**CWU/Connect Response to Ofcom on A New Pricing Framework for Openreach – Second Consultation**

This response has been jointly drafted by the Communication Workers Union and Connect who, between them, represent more than 90,000 members working at all levels across the UK telecommunications industry in more than thirty separate companies.

The CWU and Connect submitted a joint response to the First Consultation on a new pricing framework for Openreach, and the views expressed in that response continue to hold relevance for this second stage. For that reason, we reiterate below some of the key themes we raised last time, before moving on to address some of the issues specific to this Second Consultation.

The CWU and Connect support the introduction of a pricing framework for Openreach that both enables Openreach fully to recover its costs, and incentivises Openreach to make sufficient investment in its network to ensure an economically sustainable Openreach and a healthy and competitive UK communications market.

We favour a framework that will encourage both continuing service improvement around existing services, as well as innovation and timely and efficient investment in new infrastructure deployments such as NGA. This will serve to benefit consumers and citizens in the longer term, with NGA acting as a key driver of economic growth and social cohesion.

Consequently, we believe that a key area of focus for Ofcom in establishing an appropriate pricing framework should be in setting the right investment incentives for copper and future access networks. If Ofcom does not enable Openreach to make an appropriate return on capital, the incentive to improve existing services and to invest in future access networks and technologies will disappear, presenting a serious threat to BT Group's current plans for much needed investment in NGA. Such a platform is increasingly seen as critical to the UK's future economic competitiveness due to its

ability to boost productivity and commercial activity through faster broadband connections for businesses and residential consumers.
To incentivise investment both for today and for the future, we believe that the return on capital needs to reflect the higher risk factors, in the absence of compelling evidence to the contrary, and the recent movements in the financial markets as well as the availability of credit and its price.

In establishing a framework that guarantees Openreach a fair and proportionate return on investment, it is also important to maintain the principle of equality of access for all (encompassing BT Retail and all CPs), whilst setting the pricing structure to enable any other CP to compete effectively on equivalent terms.

Ofcom's Second Consultation sets out a detailed range of proposals for modified price controls, to which CWU and Connect are not in a position to respond with the same level of technical expertise and insight that might be provided by communications service providers or network operators. However, as regular respondents to many of Ofcom's strategic consultations who together represent the interests of a large proportion of the communications workforce, we have a unique perspective on the broad issues arising from this consultation, and on the impact of some of Ofcom's key conclusions on Openreach and the wider communications industry.

With that in mind, our response centres on three issues that the CWU and Connect believe are of particular importance in setting a new pricing framework for Openreach, as follows:

**1.** Setting realistic targets for cost efficiencies, which take sufficient account of the implications for workforce headcount, skills and training and therefore quality of service in their calculation.
**2.** Reflecting Openreach's full operating costs in the charge controls, including its pensions deficit.
**3.** Creating stability in the charge control to provide Openreach with the regulatory certainty it needs to justify the investment necessary to improve current networks and build Next Generation Access networks.

We have set out our views on these issues with specific reference to questions relating to Openreach's costs and revenues, price controls and cost efficiencies which are found in sections 5 and 8 of the consultation document.

**Response in relation to Section 5 – Review of the Financial Evidence**

**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.**

In broad terms, we question the conclusions made by Ofcom in its first and second consultation documents on Openreach Pricing, which are based on projected efficiencies to be made by Openreach, and are not in our view based on a sound analysis of Openreach's running costs and its previous record in achieving efficiencies. We believe that greater awareness is required of the actual and potential risks to the effective and sustainable operation of the business. Careful consideration is required of sustainable, forward-looking efficiency targets which are not based solely on evidence of the levels that have historically been achieved; this will continue to facilitate a thriving market in the UK and enable customers of Openreach to make investment decisions based on a real understanding of their underlying costs.

The assumptions drawn of potential efficiencies of 2-4% per annum appear to be largely based on Ofcom's analysis that BT has achieved at least these levels of efficiency in the past. However, as Ofcom itself acknowledges, there are limitations to the relevance of historical cost trends as a basis for future projections. Openreach functions are not new and Openreach's assumptions as to efficiencies on controllable costs indicates it has already moved down the productivity curve significantly, leaving little potential for significant efficiencies. As detailed in the consultation document, Openreach argues that the cost savings delivered to date are linked to capital expenditure to improve systems and diagnostic capabilities, and on reducing costs such as overtime payments, and the scope for further reductions in these areas is limited.

There is a clear danger that, if compelled to make efficiencies beyond what Openreach calculates to be achievable, savings will be made through cuts in workforce training, terms and conditions, and employee numbers, which will severely impact on Openreach's ability to operate effectively. The outcome of this will be felt right across the communications industry, with pressures on quality of service affecting other communications providers, consumers and the performance of the digital economy as a whole.

This concern is shared by Openreach and highlighted by Ofcom, when Ofcom states that Openreach argued in its response to the First Consultation that '…a 4% efficiency target would necessitate significant reductions in headcount, which would make it difficult to maintain current service levels'. This would seem to be a crucial point, the implications of which we believe Ofcom has not seriously enough taken into account in its final conclusions on setting appropriate efficiency expectations.

On the issue of pay and terms and conditions, Collette Bowe recently expressed the importance of appropriate rewards in attracting and retaining committed, talented people and maintaining quality standards. She did so in the context of her own remuneration package after it was criticised by MPs, insisting that Ofcom needs to pay high salaries to ensure it attracts the highest calibre recruits. In the same way, BT needs to be able to offer a competitive rate of pay and conditions if it is to attract and retain committed, well-trained employees who can deliver excellent standards of service.

Ofcom's reasons for considering that Openreach is not yet operating at a fully efficient level owe much to advice and evidence provided by KPMG in its BT Openreach Efficiency Review, in which KPMG has identified operating costs and benchmarked them against industry comparators. However, the exclusion of much of the benchmarked data in the published report due to commercial confidentiality prevents readers from assessing the appropriateness of the comparators. For example, on the issue of pay, the KPMG report states that the largest category of staff costs is 4% less efficient than the benchmark, but the absence of detailed evidence to support this claim makes it difficult for readers to agree on the value of the benchmarks and leaves the science of the exercise open to question.

The fact that Openreach staff perform roles that are very different from employees in any other organisation, due to the special nature of Openreach's activities, would suggest that it is difficult to find accurate pay comparisons for Openreach that do justice to the skills and expertise required of Openreach staff. The approach that KPMG has taken in comparing costs could, therefore, be seen to be somewhat arbitrary, as it is not clear whether appropriate comparators have been used.

We would also remind Ofcom that the KPMG research is not necessarily authoritative and that it needs to keep in view the contestability of the KPMG findings: different views as to the level of efficiency at which Openreach operates are possible and, indeed, were reached by NERA Economic Consulting in its March 2008 research report on *The Comparative Efficiency of Openreach*, commissioned by Ofcom and published as part of the Leased Lines Charge Controls consultation. This pointed to Openreach being 'somewhat more efficient than the upper decile of US LECs', a conclusion which the authors believe is supported by a separate analysis of the efficiency of BT's network costs as being 'consistently on or marginally better than the upper decile' of the LECs' network costs.

Asking Openreach to achieve the significant efficiencies that Ofcom is proposing – when, according to NERA Economic Consulting, it is already operating at comparatively high levels of efficiency as regards specifically the communications industry on an international basis – may well jeopardise the security of the business and its prospects of delivering the investment that is required to facilitate networks capable of supporting the high-speed broadband services we all want to see.

Based on the above evidence, the CWU and Connect conclude that it appears unrealistic to expect Openreach to achieve anything approaching 4% efficiencies year on year. Furthermore, to assume this level of efficiency when establishing the pricing framework would be to place undue pressure on Openreach and risk a serious erosion of service quality and customer satisfaction.

Ofcom's conclusion that there is scope for further reductions in fault rates of between 4% and 6% per annum in addition to the main efficiency target is also of concern to the CWU and Connect with regard to the impact it will have on operational business as usual and quality of service. The removal of 4%-6% of faults year on year represents a significant amount of work which will draw resources away from other parts of the business and undermine their capacity to operate effectively.

Finally, we note that in providing assessment of its own budget, Ofcom's Draft Annual Plan 2009/10 (para. 7.2) refers to itself as an 'established organisation with more stable budget requirements' following several years of major efficiency-enhancing initiatives, meaning that 'the scope for further budgetary reductions may be more limited in the coming years.' We would ask that a similarly realistic assessment of running costs and further efficiency savings be made in relation to Openreach pricing.

**Question 5.5 – 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.**

The CWU and Connect are concerned about the implications for Openreach and ultimately the wider industry of Ofcom's assessment that regulated charges should not include any amount in relation to the cost of funding the pension deficit.

The pension deficit is a liability that Openreach inherited when it was established at the end of 2005, and at £94m a year it is a significant sum that Openreach is responsible for funding. We therefore believe that it would be inappropriate to discount pension costs when determining the new pricing framework.

Ofcom gives little justification for discounting the pension costs in its formulation of regulatory charges, stating simply that these costs do not relate to the forward-looking provision of Openreach costs and services. This appears to be based on the fact that the liability has arisen in relation to employees who no longer work for BT, or those employees whose pension liability is in relation to past service. Regardless of how these costs were brought about, their funding is clearly an ongoing concern in the same way that the price control is forward-looking and, in that sense, these two considerations are inextricably linked and need to take account of one another.

To disregard the pensions liability is effectively to ignore a significant cost that is a real concern to Openreach and, if it is not factored in to Openreach's pricing framework, the question of how will it be paid for presents a significant problem. It is unlikely that the pension costs would be met elsewhere in BT, so the most probable course of action would be for BT to revisit the existing terms and conditions of its staff to find the necessary funds. This is at a time when Openreach staff are already under pressure to meet stringent targets and work unsociable hours as a result of a renewed drive for cost efficiencies and increased customer satisfaction. The improvements in service quality that are demanded by BT, and demanded of Openreach by its customers and ultimately by consumers, will not be achieved if Openreach is put in a position where it has no choice but to undermine the terms and conditions of its staff.

We note that Ofcom's own financial framework, as set out in its annual report for 2007-08, takes into account its pension liabilities inherited from the legacy regulators (including a previous regulator outside of the telecommunications sector). Ofcom's rejection of Openreach's inherited pension liabilities is inconsistent with the logic it applies to its own interests as regards its own pension liabilities.

Additionally in this section, we note that paragraph A10.53 states that 'Openreach have not made a clear case for continued significant investment in systems and processes.' We believe that a substantial element of Openreach's need for this continued significant investment is driven by remaining Undertakings requirements. We refer in particular to the 'physical separation' requirement. The associated costs are far from insignificant and the major goals have already been achieved. In our view the remaining activity behind the Undertakings has marginal benefit and is disproportionate to the costs. We believe there can be substantial rewards for the sector if the BT Design element of Openreach's cost base is refocused on driving the introduction of 21CN and NGA with all its associated benefits to the UK economy and society.

**Response in relation to Section 8 – Proposals**

**Question 8.1 Please set out your views on the proposals set out in Section 8, together with the potential implications of those proposals for CPs and for consumers, and the factors you consider we should take into account when determining the final pricing regime.**

Ofcom states that its proposals have been structured to deliver the lowest possible charges to competitors for wholesale services while ensuring that BT is able to recover costs, including a reasonable return on investment. However, in our view Ofcom's price control proposals do not go far enough to encourage BT to commit to the level of next generation network infrastructure investment that the communications industry and the wider economy requires. This view is shared by market analysts, including Tim Johnson of Point Topic who comments in January's edition of Total Telecom magazine that "Being a bit more generous to Openreach would make a lot of difference" (to its ability to invest in next generation access networks).

As stated in our response to the First Consultation, our belief is that the appropriate duration for a revised framework should be fixed for at least four years for the provision of regulatory certainty. We therefore have concerns with Ofcom's preferred approach that existing charges should be adjusted by way of a glide path which aims to allow charges for each of the Core Rental Services to move into line with fully allocated current costs within four years.

Ofcom argues that the glide path option furthers the objective of providing regulatory certainty for both Openreach, its customers and ultimately consumers. However, there is a danger that, without a fixed formula over a four year period, there will not be sufficient regulatory certainty to encourage the necessary investment from Openreach in meeting the UK's network infrastructure needs.

Ofcom also states that its price control proposals will incentivise BT to continue to seek efficiency gains and to benefit from efficiencies in excess of that anticipated in the review. This brings us back to the assumptions Ofcom makes about Openreach's potential for creating efficiencies and we reiterate that, in our view, the scope for making further efficiencies is extremely limited without ultimately impacting on service levels.

**Summary**

- We support the introduction of a pricing framework for Openreach that both enables Openreach to recover its costs in full and incentivises Openreach to make sufficient investment in its network to ensure an economically sustainable Openreach and a healthy and competitive UK communications market.

- It is unrealistic to expect Openreach to achieve 4% efficiency year on year. In our view, Openreach has already moved down the productivity curve significantly, leaving little potential for further efficiencies. To assume close to 4% efficiency when establishing the pricing framework would be to place undue pressure on Openreach, leading to the erosion of terms and conditions for staff and negative consequences for quality of service.

- It would be inappropriate to discount pension costs when determining the new pricing framework. To disregard the pensions liability would be to ignore a significant cost that is a real concern to Openreach. The need to seek funding elsewhere to meet these costs would have implications for the terms and conditions of staff, again impacting on service levels.

- Without a fixed price control formula over a four year period, there is a danger that there will not be sufficient regulatory certainty to encourage the necessary investment from Openreach in meeting the UK's network infrastructure needs.

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