflect cost and so that Openreach does not over recover in 2009/10. If the glide path to FAC means that the price of WLR will eventually rise to more than the current rate, then we agree with Ofcom that it would be inappropriate for residential WLR prices to fall below the current charge of £100.68 in 2009/10. If the impact of cheaper copper and low inflation rates means that the price is not set to rise at all or by much, then Ofcom should consider a lower starting charge for 2009/10.

QUESTION 8.2 DO YOU AGREE WITH OUR ASSESSMENT THAT THE PROPOSED CHANGES TO CONDITIONS AND DIRECTIONS MEET THE TESTS SET OUT UNDER THE ACT?

As Ofcom's proposals currently stand, the proposed charge for MPF and the proposed glide path is too high. The interests of consumers would not be furthered if service providers were forced to impose a price increase that was out of line with inflation rates and economic conditions generally. However, we agree that some charge control is necessary in order to promote efficient competition.

We do not think that the level of charges currently proposed would satisfy the Section 47 tests. Given that we believe that Ofcom's cost assumptions are too high and its efficiency targets too low, we believe this would lead to over recovery by BT. This would therefore discriminate in favour of BT and would also likely fail the requirement for proportionality.

March, 2009