NON-CONFIDENTIAL
VERSION OF OPENREACH RESPONSE
OF 6 MARCH 2009

A New Pricing Framework
for Openreach

Openreach Response to the
Ofcom Second Consultation of 5 December 2008

6 March 2009

Note: Certain confidential business secrets of Openreach have been redacted from this document.

Executive Summary

1. The macro-economic environment has worsened considerably since Ofcom initiated the New Pricing Framework Review. In parallel, Government is consulting on major infrastructure related programmes of investment. There is a recognition that even – or particularly – in an economic recession, investment in communications infrastructure holds the key to the future economic success of the UK.

2. Meanwhile, the market continues to move apace. Since our response to the First Consultation,[1] the number of unbundled lines has increased from 4.87m to 5.67m today.[2] In the three years since the creation of Openreach, the UK has developed into one of the most diverse and competitive communications markets in the world with among the lowest prices and widest choice of provider.

3. Openreach's current copper and other wholesale prices are among the lowest in Europe. The substantial and consistent improvements in quality and service delivery by Openreach have equally gone from strength to strength.[3] Yet the current charge ceilings for the copper access portfolio remain static - some set as early as 2004 and without an inflationary uplift during this time. At the same time, demand for copper access services is declining dramatically.

4. Openreach's position since the First Consultation is therefore unchanged, and if anything, more urgent. Openreach requests that Ofcom takes this opportunity to ensure the sustainable supply of Openreach's regulated services in order to enable the ongoing investment in the access capability – both this generation and next generation, which are inextricably linked – that underpins the successful competitive service model so integral to the UK communications market.

5. Openreach considers that Ofcom must deliver to the principles and objectives set out in the First and Second Consultations[4] and expect the outcome of this consultation to meet these objectives. In order that the outcomes meet the objectives, we believe that the following actions must be taken by Ofcom:

    a) Ofcom must deliver the right determination of appropriate price levels within a transparent regulatory framework. Openreach had expected, in line with

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1 Ofcom, "A New Pricing Framework for Openreach", 30 May 2008 ("the First Consultation")

2 LLU Installed Base. Source: Office of Telecommunications Adjudicator (OTA), Key Performance Indicators and Openreach internal information

3 Refer Office of the Telecommunications Adjudicator, Key Performance Indicators, <http://www.offta.org.uk/charts.htm>.

4 Ofcom, "A New Pricing Framework for Openreach – Second Consultation", 5 December 2008 ("the Second Consultation")

Ofcom's earlier position, that this would include a 4 year framework. Instead, Ofcom have indicated a 1 year position for WLR Rental and a 2 year control for LLU related services. Openreach believes that Ofcom's analytical framework over 4 years with intermittent reviews is therefore no longer relevant (and is itself flawed, as even by Ofcom's own view of Openreach's costs, the framework did not clearly move to full cost recovery on MPF or WLR Residential). To be consistent with its revised approach, Ofcom must enable full cost recovery on the Core Rental Services throughout the period of the proposed charge controls (of 1 and 2 years).

b) As Ofcom has recognised, the current regime has led to substantial under recovery of costs across a wide range of Openreach's critical copper-based product set. This is particularly extreme in the case of MPF. This under recovery has in turn resulted in price differentials between Openreach's key products which have produced a distorting arbitrage between MPF and WLR+SMPF which is unsustainable. This is an issue which must be addressed now. Failure to do so will have serious consequences – there will be no incentive to invest in either current or new services and products and a significant degradation of customer service affecting not only Openreach's customers, but also consumers and businesses across the UK.

c) Ofcom's proposals currently preclude the recovery of a reasonable proportion of the costs associated with the pensions deficit through regulated charges. Ofcom's approach is inconsistent with that of other regulators, and regulatory precedent exists in other industries for these costs to be recovered in this manner. Ofcom needs to include the costs of these payments in the regulated cost stacks, as there is no reasonable justification for their exclusion.

d) Ofcom must associate appropriate costs with appropriate products. Ofcom's proposals currently imply a level of cost redistribution to non-regulated products that is not supportable or justified. We agree that all products should have appropriate associated costs attributed to them – the maximum appropriate reallocation is £46m, and not up to £98m as proposed by Ofcom.

e) Ofcom must set an achievable rate of efficiency. Openreach's recent financial results illustrated that we continue to strive for cost savings and efficiencies, and in this time of economic crisis, we will bring forward similar programmes of work to drive more efficiencies which, in the short-term, are in the order of the ranges proposed by Ofcom. We expect to deliver to the 4% range in 2009/10. The scope for efficiency and Openreach's ability to realise efficiencies will diminish over time - Ofcom's proposed target of 4% year-on-year is not economically sustainable or replicable, even for the short 1 to 2 year charge control now proposed.

f) Ofcom must set the right Weighted Average Cost of Capital ("WACC") for Openreach's copper portfolio. A central part of appropriate regulation is the setting of the right WACC which can be recovered by Openreach for its regulated copper products (and indeed the WACC for certain other BT investments). Currently, Openreach's WACC is set too low. Moreover, consideration of current and foreseen unstable conditions in the financial markets suggest a need to be cautious in setting the WACC at a high enough level which enables ongoing investment in the regulated asset base. Accordingly, Openreach's cost of capital for regulated copper access portfolio should be set at 12.1% or more.

g) In terms of Ancillary Services, we do not consider that Ofcom's proposals meet the stated objectives of being easy to understand and straightforward to implement. Openreach believes that Ofcom's proposals will restrain any rebalancing of prices and institutionalise business models built on uneconomic charges. Openreach's preferred alternative approach is for a single larger basket incorporating all non-Core Rental Services[5] (i.e. all Ancillary Services relating to MPF, SMPF and WLR), without any sub-caps or individual constraints, and a separate Co-Mingling basket.

h) On the basis of these factors, Openreach requires modest increases to the charge ceilings for the Core Rental Services, to ensure that on a product-by-product basis charges align with costs,namely:

+ £1.73 per month for MPF rental; and

+ £1.04 per month for WLR Residential rental.

6. There is substantial justification for this immediate increase in the charge ceiling of MPF and WLR Residential rentals, such that they earn an appropriate regulated return, with an appropriate charge control framework thereafter:

a) an immediate adjustment in price ceilings is appropriate and proportionate partly due to the projected shift towards MPF, while still retaining a significant and justified price differential between MPF and WLR+SMPF;

b) to delay the increase (no immediate adjustment) would mean prolonging the current damaging under-recovery of costs and would limit our willingness and ability to invest;

c) the immediate adjustment is critical to ensure short and long term sustainability of the regulatory regime in the UK through the viability of Openreach. Without this, there can be no justification for further investment or development to enhance the MPF product family;

5 "Core Rental Services" as defined in the Second Consultation

d) despite huge value being driven out of the market at a retail level, evidence suggests that this increment still enables sustainable returns at a retail level;

e) the measures suggested above are appropriate considering the decision by Ofcom to set a 2 year period (for LLU) or 1 year (for WLR) for these charge controls. Regardless of Ofcom setting out a view as to what may or may not happen subsequently, the obligation on Ofcom should be to ensure a full return throughout the control period and, we believe, to do so as swiftly as possible; and

f) speed is particularly key as some Communications Providers ("CPs") are currently considering making investments. Enabling such new investments to go forward without correcting the inconsistency in the market would put Ofcom in a position where it is knowingly encouraging inefficient investment.

7. Our conclusions are therefore largely the same as set out in the response to the First Consultation: Ofcom must come to the right conclusion and discharge its statutory duties appropriately. Without such decisive action, the effect will be one of regulatory "hold up" as doubt and distrust in the UK regulatory regime grows and affects all areas of investment in current and future network technology. With the right outcome, however, Openreach can continue to underpin the UK communications industry in a financially sustainable manner, taking into account the ongoing costs of meeting the obligations of the Undertakings, [6] for the benefit of Openreach, our customers and the industry as a whole.

6 Undertakings of 22 September 2005 given by BT to Ofcom in lieu of a reference to the Competition Commission pursuant to section 154 of the Enterprise Act 2002 ("the Undertakings")

Introduction

8. Openreach welcomes Ofcom's Second Consultation and this opportunity to respond to it.

9. Regulation must enable Openreach to recover an appropriate return on its (regulated) investments, and create the appropriate framework to incentivise investment. In that context, we are generally encouraged by Ofcom's recognition of the issues identified by Openreach throughout this review, and Ofcom's proposed revision of the current fixed nominal charge ceilings, with a view to addressing the adverse economic outcomes and market distortions caused by the current charge ceilings.

10. We note Ofcom's conclusion that evidence supports a general case for increases in the charges for regulated access services, and that there is now a relatively greater need for an increase in the price of MPF rentals in particular. Ofcom's general conclusions are consistent with Openreach's, although in Openreach's view Ofcom's assessment of the evidence understates the required changes in price.

11. It is also Openreach's view that Ofcom's proposed approach does not fully meet Ofcom's stated objectives for this review, for example, regulatory certainty and cost recovery (see paragraph 2.13 of the Second Consultation). The proposed operation of Ofcom's intended "glide paths" falls short of providing the enduring regulatory certainty required by Openreach and industry, and does not allow for the recovery of efficiently incurred costs. Moreover, Ofcom's analysis of Openreach's costs, and some of the key assumptions used in the derivation of Ofcom's model of costs, appear flawed. Openreach's views on this are set out in further detail in this response. As a result of these errors, Ofcom's proposed charge controls would, even after the completion of the possible 4 year glide path, remain below Fully Allocated Costs ("FAC") and would continue to perpetuate the distorting arbitrage between the pricing levels for MPF and WLR+SMPF and would fail to achieve Ofcom's objectives for this review. The only way to satisfy these objectives is through rigorous modelling of Openreach's costs to ensure that the charge controls are appropriate for the meeting of Ofcom's stated objectives and statutory duties.

12. In this response to the Second Consultation, Openreach notes that if the short term charge control approach proposed by Ofcom, i.e., 1 and 2 year charge controls, is implemented, it will be necessary to implement an immediate step change adjustment of those prices to the levels needed to enable full cost recovery. In addition, Openreach's modelling and analysis again shows that Openreach's Return on Capital Employed ("ROCE") for "Core Rental Services" (as defined in the Second Consultation) could potentially fall to zero in 2012/13 absent an immediate step change adjustment of prices. Outcomes of this nature would clearly be unacceptable to investors considering an investment in a business with Openreach's risk profile.

13. Openreach's analysis in this response also discusses the apparent errors in Ofcom's proposed approach and the assumptions made, including in respect of cost re-allocation and costs disallowed by Ofcom.

14. In particular, our critique of Ofcom's proposed additional constraints on the basket charge controls illustrates how Ofcom's proposals cannot effectively meet its stated objectives. It is important to note that any outcomes which place Openreach in a position where it cannot fully recover its efficiently incurred appropriate costs would result in price levels which are not economic.

15. Section 88(1)(a) of the Communications Act 2003 stipulates that SMP conditions on prices can only be imposed if there is a risk of "adverse effects arising from price distortions" (and if other objectives are met – see subparagraph(b) of section 88(1)). It then necessarily follows that any new charge control should avoid setting prices at levels which would be uneconomic (by definition such price levels would not enable Openreach to fully recover costs incurred legitimately and efficiently) as to do otherwise would lead to market distortions, which the charge control is precisely intended to address.

16. In this response we set out a detailed consideration and critique of Ofcom's 'desk top' based approach to the review of efficiencies which, when combined with further consideration of existing factors, provides for a more robust and objective measure of prospective efficiencies.

17. In this response, we set out Openreach's review of Ofcom's approach to the modelling assumptions it employed and its proposed price ranges. Our analysis demonstrates that, even if a number of Ofcom's assumptions - as to certain costs and other key parameters - were to hold, the proposed price ranges for the Core Rental Services would still be above those proposed by Ofcom.

18. In order for Openreach to develop an executable strategic plan, and to have the confidence to continue to invest in its people, networks, systems and service quality, the issues identified in this response must be properly considered and effectively addressed.

19. Openreach welcomes the fact that in many key respects, the "current views" expressed by Ofcom in the Second Consultation reflect Openreach's own analysis, as put forward in response to the First Consultation. Openreach remains of the view that the points that Ofcom has accepted are correct and, in this response, Openreach has not sought to present those points again.

20. However, we note that in certain respects, Ofcom has not fully explained in the Second Consultation the methodology or bases it has used to reach some of its conclusions, so it is not always apparent whether Ofcom's conclusions have a sound, considered and objective basis or not. In respect to those points where Ofcom has reached a different view in its Second Consultation to Openreach,

Openreach has sought to respond as fully as possible to Ofcom's view. Where it disagrees with Ofcom's approach, we have sought to explain why.

21. Openreach's response to the Second Consultation is set out as follows:

    a) Section 1 contains a review of Ofcom's key proposals;

    b) Section 2 contains Openreach's review of Ofcom's modelling of the costs and other parameters, and sets out an indicative range of price ceilings based on an analytical review of Ofcom's approach;

    c) Section 3 provides detailed answers to each of the questions raised in the Second Consultation;

    d) Annex A provides a report on the principles of pensions deficit costs;[7]

    e) Annex B provides a detailed view on the weighted average cost of capital (WACC);[8] and

    f) Annex C provides a critique by Ernst & Young LLP ("E&Y") of the KMPG efficiency study.[9]

22. Openreach will continue to provide updated information relating to its most recent estimates of future costs and demand. As new information becomes available, the Openreach forecasts may have to modify projections of the costs for the key copper access products in the future and this may have an effect on the resulting price ceilings.

23. This response is provided by Openreach, a business unit within British Telecommunications plc ("BT").

24. To the best of BT's knowledge, all information provided in this response is complete and accurate. However, certain information provided is indicative, and although all reasonable care has been taken to validate its accuracy at the date of this response, BT reserves the right to amend such information including if new information becomes available. The information in this response should not be relied upon by Ofcom or any third party, aside from the purpose for which it is expressly provided.

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7 "Treatment of Openreach Pensions", a report prepared for BT, 3 March 2009, by Christopher Decker, Stephen Jones and Professor George Yarrow of Davison Yarrow Ltd.

8 "BT's Position on the Cost of Capital for BT and Openreach", a BT report, March 2009, report prepared by BT with advice from Professor Ian Dobbs of the Business School, Newcastle University

9 "BT Openreach Efficiency Review – Comments on KPMG Report", 5 March 2009, by Ernst & Young LLP

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Section 1

Review of Ofcom's key proposals

1. Introduction

26. In our response to Ofcom's First Consultation, Openreach demonstrated that the current charge ceilings for LLU and WLR set by Ofcom do not allow for Openreach to fully recover what Openreach considers to be its appropriate and efficiently incurred costs. We are therefore encouraged that Ofcom is minded to propose revised charge ceilings, with a view to enabling Openreach to recover these costs.

27. As the market for communications services continues to evolve, Openreach is increasingly faced with the need to balance competing pressures on its finite resources – its physical assets, systems, products and people. Given the importance of Openreach to the business models of Communications Providers ("CPs") and its position as a supplier of inputs to those business models, the strategic imperative for Openreach remains to find a path through these pressures while making an appropriate return on its underlying assets. This is indeed a key reason why Openreach was created as a result of BT's 2005 Undertakings, namely to create a viable and sustainable access services business.

28. Openreach's response to the First Consultation sought an immediate review of the price ceilings on Openreach's key copper access products. The continuing disparity between regulated prices and efficiently incurred costs is influenced by a range of factors such as changing product mix, changing future demand, the impacts of previous regulatory accounting adjustments, and inflation. While the parameters governing some of these assumptions have marginally changed since our response to the First Consultation, the underlying pressure on costs remains considerable. It is important to note that these pressures on costs exist irrespective of the current and forecast macro-economic environment.

29. In consideration of these factors and the need to address these cost pressures, appropriate regulation is essential to setting the right framework. Openreach's response to the First Consultation proposed a regulatory framework recommending the following:

    a) an immediate **increase in the price of MPF rentals**, such that MPF earns an appropriate regulated return, with a subsequent RPI + X regime thereafter;

b) **separate price control baskets for MPF, WLR, SMPF and Co-mingling product sets** that enable Openreach to realise an appropriate return, including its regulated cost of capital;

c) a price **control regime set for a minimum of 4 years** in order to underpin stability in the market;

d) an **efficiency target that is appropriately sized** in relation to the true potential of Openreach to reduce its cost base, and to ensure the maintenance and improvement of service levels, to continue to meet industry's expectations; and

e) **all relevant costs to be included in the regulated cost base and recovered in Openreach's product prices** under the new pricing framework.

30. A central part of appropriate regulation is **the setting of the right WACC** which can be recovered by Openreach (and indeed certain other BT investments), consistent with the Competition Commission's methodology ("CC"). Openreach urged Ofcom to consider the current and forecast conditions in the financial markets, and advocated a cautious approach in setting the WACC to enable any ongoing investment in the regulated asset base.

31. While some of Ofcom's proposals in the Second Consultation go toward addressing some of the issues identified above, a number of issues remain unresolved. Openreach is not persuaded by a number of assumptions and assertions made by Ofcom in its estimation of Openreach's (efficiently incurred) costs and associated price ranges. These issues are discussed in more detail below.

2. The First Consultation and recent market developments

32. The macro-economic environment has changed since Ofcom's review was initiated, and ongoing developments continue to take their toll on the wider economy. A recovery of the economy is not expected in the short-term, and we expect these difficult macro-economic conditions to endure throughout the 1 to 2 year period of Ofcom's proposed charge controls.

33. Notwithstanding the increasingly difficult and volatile economic background, Openreach continues to consider that a workable and economically sustainable outcome is achievable, appropriate and necessary to avoid market distortions.

34. While the economic climate may influence the outcome of the review, it does not prevent the development of an effective regulatory framework, and actually serves to illustrate the need for immediate price stability at the right price levels, and continued regulatory certainty over an appropriate period of time. Equally,

Ofcom's determination of the new framework will be critical to the creation of appropriate economic investment incentives.

35. Openreach notes Ofcom's revised approach on the timescales for proposed 1 to 2 year charge controls. We are concerned that such an approach inhibits effective business planning. It is therefore imperative, given the short-term nature of the proposed charge control period, to establish at least short-term price stability by moving immediately to the right price levels. This is essential to economic sustainability and the maintenance of incentives for Openreach and industry to invest in both existing and future services.

36. The "opportunity cost" of Ofcom not enabling immediate price stability would be considerable. For example:

    a) Resource and (ongoing) investment in existing products and services would almost certainly be jeopardised, in particular in the current economic climate.

    And

    b) Similarly, investment in new products and services would also be at risk. Set against the current economic background, in which accessing adequate financial resource on economic terms may in itself be extremely difficult, any proposed investment in new and wide-scale access technology such as Next Generation Access ("NGA") represents a very significant business risk. In the event that Ofcom's new framework were to fail to provide the correct signals and incentives, any such investment may bear an unacceptable commercial risk in the short-term.

37. Openreach accepts that the current and forecast macro-economic conditions will have some bearing on the outcome of Ofcom's framework review. However, these conditions do not prevent the achievement of short-term price stability and the maintenance of appropriate investment incentives. Indeed, we urge Ofcom to consider the review of the framework as a vehicle for helping to provide Openreach and industry with the necessary surety and economic sustainability.

3. Analysis of the key policy proposals

38. We set out below Openreach's views on Ofcom's key policy proposals, together with a summary of Openreach's suggested approach. We focus our analysis on the following:

    i. short-term charge controls and their implications;

    ii. Ofcom's cost analysis and cost reallocation;

iii. contribution to pensions deficit costs

iv. Ofcom's estimation of the cost of capital;

v. Ofcom's assessment of prospective efficiency (and fault rates);

vi. ancillary charge control baskets; and

vii. customer and market impacts.

i) Short-term charge controls and their implications

39. Ofcom's proposed approach with respect to the 1 to 2 year duration of the charge controls is inconsistent with Openreach's reading and understanding of Ofcom's intentions from the outset of this review process,[10] and indeed, inconsistent with Ofcom's indications at the time of the First Consultation in May 2008 (see paragraph 8.12).

40. Ofcom's proposals in the Second Consultation represent a significant departure from these publicly stated intentions and could therefore undermine the principles now being applied by Ofcom to determine the charge control proposals. For example, while the reference to and proposed use of a "full rebalancing" modification is over a 4 year period, the charge controls are proposed over only 2 years (in the case of LLU services) or 1 year (in the case of WLR).

41. One of Ofcom's objectives for this review is that Openreach should be enabled to recover all of its relevant and efficiently incurred costs. Now, as a result of the shorter duration of the charge controls, it is now even more essential for Ofcom to discharge its duty by implementing an immediate adjustment of LLU and WLR prices to the appropriate levels as per Openreach's proposals (see Section 2 of this response).

42. Openreach continues to consider that a more appropriate approach would be a charge control regime over 4 years - the incentive properties of which are well understood and set out in our response to the First Consultation – as this would be based on the principles of regulatory certainty and financial (and price) stability.[11] All of these factors are key to Openreach's ability to function effectively and responsively, and critical to the long-term health of the competitive process.

[10] See also Ofcom 2007-8 Annual Plan, page 15, where Ofcom stated one of its priorities as being "..creating a long-term framework for Openreach…".

[11] See paragraph 3.3.2 of the First Consultation, and Openreach's response to Question 8.4 in the First Consultation

43. Ofcom's short-term charge controls may serve to effectively constrain certain prices, but will not provide the level of certainty and/or incentive properties usually associated with effective price regulation.

44. The methodological approach taken by Ofcom is one which reverses the traditional RPI +/- X price control such that, over time and using a "glide path", prices eventually reflect the underlying and efficiently incurred costs. This approach is more appropriate when considering a charge control over a 4 year framework. However, the time horizon over which the actual charge controls will apply is now considerably shorter. Therefore, while Ofcom's methodology is well understood, the application of a 4-year analytical cost framework to the determination of "short term" charge controls is not appropriate. Furthermore, we note that in the context of a 4 year charge control, Ofcom's proposed price ranges would not enable Openreach to recover what we consider to be all of our efficiently incurred costs.

45. Beyond the period of the short-term charge controls, there is no certainty regarding price levels over the remaining years of the 4 year framework. The policy context has now changed, and the analytical framework and principles used by Ofcom to determine charge controls (with Openreach being in a position to fully recover efficiently incurred costs only at the end of the 4 year glide path, subject to an initial step-change in the price level) therefore no longer appear appropriate for a 1 or 2 year charge control.

46. While Ofcom's objectives for the review have been refined, the underlying policy principles remain:

    a) the need for regulatory certainty;

    b) the ability for Openreach to recover all its relevant and efficiently incurred costs; and

    c) the maintenance of incentives to invest and innovate.

47. We believe that Ofcom's proposals may fail to achieve these objectives. Indeed, while we welcome Ofcom's overarching conclusions of the review that prices need to be adjusted, we consider that regulatory certainty, cost recovery and the maintenance of investment incentives can now only be achieved by re-framing the proposed price ranges in the context of the 1 and 2 year charge controls. In particular, it now becomes necessary to implement an immediate adjustment of prices to the appropriate levels proposed by Openreach.

48. Openreach must be allowed to recover all its efficiently incurred costs throughout the Ofcom proposed timeframe of 2 years. This requires that charge ceilings for MPF Rentals and WLR Residential rentals are set, in April 2009, at a level equal to the current cost of providing the service.

49. We also believe that Ofcom should remove the additional proposed basket constraints (specifically, the sub-caps) on LLU Ancillary Services (as defined in the Second Consultation) such that Openreach is properly able, where necessary, to realign charges to underlying costs within the overall basket. This is addressed in further detail below in paragraphs 134 to 142.

ii) Ofcom's cost analysis and cost reallocation

50. Ofcom broadly accepts the bases on which Openreach has allocated common costs between services where Openreach does and does not have SMP, and recognises that Openreach has adopted a reasonable approach to the allocation of costs to its services, which Openreach welcomes.

51. However, Openreach has concerns about the way in which Ofcom has sought to reallocate certain costs from the Core Rental Services over four particular non-regulated services.

52. Openreach considers that, in principle, some cost reallocation may be appropriate. However, the methodology Ofcom appears to use to reallocate costs seems arbitrary. Our concerns are addressed in further detail in paragraphs 55 to 64 below.

53. Ofcom's consideration of Openreach's costs also raises concerns with respect to Ofcom's intention to exclude the costs associated with pensions deficits from the unit cost-stack. We set out in paragraphs 65 to 73 below why we disagree with Ofcom's proposed treatment of pensions deficit costs.

54. Finally, we refer to our comments with respect to Ofcom's proposed approach on other costs which are set out in our response to Question 5.5. We also note that Ofcom's consideration of WACC appears to us to be inconsistent with the approach of other regulators and with the Competition Commission's methodology - see paragraphs 74 to 92 below.

<u>The re-allocation of costs from Core Rental Services to non-regulated services</u>

55. Section 5 and Annex 10 of the Second Consultation refer to cost allocation and Ofcom's assertions that some of the non-regulated services do not appear to pick up a "fair share" of costs.

56. Openreach accepts Ofcom's view that a proportion of cost could potentially be reallocated from Core Rental Services to non-regulated services. However Ofcom's approach to how a "fair share" of costs should be allocated to non-regulated costs appears to be at least in part unexplained or arbitrary.

57. Any proportion of costs to be reallocated must first be based on an accurate assessment of existing and relative costs, secondly, based on a rational and non-arbitrary allocation methodology, and third, taking into account the products from and to which any costs are reallocated.

58. First, Openreach considers that Ofcom did not take into account the relevant cost base when considering this issue:

a) Ofcom appear to have miscalculated the relevant cost base for these non-regulated products, and appears to have excluded or omitted the costs (and revenues) associated with the Special Faults Investigation service ("SFI").

It can be seen from Figure 1 below that the inclusion of these costs fundamentally alters the basis for Ofcom's analysis when applying the Ofcom methodology (Table 10.8, Annex 10 in the Second Consultation). The inclusion of the SFI service increases actual costs by approximately £60m, with a less than proportionate increase in revenues.

Figure 1: High-level analysis of costs for non-regulated services based on Ofcom's methodology

Non Regulated Services	Revenue in 12/13	Costs	OFCOM Methodology for cost reallocation		
			Extra Costs to be reallocated to non-regulated services to reach a 20% margin	Low = 30% of the extra costs to be reallocated away from Core Rental Services	High = 60% of the extra costs to be reallocated away from Core Rental Services
TRCs, Enhanced Care, Redcare*, Ownuse and other**	228	18	164	49	98
SFI and Extra TRC costs	39	64			
Corrected non-regulated services	**267**	**82**	**132**	**40**	**79**

Source: Openreach internal analysis and Ofcom low/mid/high scenarios for cost reallocation

* As defined in the Second Consultation, "Redcare" refers to the Openreach Narrowband Line Sharing product sold as an input into BT Retail's Redcare product offering.
** Categories reflected by Ofcom in its table 10.8

b) Ofcom's view of the costs attributable to non-regulated products also appears flawed; Ofcom assumed costs of £18m for Time-Related Charges ("TRC") services in 2012/13, when the actual projected cost is £22m.

c) These adjustments to the underlying costs obviously narrow the scope for any proposed reallocation.

59. Secondly, Openreach also has concerns with Ofcom's proposed methodology to calculate the "fair share" of costs to be reallocated from Core Rental Services to non-regulated services. Ofcom appears to have applied a generic margin of 20% to the revenue streams in order to obtain a rough estimate of the appropriate share of Openreach's costs to be allocated to these products. Ofcom has then allocated these costs away from Core Rental Services in two arbitrary proportions (30% and 60%) representing high and low scenarios. Ofcom has not explained the methodology it employed or objective basis used to determine the 20%, 30% and 60% figures respectively. The economic basis underpinning these figures has not been explained.

60. Openreach considers that both the level of costs associated with products and the allocation of costs between non-regulated and regulated cost bases should be conducted on a more objective and considered basis. We believe that a smaller adjustment is required to be made to costs associated with these revenue streams. We refer to the response to Questions 5.4 and 5.5 below on this.

61. The third point is that consideration also needs to given to the source product from which any reallocation of costs should be carried out, e.g., from which Core Rental Service(s) and/or combination of Core Rental Services should the costs be reallocated, and which product any costs should be reallocated to.

62. Ofcom has not indicated in its Second Consultation from which Core Rental Service(s) costs should be reallocated, as a result of which we have been unable to comment on that aspect of Ofcom's proposal. The reason this is important is that, given the range of costs that Ofcom has identified as being "reallocatable", this would give Ofcom very broad discretion to determine from which services costs are reallocated, and to consequently have an impact on the price levels of those services away from which such costs are reallocated.

63. In Openreach's view, the maximum possible cost reallocation is approximately £46m (see Figure 21), and we believe this should be attributed across Enhanced Care, Redcare and Own-use, in the proportions shown. These services are currently forecast to attract negligible operating costs, whereas the other services (TRCs, SFI) already attract a reasonable proportion of costs.

64. Openreach is concerned that any reallocation of further costs to items such TRCs and SFI will unnecessarily blunt the (commercial) incentive to develop further non-regulated services which may be requested by industry, not least because Ofcom's proposal would have the effect of retrospectively "clawing back" non-regulated returns and would also make it much more difficult to develop new and competitively priced propositions going forward.[12]

[12] Indeed, section 5.11 of the BT Undertakings expressly recognises that when considering requests for new non-regulated products, Openreach should treat those requests "as would any other commercial organisation", taking into account such criteria as (i) fit with the assets, skills and resources and terms of reference of

iii) Contribution to pensions deficit costs

65. Ofcom disagrees with Openreach's position that the funding of an existing pensions deficit should be included as a relevant cost attributable to Openreach for the purposes of the cost assessment.

66. Ofcom has entirely disallowed the £94m costs which constitute the Openreach contribution to the annual pensions deficit (of which £57m was allocated to Core Rental Services). This appears to be on the basis that "these costs do not relate to the forward looking provision of Openreach costs and services" as "it is likely that the liability has arisen wholly or partially in relation to employees who no longer work for BT and employees who continue to work for BT but whose pension liability is in relation to past service" (see paragraphs A10.74 to A10.77, Second Consultation).

67. Openreach is disappointed to note that Ofcom appears to reject out of hand the urgent need to address a pensions deficit contribution from regulated services.

68. Openreach has stressed that the cost of servicing this deficit – which will be likely to increase in the near future – can only be paid out of current and future cash flow and therefore represent current and forward-looking costs that Openreach will be required to incur. This remains an unalterable fact irrespective as to whether or not Ofcom chooses to argue that only costs which are forward-looking are relevant to the setting of prices.

69. Openreach believes that Ofcom is out of step with the practice of other regulators who have recognised that such costs – which on occasion date back to privatisation and inherited obligations – have to be taken into account.

    a) Openreach has commissioned independent experts to review this issue and their report is attached at Annex A.

    b) The report illustrates that other regulators have: considered this matter in detail; have accepted that accrued pensions deficits need to be taken into account; and in slightly differing ways and to varying degrees, have allowed for the recovery of these pensions deficit related costs through regulated charges.

    c) Ofcom's substantive approach to this issue appears to be at odds with the approach taken by other regulators, namely: OFWAT, Ofgem, the Office of Rail Regulation, Postcomm and the CAA. This is particularly the case with respect to Ofcom's position that all risk associated with pensions deficit costs should be borne by the company and its shareholders, and not

Openreach, (ii) **commercial attractiveness to Openreach**, and (iii) opportunity cost to Openreach [Emphasis added].

reflected in prices charged to customers. Even taking into account the fact that circumstances between sectors may differ such that different approaches to the treatment of pensions deficit costs may be warranted, Ofcom has not provided a reasonable basis or explanation for its position and for why it is taking a different approach from other regulators.

d) The report in Annex A further suggests that there is no underlying conflict between taking pensions deficit costs into account and an economic based approach to pricing once it is recognised that there is a significant economic cost associated with the uncertainty in future cash flows and which is not factored into conventional cost models (and historically has not been by Oftel or Ofcom).

70. BT is in no different a position from other regulated sectors of the economy in this regard. We consider that there is no good reason for Ofcom to depart from the precedents and best practices of other regulators in terms of adequately addressing the pensions deficit costs problem. At a minimum, this suggests that Ofcom ought to have set out more clearly its principles relating to the recovery of pensions deficits costs.

71. As a result, Openreach should be allowed to fully recover the pensions deficit costs attributable to Openreach products under this review and this remains Openreach's position, supported by the above-mentioned report. Ofcom has not adequately explained why Openreach's view is incorrect, or why a different view is more appropriate.

72. Openreach also notes that the triennial actuarial funding valuation of the BT Pension Scheme as at 31 December 2008 is currently underway. In light of the recent decline in global investment valuations, this is likely to result in an increase in the funding deficit and may result in an increase in the cost of servicing this deficit, notwithstanding the pensions review which BT has just completed. To the extent that Openreach's contribution to the pensions deficit related costs increase as a result of the triennial review, we consider that it is critical that Openreach's regulated costs stacks be adapted to reflect any such increase, and that the charge ceilings be adapted accordingly.

73. Openreach further notes that since its response to the First Consultation, the European Commission has adopted a decision[13] relating to BT's pension plans. This decision concludes that the Crown Guarantee covering the pension liabilities of the pre-privatised British Telecommunications plc amounts to state aid. As a result, a financial contribution reflecting the value of the Crown Guarantee will need to be recovered from BT going forward.[14] This decision will result in

13 See IP/09/243 of 11 February 2009. Decision C-55/2007, not yet published, on the State Aid Register of the DG Competition website.

14 It should be noted that this is not a situation of Openreach's or BT's making, insofar as it results from government legislation on contributions to the UK Pension Protection Fund since 2005 and from the legislation leading to the privatisation of BT.

additional current and forward looking costs that Openreach will incur over the 1 to 2 year period of the charge controls.

iv) Ofcom's estimation of the cost of capital

74. BT[15] is pleased to note that Ofcom has taken some account of evidence in response to the First Consultation which:

   a) justifies a wider range for consideration of the appropriate WACC; and
   b) indicates that the regulatory WACC should be set at a level above that suggested in the First Consultation.

75. However, we have considerable reservations on some aspects of the methodology that Ofcom has used to estimate BT's cost of capital and the analysis of the evidence presented to Ofcom. Our detailed analysis of Ofcom's position is set out in Annex B, which also includes comments on Annex 16 of the Consultation (Brattle Report). A summary of BT's views is set out below.

Summary of our position

76. BT's position on the calculation of the appropriate regulatory WACC for BT Group and Openreach is as follows:

   a) BT does not agree with Ofcom's methodology and assessment of the evidence in setting the values and ranges for the WACC parameters;

   b) the range for WACC proposed by Ofcom is too narrow; and

   c) the appropriate methodology to use when setting a level of WACC from a possible range, and to ensure appropriate incentivisation, is that adopted by Competition Commission ("CC") in its determinations for the recent reviews of the Allowed Regulatory Rate of Return for airports.[16] Ofcom's analysis is inconsistent with the CC methodology.

[15] References in this section to BT reflect the views of the BT Group including Openreach. The BT Group view is relevant in relation to determining regulatory WACC because Ofcom is seeking to determine regulatory WACC for BT Group as a whole and for regulated services outside Openreach in addition to the regulatory WACC for Openreach's copper access products.

[16] Competition Commission, 2007, BAA Ltd : A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd); 23rd October 2008 Stansted Airport Ltd Q5 price control review Presented to the Civil Aviation Authority. Documents available at http://www.competition-commission.org.uk

77. Applying the CC methodology to the WACC range, based on BT's view of the WACC parameters, provides a WACC of at least 12.1% for Openreach (copper access portfolio), 12.7% for BT Group and 13.3% for Rest of BT (and Openreach's Ethernet portfolio).

Level and range of WACC Parameters

78. BT considers that Ofcom's revised proposed value for **Equity Risk Premium** ("ERP") is too low and its range too narrow given the increasing volatility in financial markets. BT considers that measures cited by Ofcom are not sufficiently forward-looking and do not take into account relevant evidence. In particular, BT considers that significant weight should be placed on the views of Professors Myers and Schaeffer, two of the foremost experts in this field. Their recently proposed upper limits for ERP are 6.5% and 6% respectively.

79. BT also considers that Ofcom and Brattle Group's assessment of the BT Group Beta, and in particular the narrow range proposed for the **BT Group beta**, is not appropriate based on the evidence,[17] in particular:

a) Evidence of a rise in beta (noted in the Brattle Group Report);
b) The higher values of beta using the All-world index;
c) Economic evidence provided by Brattle Group;
d) International (IRG Countries) benchmarking showing Ofcom's beta proposal for BT is significantly below average;
e) The absence of evidence to suggest that the beta is materially different from 1 as supported by theory (a position which Ofcom has previously supported).

80. In respect of the issue around which index to measure BT beta against, Ofcom notes at paragraph A12.52 that the FTSE Allshare Index is its "preferred index". However, it does not explain the reason for this preference. We raised this issue in our response to the First Consultation (see paragraph B.2.3). In the Second Consultation, Ofcom states (at paragraph A12.66) that Brattle has responded to all the points raised by BT in respect of the Beta calculations. However, in response to the point we raised, Brattle simply notes (see response to Second Consultation, Annex 16, p7) that "[Brattle] agree[s] that the BT equity beta as estimated against a world index is higher than when measured against the UK index". Accordingly, we cannot understand (and no reason has been provided by Ofcom) why the world index calculations should not be taken into account when calculating BT's equity beta.

81. In respect of **Openreach's equity beta**, Openreach considers that Ofcom's downward adjustment to BT Group's beta to arrive at Openreach's beta is not appropriate. Ofcom relies on an adjustment it determined in its 2005 Final

17 This point is expanded on in Annex B.

Statement.[18] Furthermore, Ofcom has made an adjustment to the figure (adjusting the discount factor from 0.2 to 0.1) so that it does not result in a disproportionately low beta (see paragraph A12.59 of the Second Consultation). We consider that these adjustments are not justified.

82. In respect of the **risk free rate** and **debt premium measures**, we broadly agree with Ofcom's analysis, with the exception of the manner in which Ofcom has combined the ranges for the risk free rate and the debt premium measures. BT considers that Ofcom's approach in adding the low end its range for risk free rate to the high end of its range for debt premiums is not based on sufficiently sound assumptions. In addition, such an approach is inconsistent with Ofcom's previous practice and with the practice of other regulators. More detail is set out in Annex B.

Setting the appropriate range and point for WACC

83. We remain concerned that Ofcom has not explained how it intends to set a regulatory WACC within its proposed ranges and on how this links through to the more generic issue of incentivisation of investment in the sector as a whole.

84. BT considers that the CC methodology for setting WACC within a proposed range is the most appropriate methodology. As described in Openreach's response to the First Consultation (see section B.3.1), the CC methodology would apply a Monte Carlo type simulation to find the approximate distribution model for BT's WACC. A point figure for WACC is obtained by choosing the appropriate percentile of the distribution form which to choose the figure. The percentile figure is chosen in order to ensure that investment incentives are captured in the estimation of the WACC.

85. BT welcomes Ofcom's assessment that the risks of setting WACC too low are greater than the risks of setting WACC too high (albeit that Ofcom expresses it only in respect of the level at which it sets ERP (A12.41), which BT considers is not in line with the practice of other regulators). Accordingly, a percentile value needs to be chosen that is above the mid-point. This is the approach taken by the CC/CAA in determining a WACC for British Airports Authority ("BAA") that was above the mid-point. On a like-for-like basis, this suggests that Ofcom should set a value for Openreach's WACC of **12.1%,** and for Rest of BT (and for Openreach's Ethernet portfolio) of **13.3%**. This is set out in the following figure, based on BT's model, showing a comparison of BT/Openreach values with those provided by Ofcom:

[18] "Ofcom's Approach to Risk in the Assessment of the Cost of Capital, Final Statement", 18 August 2005

Figure 2:- Comparison Of BT And Ofcom Proposals For WACC

	Ofcom's December 2008 Assessment		Our February 2009 Assessment (applying the CC methodology)	
	Range#	ARoR+	Range*	ARoR**
Openreach	9.25-10.75	Not stated	9.1-12.5	12.1
RoBT	10.25-11.75	Not stated	9.7-13.7	13.3
BT Group	9.75-11.25	Not stated	9.4-13.1	12.7

+ Allowed Rate of Return.

\# Note that, since Ofcom's range is developed on an ad hoc basis, there is no reason to expect that it corresponds to a 95th percent confidence interval.

* BT's range is explicitly a 95th percent confidence interval.

** The allowed rate of return here is set at the 90th percentile as recommended by the CC.

Ofcom's estimates are not consistent with the CC methodology

86. Ofcom appears to suggest (see A12.117 of the Second Consultation) that the mid-point of its new range for regulatory WACC would be compatible with the equivalent values set by the CC in its determinations (which were adopted by the Civil Aviation Authority).

87. Figure 3 below shows that this is not the case and that Ofcom would have to set a value for WACC toward the upper end of its range if it had followed the CC's methodology:[19]

Figure 3: Comparison of Ofcom estimate and CC methodology adopted in "London Airports Price Review" investigation

	Competition Commission / CAA			CC approach applied to Ofcom estimates
	Heathrow March 2008	Gatwick March 2008	Stansted October 2008	Openreach+ December 2008
WACC Low	8.8	8.9	8.9	9.2
WACC High	10.5	10.9	11.4	10.8
Regulatory WACC	10.3	10.6	11.0	10.5

* Converted to nominal rates, re-levered for 35% gearing and rounded to one decimal place. (Note there are some rounding differences compared with Ofcom; see **Annex B**, Appendix 1.)

+ References to Openreach in this response pertain to the services within Openreach subject to this specific consultation.

Source: BT calculations based on BT data and the CC airports cases

19 BT notes that Figure 3 contains figures based on Ofcom's assessment of the WACC parameters which, for the reasons set out at paragraphs 78 to 82 of this Response, are not accepted by BT

88. Ofcom suggests, but does not demonstrate, that its methodology is consistent with that of the CC. We do not agree with this proposition and has analysed both the methodology of Ofcom and the CC in detail using Ofcom's assumptions and those of other commentators (see our analysis in Annex B). We also refer to Figure 3 above which demonstrates that this is not the case and that Ofcom would have to set a higher value for WACC if it had followed the CC's methodology adopted in these determinations. More generally, Ofcom has not explained why it considers that its methodology is consistent with that of the CC, or why the application of Ofcom's methodology produces a lower number than Openreach's (we note that we have consistently said that the appropriate WACC would be at 12.1% or more – see the end of the answer to question 6.8, response to the First Consultation).

89. Accordingly, we consider that Ofcom should adopt a methodology which is consistent with the CC methodology in determining the appropriate value for BT's WACC.

90. It is not clear to us to what extent (if at all) Ofcom is intending to maintain its previous practice of setting an allowable rate of return toward the upper of its range. Simply setting at the mid-point (10% for BT) would imply no increase in WACC since 2005. This would in our view be in direct conflict with widely held views of academics and City analysts that the cost of capital has risen significantly since then, and that all firms will find raising finance to be materially more expensive for the foreseeable future (for further analysis see Annex B).

91. BT notes that the CC undertook a full simulation of the WACC[20] and set a regulatory return which guarded against the negative welfare effects of setting a return which was in fact too low. In practice, the allowed returns for the three airports gave an implicit weighting of at least 80% to the upper value of the range of WACC (corresponding to the 95th percentile) and 20% weighting to the lower value of the range (corresponding to the 5th percentile), and BT suggests that this is an appropriate minimum value to apply for this review.

92. For all the above reasons, we urge Ofcom to give careful consideration to the evidence justifying a regulatory WACC considerably above the mid-point of the range it has presented in the Second Consultation. We consider that Ofcom should be setting a WACC value for Openreach's copper access portfolio of **12.1%,** and for Rest of BT (and Openreach's Ethernet portfolio) of **13.3%**.

v) Ofcom's assessment of prospective efficiency (and fault rates)

93. Openreach notes Ofcom's assessment that efficiency targets should be applied only to compressible costs and that Ofcom has accepted Openreach's

[20] See also our response to the First Consultation, in Annex B, for further detail.

assessment of which costs are compressible. Moreover, the relevant timeframe for consideration is now 1 to 2 years in light of the shorter duration of the proposed charge controls.

94. However, Openreach disagrees with the level of the efficiency target that Ofcom considers should be applied. The main differences between Openreach's and Ofcom's positions arise in respect of the Ofcom-commissioned report[21] prepared by KPMG comprising a benchmarking study of Openreach operating costs. Openreach's specific concerns with the KPMG report and Ofcom's interpretation of the KPMG report are set out in more detail below.

95. However, Openreach also notes the following broad issues:

a) Openreach broadly agrees with Ofcom's analysis of the definition and scope of efficiency (i.e., the appropriate identification of "compressible" costs), but we are not persuaded by Ofcom's research and analysis, and consider the "high-end" of Ofcom's proposed range to be unsustainable over a longer period of time.

b) Furthermore, we note Ofcom's statement that "*we also accept its* [Openreach's] *argument that the level of efficiency savings delivered in recent years cannot be assumed to continue into the future, as it becomes more and more difficult to identify further efficiency savings*" (see paragraph A14.55 in the Second Consultation). As a result, the Ofcom proposal which appears to nonetheless propose a range containing a potential year-on-year efficiency gain of 4% appears to us to be disproportionate and inappropriate. Indeed, having accepted that the level of efficiency savings delivered in recent years cannot be assumed to continue into the future, Ofcom has not explained how this translates into its proposed efficiency target of 2% to 4% p.a. year on year.

96. Set out below is a summary of an Openreach commissioned critique by E&Y of the Ofcom/KPMG study (see Annex C), which queries the approach, methodology and KPMG's conclusions. Also set out below is Openreach's response to Ofcom's proposals regarding fault rate reductions.

<u>Ofcom commissioned KPMG report</u>

97. We note that the Ofcom-commissioned KPMG report on efficiency is based on a relatively narrowly defined scope. Neither Ofcom nor KPMG explain why such a narrow approach is reasonable or appropriate. It is Openreach's view that any such benchmarking exercise should take a more holistic approach to assessing efficiency, which would include, for example, taking into account the inherent trade-offs facing Openreach when determining an appropriate balance of capital

21 See "KPMG, BT Openreach Efficiency Review for Ofcom", November 2008 ("the KPMG Report")

and labour for any given level of output. These are matters that KPMG appears not to have taken into account.

98. Further, we understand that a basic requirement of any benchmarking exercise should be its reference to a representative sample, namely a sample which has the same or very similar characteristics to the company that is being considered, and that some attempt is made to normalise for uncontrollable cost factors.

99. The benchmarking exercise undertaken by KPMG for Ofcom appears not to fulfil these criteria;

    a) the study considers only operational costs;

    b) there appears to be no clear rationale or objective criteria for the benchmarks actually selected by KPMG, nor are they evidenced as being representative of the specificities of Openreach; and

    c) KPMG does not appear to have conducted a normalisation exercise to ensure the effective comparability of the data used in the benchmarking exercise.

100. A key assumption in the KPMG report relates to the proposed annual average productivity gain; KPMG bases the estimated efficiency adjustment of 3.2% - 3.5% on an assumption of an annual average productivity gain of between of 2.1 -2.3%.

101. The bottom of the range, 2.1%, represents a 20 year average of the annual labour productivity growth for the UK economy as whole (GDP per worker). The top end of the range, 2.3%, calculated on a shorter-term basis, reflects productivity growth during times of recession. These numbers are taken from data on UK productivity from the OECD.[22]

102. As discussed above, were a more considered approach to be taken, the assessment of annual average productivity gains, in particular one that considers the likely trade off between labour and capital, would result in a lower potential range.

103. The figure employed by KPMG reflects only labour productivity improvements, and therefore does not take into account this potential trade off. KMPG does not explain why it does not take into account the likely trade-off between labour and capital or multi-factor productivity. It should be noted that the OECD also

22 http://stats.oecd.org/WBOS/index.aspx?DatasetCode=CSP2008

provides information on multi-factor productivity[23], and on that basis, long term annual productivity improvements in the UK have been around 1% per year[24].

104. While the Ofcom commissioned KPMG report may provide for an approximate view of the potential "direction" of Openreach's operational costs, Openreach is not persuaded by the approach (or methodology) adopted by KPMG. It is not sufficiently robust to support a definitive estimate of prospective efficiency adjustment, or to serve as a basis to reject Openreach's estimate of prospective efficiency.

Openreach's efficiency

105. As discussed in the response to the First Consultation, Openreach continues to strive to reduce costs and improve efficiency in all areas. However, Openreach must continue to take a balanced approach to these programmes; maintaining and improving network reliability against the backdrop of an ageing copper network which requires ongoing investment to maintain current standards and service levels, and ensuring that customer demands for quality service provision are consistently delivered. This will require significant ongoing investment in resources, limiting the scope for overall long-term unit cost savings.

106. We note that Openreach has in fact in Q3 2008-9 achieved efficiencies of the order proposed by Ofcom in the Second Consultation (Openreach achieved efficiencies of ~4% in Q3 2008-9 compared with Q3 2007-8). This was achieved as a result of considerable work to bring forward as many potential cost savings as possible with a view to mitigating the impact of the current very difficult economic circumstances. Openreach will continue to set itself challenging targets, and we expect to be in a position to realise further efficiencies for the remainder of the 2008-9 financial year by continuing focussed efforts to bring potential cost savings forward as rapidly as possible. However, these gains are not sustainable or replicable over a sustained period.

107. In light of the current and forecast economic environment and as a commercially rational operator, Openreach continues to take all reasonable measures and undertake all possible activity to mitigate the effects of the downturn, and further drive efficiency. Moreover, Openreach will continue to bring forward planned future initiatives and undertake measures sooner with a view to realising effective cost savings in the fastest time frame achievable wherever this is possible and appropriate.

[23] Ibid. The OECD provides information on labour productivity measure as GDP per hour worked and multi-factor productivity, which takes is computed as the difference between the rate of change of output and the rate of change of total inputs.

[24] 1985 – 2005 average Multi-factor productivity for the UK was 1.1%

108. It should be recognised that Openreach may set itself more challenging short-term targets to help mitigate the effects of the downturn. However, Openreach may not be in a position to effectively realise the benefits of achieving these targets in the time frame in relation to which these targets were set. Furthermore, to the extent that such targets can be achieved, Openreach must be able to exercise discretion in how we seek to realise any such benefit, and the time frame over which this might be realised.

109. It should however be noted that, while Openreach is expecting to achieve cost savings of the order discussed by Ofcom in the Second Consultation in Q4 2008-9, these gains cannot, and should not, be considered constant, i.e., these levels of efficiency are not achievable year-on-year.

<u>Ofcom's proposed 4% year-on-year efficiency target is not sustainable</u>

110. In light of the cost pressure in a number of areas, the most "malleable" component of compressible costs is labour and, as a result, an efficiency target of 4% would imply an even higher percentage of reduction in the Openreach workforce.

111. Over 90% of Openreach's total workforce in 2007/08 were employed in service delivery, the vast majority as engineers. It is important to note that, for example, a 5% headcount reduction each year from current levels (until 2013) would imply significant headcount reductions.

[OPENREACH BUSINESS SECRETS HAVE BEEN REDACTED]

112. We note that Ofcom has not addressed the issue of the effect on Openreach's labourforce of its proposed efficiency target nor has it explained how it anticipates that Openreach may actually be able to meet these efficiency targets. As set out below, Ofcom's efficiency target's – if continued year on year – would lead to the conclusion that Openreach is seriously overmanned, yet Ofcom does not present any objective evidence to support such a conclusion.

113. Confidential Figure 1 below shows what applying different efficiency targets does to the Openreach direct labour figures. (See Question 5.4 which addresses the effect of volume reductions).

[CONFIDENTIAL FIGURE 1 CONTAINS OPENREACH BUSINESS SECRETS AND HAS BEEN REDACTED]

Source: Openreach Cost Forecast model

114. The consequences of such dramatic cuts in FTE would be significant:

a) Clearly, maintaining service levels in the face of such drastic cuts would be extremely difficult if not impossible with the current systems and network, which means fault rates would increase and service levels (and SLG payments) would be adversely impacted;

b) Openreach has and continues to take steps to ensure that its workforce is deployed in a way that can most efficiently and effectively meet variable and sometimes volatile demand across a wide geographical area. This has involved reducing the extent to which engineers work overtime (with a resulting removal of certain costs associated with overtime) and reducing the use of agency staff. As a result, the scope for further significant cost reductions in these areas is limited;

c) Reducing headcount will reduce Openreach's ability to react to peaks in demand and to meet the service levels contractually required in terms of fault repairs and provisioning and expected by industry;

d) To operate the business effectively, we need to maintain sufficient flex in its labour force. As a result, it is important to avoid headcount reductions that may subsequently need to be reversed, particularly as the investment required in the workforce to train engineers and equip them can take around nine months and would drive further costs, including recruitment costs;

e) Openreach must ensure its workforce is suitably skilled, experienced and resourced to address all future technological requirements, including issues that may arise through the roll-out of next generation access services;

f) Activities to improve the overall reliability of the network and generally deal with faults more efficiently will require investment. As a result, higher reductions in opex will require additional capex; and

g) The variability of demand for provisioning is linked to the absence of effective incentives for CPs to provide accurate forecasting. We note that this contrasts with the fact that regulation heavily penalises service failure via the new SLG regime, even where this service failure is attributable to inaccurate forecasting.

115. In addition to the above points, it is important to understand that it is extremely difficult for Openreach to actually *realise* significant cost reductions in this area given inherent difficulties in unpicking legacy structures. In particular, natural attrition rates within the Openreach workforce are low and slowing, largely as a result of the current difficult economic circumstances, making headcount reductions even more challenging. The costs associated with making redundancy and leavers' payments necessary to enable FTE reductions therefore need to be factored into any assessment of the scope for cost reductions. Because of the payback on the redundancy and leavers' payments, it currently takes on average over 2 years before potential cost savings for engineers leaving on certain terms might actually be realised. This indicates that the savings that could *actually* be realised during the 1 or 2 year period of the proposed charge controls would be very limited.

116. In the context of this analysis, it is unreasonable to expect that Openreach can deliver efficiency savings across all operational costs of as much as 4% on a year-on-year basis. We believe that to do so would have a material adverse impact on Openreach's ability to meet the needs of its customers, maintain service levels and avoid fault rates increasing.

117. Whilst Openreach welcomes Ofcom's agreement that any efficiency should be applied to compressible costs only, Openreach also believes that – in the context of the issues set out above – any application of efficiency over the next 4 years should be approximately 2.5% per annum (on a tapered basis). Specifically, in keeping with recent trends and prospective efficiency gains to be made by Openreach, an average of 2.5% could be applied. This is derived as follows: starting at 4% from 2009/10, then 3% in 2010/11, 2% in 2011/12, and 1% in 2012/13. Anything above this level would be unreasonable and disproportionate.

118. This profile and level of efficiency target provides the incentive for Openreach to continue to deliver year or year efficiencies without inefficiently increasing its investment. We note that in the 1 to 2 year duration proposed by Ofcom for the charge controls, the efficiency target proposed by Openreach is in fact at the high end of Ofcom's proposed efficiency range.

<u>Ofcom's proposed reduction in fault rates</u>

119. Openreach does not agree with Ofcom's assessment (see paragraphs A10.35-A10.39 of the Second Consultation) of the level of fault rates that Openreach will

be able to achieve in the future. While Ofcom has accepted that the higher levels of decline achieved in previous years are unlikely to be repeated, it proceeds to base its reasoning on historical rates of decline with an arbitrary adjustment applied. Ofcom does not explain the economic or objective basis for that arbitrary adjustment, nor the methodology by which it arrives at its figure for fault rate reductions of 4% to 6% per annum year-on-year, which we consider to be unreasonable.

120. Furthermore, Ofcom does not seek to identify the relationship between reduction in fault rates and capital/operational spend. Instead, Ofcom seeks to identify cost savings from fault rates without taking into account the cost increases that are required to bring about these reductions in fault rates or whether the investments necessary to bring these about would be economical.

121. In response to Ofcom's analysis, Openreach sets out below and in Question 5.3 a detailed forecast of its fault rates and information as to the expenditure that would be required to bring about the decreases in fault rates that Ofcom proposes.

122. It should be noted that the network faults reduction experienced over the last number of years is as a result of a combination of issues, including:

a) Openreach's improved and deeper understanding of the drivers and types of faults;

b) Openreach's continuing investment, as well as well targeted repair programs in the appropriate areas, for example, training, improved skill set/multi-skilling, better sealing/water proofing, improved closures, etc.

This has been combined with better training and lower staff turnover, resulting in an improved engineering skills base.

123. Openreach contends that the overall level of faults and associated repair is now at a manageable, "efficient" and relatively stable level. For example, despite the Openreach network experiencing one of the wettest years in 2008, the business did not experience the volatility or level of increase in faults experienced in previous years of high rainfall.

124. While Ofcom has accepted that the same level of decline achieved in previous years is unlikely to be repeated (see paragraph A10.38, Second Consultation), Ofcom proceeds to base its reasoning on historical rates of decline with an arbitrary adjustment applied. Ofcom also does not explain how it arrives at its figure for fault rate reduction of 4% to 6%.

125. Ofcom provides limited reasoning for its estimate for decreasing fault rates and does not seek to identify the relationship between reduction in fault rates and capital/operational spend. Accordingly, Ofcom seeks to identify cost savings from fault rates without taking into account the cost increases that are required to bring

these about these improvements in fault rates (or whether these would be economical).

126. Openreach strongly disagrees with Ofcom's view that historical trends in the reduction of faults will continue at the same, or a higher, rate. Openreach information and evidence, set out in more detail below, clearly suggest that the fault rates could actually increase due to the increase in the penetration of broadband. While Openreach accepts that this may be offset by a decline in the "base level" of faults, and continued improvements in the management of volatility associated with rainfall and network interventions, we cannot envisage an annual and ongoing reduction in faults in the order of 4% or above as proposed by Ofcom, nor is there any justification to suggest that such a continued reduction in faults would be possible.

127. Going forwards, there are several factors which are likely to increase the level of faults reported into Openreach and the fault reports that Openreach will accept and address.

128. These include:

a) **Natural degradation of the ageing network**:

The network is naturally degrading as it ages. Openreach estimates that the natural rate of degradation, without intervention, is around 12% per annum.

b) **Increasing 'cable fill', leading to increasing noise and interference of lines as penetration of data services increases**:

The rate of cable fill will increase as penetration and usage of high bandwidth data services on the network increases. Cable fill is a form of interference that occurs if there is more than one DSL line operating in a cable. The effect of cable fill is highest at low penetration meaning that consumers may see a degradation of perceived line speed as the cable fill increases. Increased cable fill could increase fault reports into Openreach as end-users contact their CPs to complain about a possible fault given that they observe reduced data speeds. If the correct structured questionnaire is not carried out by the CPs Service Management Centre, then it could materialise as a fault report into the Openreach systems. These faults are more prevalent with the introduction of new technologies such as ADSL 2+, VDSL 2, etc., and their number will increase as new technologies are deployed more extensively in the network and end users' service expectations rise accordingly.

c) **The recently implemented 6dB rule, as a result of which line loss in excess of 6dB is reported as an Openreach line fault**:

Openreach has recently agreed with industry that on receipt of a fault report where the line tests "ok" and there is nonetheless a degradation of line loss of more than 6dB, this will be categorised and accepted as an Openreach line fault. Prior to the introduction of the new rule, the fault report would have been rejected if a subsequent test confirmed the initial test result. Where a line has not degraded by more than 6 dB, then the CP will be advised that there will / may be a charge for any visit by Openreach.

and

d) **The adoption of the SIN5XX Statement of Requirements which will generate additional faults**:
As part of its work with industry in response to a Statement of Requirements known as "SIN5XX", Openreach has implemented a capability that allows CPs to submit DSLAM data relating to speed issues via the SFI process. This provides Openreach with an opportunity to identify and deal with fault conditions that might otherwise be left undetected, which will increase fault rates.

129. Based on analysis of Openreach data, Openreach forecasts that the overall fault rate is more likely to remain relatively flat over the 1 to 2 year charge control period, assuming current (and committed) levels of investment spend. We consider that the increase in faults resulting from the factors described above will be offset by a decline in the base level of faults, and also a continued improvement in managing the volatility associated with rainfall and network interventions. Even combining an aggressive forecast on investment, and assuming that the impact of broadband can in some way be ameliorated, we believe the fault rate would decrease at a per annum rate which is below Ofcom's project 4-6% range.

130. As the "easy win" opportunities (in terms of improvements to fault rates) of the past 5 years have already largely been taken, Openreach predicts that the overall fault rates are more likely to be flat over the next 4 years, given current levels of investment, predictions of increased broadband penetration and the step changes already achieved.

131. We estimate that for Openreach to achieve a 4% - 6% annual reduction in fault rates, as proposed by Ofcom, would require a significant amount of extra investment, the payback on which may not be realised within a 4 year period, let alone within a 1 to 2 year charge control.

[OPENREACH BUSINESS SECRETS HAVE BEEN REDACTED]

132. This would entail transformational work, as opposed to improvement programmes of the type carried out since Openreach's creation. It is unclear whether this investment will actually provide the economic and financial benefit to justify the extra spend. As a result, we consider that Ofcom's proposed fault reductions rates are not reasonable or proportionate, nor are they sufficiently justified by objective evidence or analysis.

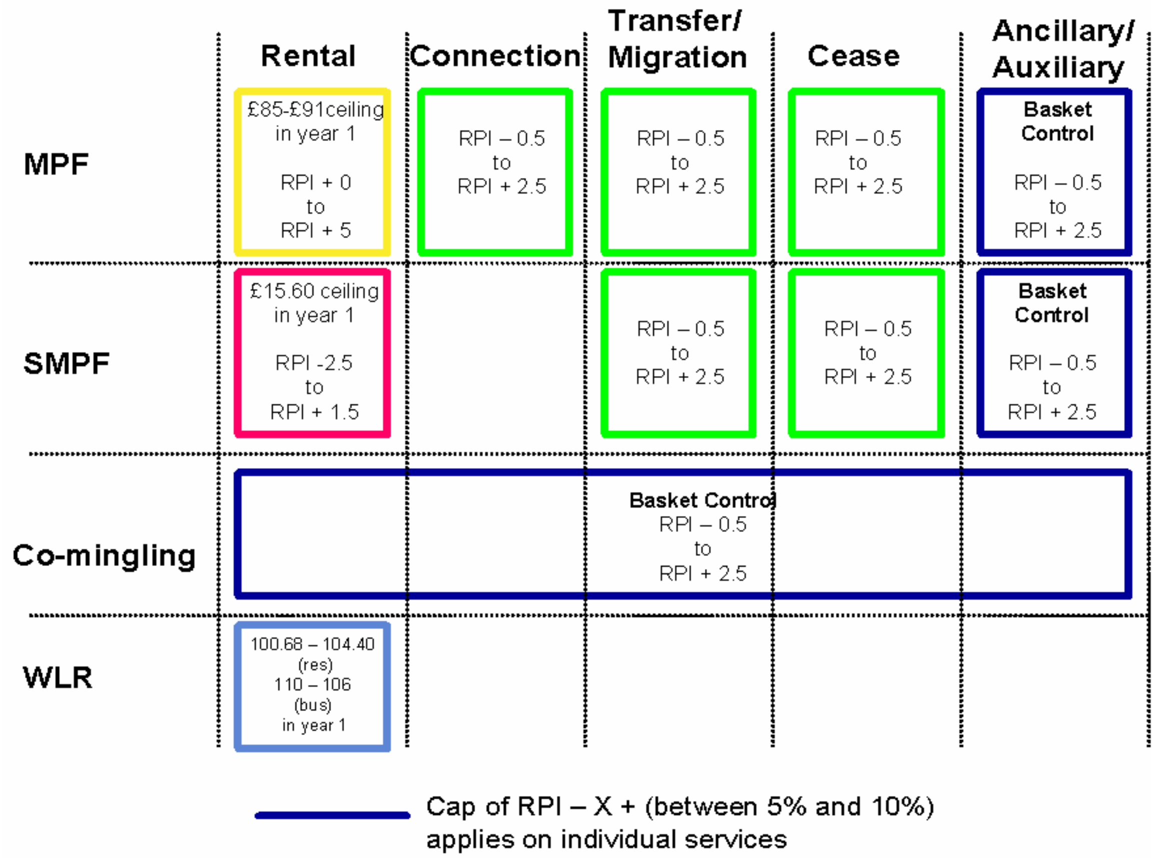
133. In light of the above, Openreach's latest estimates for fault rate reduction from 09/10 remain unchanged, and Openreach continues to consider that a reasonable assumption is to keep fault rates flat over the duration of the charge control.

vi) Ancillary Services charge control baskets

134. Openreach welcomes Ofcom's proposed basket oriented approach to the control of "LLU Ancillary Services" (see Section 7 of the Second Consultation for the definition of LLU Ancillary Services). As stated in our response to the First Consultation we believe that it is preferable for price controls to cover a basket of related services rather than individual services; a basket approach should provide for greater flexibility to accommodate variations in customer demand within the overall regulatory framework. Whereas individual charge controls can be inflexible and raise the risk that individual prices might diverge from costs over time, it is more likely that an overall basket will be less subject to such a divergence.

135. Openreach further considers that a basket approach is preferable to individual charge controls as the administrative cost and burden of determining individual charge controls would be considerable. Other reasons why intervention at each individual product level would not be either proportionate or appropriate include the number of prices involved (more than 70 for all Ancillary Services), the state of the market and the fact that these services are purchased by CPs as elements of an overall solution and should be treated as such.

136. Set out below is a summary of the Ofcom proposition, which illustrates its complexity:



Source: Openreach analysis of the Second Consultation.

137. The pricing of the products which Ofcom proposes to include in the Ancillary Services baskets has developed over a number of years and reflects a patchwork of changes due to regulatory intervention and determination, developing working processes and market demand.

138. The proposed control must therefore help to facilitate the creation of a harmonised and consistent portfolio, where prices more accurately reflect cost and where customer options are transparent and economic, and do not result in extraordinary outcomes or market distortions.

139. The patchwork of charge determinations and Openreach's inability under the proposed charge control to properly align costs with charges and demand will continue to drive uneconomic outcomes. We believe that any future basket oriented control must allow Openreach to address these types of issues (and customer behaviours), as well as providing the financial incentives for price and product innovation and investment.

140. However, the complexity of the proposed baskets coupled with the imposition of sub-caps on certain services appears to negate Ofcom's principles of flexibility

(see Section 7 in the Second Consultation), and the ability for Openreach to align its charges with costs.

141. It is generally accepted that where new charge controls bring disparate products together, a basket control should enable some prices to increase and others to decrease. The result should, in effect, be "neutral" within the overarching basket constraint. Within the proposed basket approach, price changes to products that have higher volumes will require larger opposite changes in price to those products with lower volumes. However, Ofcom's proposed imposition of sub-caps on certain products in addition to the generic constraint that prices for individual products within the basket can only flex by a small percentage will severely and unnecessarily restrict Openreach's ability to amend prices. Ofcom's current proposals to introduce sub-caps within the basket control will effectively set the current pricing in stone.

142. This issue is discussed in more detail in our response to Question 7 below, and Openreach's preferred options for the shape and structure of the Ancillary Services charge control basket is set out there.

vii) Customer and market impacts

143. Ofcom's assessment of the likely impact of its proposals is set out in Section 3 and Annex 5 (Impact Assessment) of the Second Consultation. In brief, Ofcom considers that the most appropriate option for modification of the charge ceilings is the restructuring of the existing controls and charge ceilings (see paragraph A5.25 of the Second Consultation).

144. As discussed elsewhere in this response, Openreach welcomes Ofcom's intention to revise the current charge controls, although we do not agree with Ofcom's proposed approach - this is discussed further below.

145. Section 3 of the Ofcom Second Consultation presents a high-level assessment of the proposed price changes in the context of "market sensitivity" and how potential price increases might impact existing margins, growth and investment. Openreach has also analysed the potential impact of the proposed price changes, measured relative to current (customer) expenditure, estimated cost-stacks and potential investment choices.

146. Our analysis suggests that charge controls at the higher end of Ofcom's proposed price ranges or above will not unduly disrupt the market or specific customers, and the controls would not have a material negative impact on margins or the incentive to invest.

147. We consider that a price increase from Openreach does not have a material adverse impact on the LLU CP business model. Even with the price increases at

the level proposed by Openreach, investment in MPF will remain more attractive to CPs than WLR+SMPF. It will then be to a CP's benefit to maximise utilisation of their assets, and as they increase the volume of their customers and enjoy economies of scale, their profits will continue to increase over time.

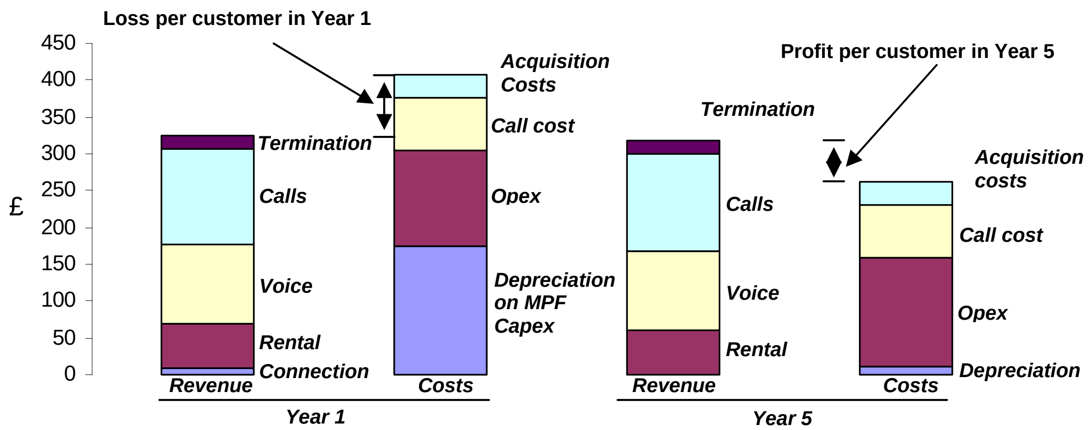
148. Furthermore, for many CPs the impact on the market of copper price increases will be offset to a certain degree by decreases in the price of Ethernet.

<u>Increased MPF charge ceilings do not change the economics of existing MPF investment</u>

149. Openreach has analysed what it believes to be a typical MPF investment model and a typical SMPF investment model.

150. Set out below in Figure 4 is a schematic of a typical MPF investment model. While being an illustrative model only, it highlights that the profit per customer will naturally increase as LLU operators are able to more efficiently utilise their exchange presence, and recover their fixed costs (both LLU investment and other corporate fixed costs).[25]

Figure 4: An illustration of a "typical" MPF business model



Source: Openreach

151. Our model has been built based on our detailed understanding of the market and our knowledge of CP business models, based on various factors, including: how much it costs a CP to set up in an exchange; the economics of how a CP can load an exchange with customers and the profitability per exchange; our assumptions regarding CP Average Revenue Per User based on numbers

[25] It should be noted that costs presented are illustrative and could vary considerably according to a CP's own business model. For example, special broadband offers which might bundle accessories such as mobile phones or laptops will likely result in higher customer acquisition costs.

published by CPs and market intelligence; and assumptions based on CP opex (e.g. we know their backhaul costs as they buy backhaul from us).

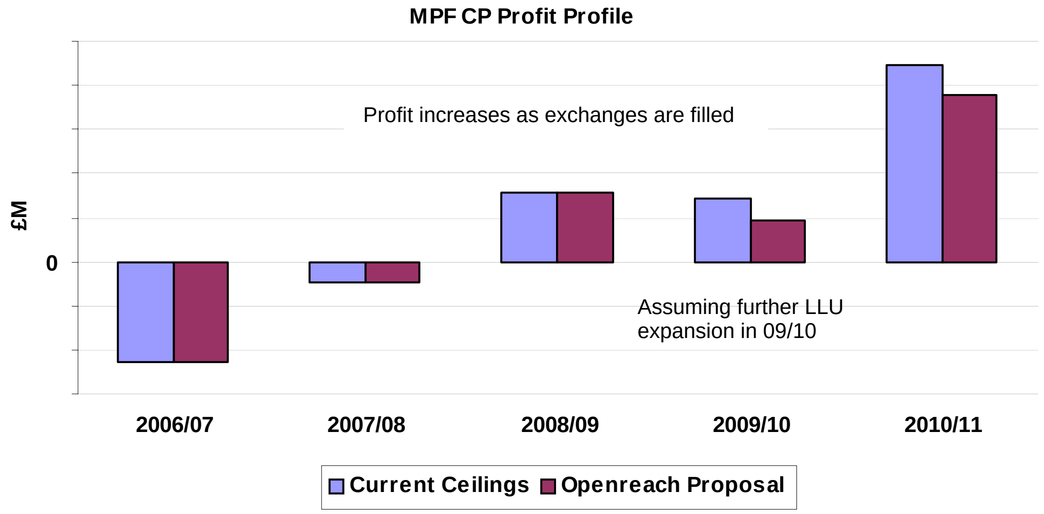
152. If it is assumed that (i) much of the LLU MPF investment was made in 2006/07 (and we note this is consistent with Ofcom's assumption[26]), and (ii) the illustrative profit per customer estimates in the above figure are broadly correct, then it follows that the prices proposed by Openreach would not represent a material adverse impact on a typical MPF provider's business model. It is also worth noting that LLU rental prices are only one element among many in a CP's decision to invest in LLU.

153. Figure 5 below provides an illustration of the estimated profit cycle for a typical scale LLU (MPF) provider, where losses would be realised in year 1 (2006/7 in the illustrative example below), smaller losses are then also incurred in year 2 (2007/8), and profits are realised as of year 3 which then continue to increase.

154. Figure 5 shows that while an increase in the current MPF charge ceiling will have an effect on aggregate profit, it would not have a material adverse effect on overall profits such as to render a CP's business model unprofitable, nor will it change the incentives to invest in LLU as shown below.

155. Absent an increase in the MPF charge ceiling, and assuming (flat) nominal prices, it appears Openreach is de facto "subsidising" profits in the downstream markets. Conversely, an increase in the MPF charge ceiling would enable Openreach to realise a reasonable return on its investment, without having a material adverse impact on the profits of LLU CPs.

Figure 5: Profit profile for a typical MPF CP, pre and post MPF rental increases in 2009/10 and 2010/11



26 See paragraph A5.127 of the Second Consultation

The incentive to invest in LLU remains

156. Going forward, we consider that increases in the current MPF charge ceiling will not undermine existing MPF based investments. Moreover, increases in the MPF charge ceiling would neither distort nor undermine the incentive to invest in MPF in the future. Openreach's analysis indicates that, depending on the assumptions used as to price, the estimated pay-back period on a typical scale MPF based investment increases by 3 months (less for SMPF + WLR).

Figure 6 : Estimated Pay back periods for LLU investment

	MPF	SMPF+WLR
Current Ceilings	3 years 10 months	4 years 4 months
Openreach Proposed Prices	4 years 1 months	4 years 5 months

157. Furthermore, the Openreach analysis indicates that relative to other product mixes – and employing the same price assumptions as above - investment in MPF remains economically attractive. This is evidenced by the estimated shorter payback periods for MPF based investment, relative to investment in WLR and SMPF.

158. It should also be noted that considerably shorter payback periods for MPF based investment demonstrate that incentives to invest in MPF would not be negated were Ofcom to allow an immediate adjustment of the MPF price to the appropriate level proposed by Openreach.

159. Openreach's analysis is further reinforced by current market trends, such as Sky's and Opal's announced moves towards greater reliance on MPF than on SMPF+WLR.[27]

The benefit of recent Ethernet price reductions needs to be taken into consideration

160. If the copper charge controls are considered in a wider context, for example, including the recent price reductions on Ethernet (and assuming no immediate

[27] For Sky: See page 7 of Sky's Results for the half year ended 31 December 2008 under "Broadband and Telephony", available online at: http://corporate.sky.com/documents/0b404e8a89164db186e8b847ced3a11c/221aa60ce8cc4089a7eb126b6c09c7e1.
For Opal: In Opal. "Opal's Next Generation Telecoms Network", p3. (http://wwwtest.opaltelecom.co.uk/global-assets/pdf/LLU%20White%20Paper.pdf, as cached on Google) According to this document, Opal were intending to unbundle up to 1,000 exchanges covering about 70% of their UK customers over a twelve-month period

change in demand),[28] the impact of the copper price increases will be materially reduced. This is because CPs representing a large proportion of overall purchases of copper-based LLU and WLR products from Openreach also purchase Ethernet access and backhaul services from Openreach to use in conjunction with their copper-based products.

[28] See among others "Ethernet price reductions from 1st February 2009", Briefing ETH-008/09, available at www.openreach.co.uk

Section 2

Review of Ofcom's modelling & proposed price ranges

1. Introduction

161. The basis for Ofcom's proposed price ranges is essentially the review of the (Openreach supplied) financial evidence, and Ofcom's own cost modelling exercise (which is derived from the model originally supplied by Openreach to which Ofcom has made its own adjustments). As part of that exercise, Ofcom considered each of the key cost components and other key assumptions, and developed a range of estimated costs and associated charge structures - for each product – using its preferred measure of cost.

162. While Openreach welcomes Ofcom's detailed and "forensic" review of Openreach's costs and related model, we believe that a number of Ofcom's proposed revisions and/or assumptions are inappropriate, disproportionate or incorrectly estimated. This Section contains Openreach's review of Ofcom's cost modelling and other parameters, and sets out an indicative range of prices based on this analytical review of Ofcom's proposed approach.

163. For the purposes of modelling and the compilation of estimated price ceilings, Openreach has included some of the Ofcom cost assumptions. The inclusion of some of the Ofcom proposed assumptions or adjustments for modelling purposes is made below solely with a view to enabling effective comparisons to be made and to facilitate a more considered critique of the Ofcom proposed approach. The inclusion of some of the Ofcom proposed assumptions or adjustments for modelling purposes should not, however, be interpreted as acceptance of Ofcom's proposal. Indeed, we refer to our position on each of the Ofcom proposed assumptions and adjustments as set out in more detail elsewhere in this response (see in particular our response to Question 5.5).

2. Openreach's review of the Ofcom cost assumptions

164. Figure 7 below replicates the Ofcom analysis contained in Section 5 of the Second Consultation. The figure provides an overview of each of the Ofcom adjusted assumptions and cost components, and also Openreach's own proposal in respect of each of these components.

165. Where a difference in approach or assumptions has been used, a brief summary of the rationale for the Openreach proposal is set out below. More detail underpinning the reasoning for the inclusion of certain Ofcom assumptions, or amendments to previous Openreach assumptions is set in this response.

Figure 7: Cost assumptions

Component/Assumption	Openreach view in Response to First Consultation	Ofcom view in Second Consultation	Openreach view in this Response
Decline in Total Volumes between 2007-8 and 2012-13	-7%	-3.5%	No change proposed to Openreach's initial assessment (-7% or more)
Product mix	14m MPF lines in 2012/13 and loss of 7m SMPF lines	25% lower rate of migration to MPF than Openreach's estimates	Total MPF consumption 5.5-6m lines estimated 2012/13 based on updated data
Inflation	3% p.a.	3% p.a.	2% p.a.
Prospective efficiencies	1%	2% - 4%	2.5% per annum on tapered average basis[29]
Fault rates	0% reduction in fault rates	4% - 6%	No change proposed to Openreach's initial assessment
Cost reallocation	No costs reallocated	£49m - £98m	£46m
Group costs	Group costs included	Various adjustments proposed	No change proposed to Openreach's initial assessment
Pensions deficit costs	Contribution to pensions deficit costs included	Entirely discounted from the model	Contribution to pensions deficit costs included
Line cards	Recovery of line card costs based on number of	No adjustment proposed	No change proposed to Openreach's

29 Taking into account efficiencies brought forward in Q3 and anticipated in short term to cope with economic circumstances

	services provided		initial assessment
SLG payments	Efficient level of recovery estimated to be around £25m	Efficient level of recovery estimated to be between £5m and £9m	Efficient level of recovery estimated to be around £10-15m
LUS	LUS costs to be recovered	Costs discounted from the model as minimal and any costs to be absorbed by BT Retail	To be addressed as part of the upcoming USO review
RAV	Calculations included	No adjustment proposed	No change to Openreach's initial assessment
Line length	Methodology as per regulatory accounts	No adjustment proposed	No change to Openreach's initial assessment
WACC	12.1% or more	9.25% - 10.75%	12.1% for Openreach (based on CC methodology)
Dropwire costs	No adjustment of dropwire asset wires	Costs adjusted for assets pre-2005	Costs adjusted for assets pre-2005

Source: Comparison of Openreach response to First Consultation, Ofcom Second Consultation and Openreach response to Second Consultation

3. Indicative price ceilings (based on a review of Ofcom's cost modelling - CCA/FAC)

166. A recalculation of the respective cost stacks based on the above assumptions provides an indicative range of price ceilings. Taking into account Ofcom's proposed short-term duration for the charges, we set out below in Figure 8 revised proposed indicative prices for a period of 1 and 2 years only.

Figure 8: Indicative price ceilings

Service	***Ofcom proposal***	***Indicative price ceiling***
MPF	£85.00 to £91.00	£102.50
SMPF	£15.60 to £16.20	Unchanged
WLR Res	£100.68 to £104.40	£113.12
WLR Bus	£106.00 to £110.00	Unchanged

167. Openreach's critique of Ofcom cost modelling illustrates that, while Ofcom consider charge increases necessary, Ofcom's approach would underestimate the level of price increase required to meet Ofcom's objectives on, at least, MPF rentals and WLR Residential rentals.

168. In the case of WLR Business rental and SMPF rental, our analysis shows these are consistent with the current price ceilings.

169. In terms of the indicative price ceilings for MPF rentals and WLR Residential rentals, however, these are estimated to fall above Ofcom's proposed price range. While much of the difference in the indicative price ceilings and the prices originally proposed by Ofcom can of course be explained by reference to the use of different cost assumptions (e.g., forecast efficiency gains, pensions deficit, WACC) any remaining difference appears to be a result of Ofcom's proposed "glide path" over 4 years. It should be noted that Ofcom's projected "high" unit cost stack for MPF rentals in 2010/11 is ~ £98.00 – this is not much below the indicative price of £102.50 estimated for 2009/10.

170. Ofcom's preferred option for prices to converge to CCA based FAC only over a 4 year period (notwithstanding the shorter duration of the proposed charge controls), combined with its considerations on re-balancing and aggregate Openreach returns, precludes Openreach from recovering its efficiently incurred costs on MPF rentals and WLR Residential rentals throughout the 1 and 2 year periods of the relevant charge controls. For the reasons set out in more detail in Section 1 and elsewhere in this response Openreach disagrees with Ofcom's proposition and Ofcom's intended option for modification.

171. Given Ofcom's intention to now determine charges on a shorter (1 to 2 year) term basis, it is essential to implement an approach that enables cost recovery throughout the revised Ofcom time frames of 1 year on WLR and 2 years on LLU based on an immediate adjustment of prices, particularly given the significant misalignment of costs on MPF and WLR Residential relative to the other Openreach copper access services.

172. If the Openreach indicative price for MPF rentals and WLR Residential rentals were applied, it would:

a) allow for Openreach to recover its efficiently incurred costs on MPF rentals and WLR Residential rentals throughout the revised Ofcom timeframe (of 2 years and 1 year respectively); and

b) effectively re-balance the MPF and WLR prices such that "arbitrage" between MPF and SMPF+WLR is minimised and consequent economic distortion reduced.

173. Ofcom's decision to change from the 4 year charge control period (discussed in the First Consultation) to the 1 and 2 year charge controls in this consultation will not provide sufficient certainty and clarity on cost recovery, unless it is accompanied by an immediate price ceiling adjustment for MPF and WLR Residential.

174. In order to provide longer-term surety, it is important that Ofcom enables Openreach to fully recover efficiently incurred costs beyond the duration of these initial 1 to 2 year charge control periods. This principle should be the basis for the relevant upcoming WLR and LLU market reviews.

Section 3

Answers to Ofcom questions

175. This Section sets out Openreach's detailed responses to the questions asked by Ofcom in the Second Consultation.

QUESTION 2.1: Do you agree with the stated scope of the review in the context of the proposed market reviews for Fixed Narrowband Market Review and Wholesale Line Access? If not please provide your reasons.

Product scope

176. Openreach continues to believe that the key aim of Ofcom's review should be an examination of the Core Rental Services provided by Openreach (in other words the SMP key copper access products of MPF, SMPF and WLR, as well as related Ancillary Services).

177. When responding to Ofcom's First Consultation, Openreach was in agreement with the defined lists of products to be included within the scope of Ofcom's review.

178. Openreach continues to be in agreement with Ofcom over the scope of the product set to be included in the review and that Ofcom should take into account the costs of providing the Core Rental Services and Ancillary Services.

179. In addition, Openreach also suggested that it was preferable for any new price controls to cover a *basket* of related services for a particular product rather than being specifically applicable to an individual product/service.

180. A more detailed discussion on the appropriate structure of any basket-oriented control is set out in our response to Question 7.1.

181. We also asserted that in general, Ofcom's aim should be to minimise the regulatory burden over time and that price controls should not be extended beyond the products currently in existence.

Market Reviews and its impact on the duration of review

182. Openreach was of the view that any price controls implemented by Ofcom would cover a 4-year period, as stated by Ofcom in its First Consultation.

183. In its Second Consultation, Ofcom has proposed that the charge controls will only be fixed for a period of 1 year (for WLR) and 2 years (for LLU), in light of the forthcoming WLR and LLU market reviews.

184. Regardless of this, Ofcom continues to maintain that full cost recovery for Openreach can only be achieved at the end of a 4-year glide path.

185. Openreach considers this position to be untenable. Openreach considers that Ofcom's proposals for reduced charge control periods combined with a 4 year glide path for full cost recovery:

    a) do not enable Openreach to fully recover efficiently incurred costs throughout the 1 to 2 year period of the charge controls;

    b) do not provide the necessary incentives to maintain and invest in the copper access network; and

    c) do not provide the regulatory certainty which is so essential for both Openreach and industry.

186. As a result, Openreach considers that an immediate step increase in the price of MPF[30] and WLR Residential rentals is needed for the reasons set out earlier in this response.

QUESTION 2.2: Do you agree with the proposed objectives for this review? If not please provide your reasons.

187. In our response to Ofcom's First Consultation, we set out at Section 3 of our response our comments on the regulatory objectives and new pricing framework Ofcom had proposed.[31]

188. Openreach was broadly in agreement with Ofcom's objectives, while Openreach's alternatives focussed more particularly on the aims of this review.

30 Indexed in year 2 of the LLU charge control at RPI + X.

31 See: Section 3 (pages 11 – 19) of Openreach response to First Consultation.

We summarised our thoughts in the following Figure (reproduced below for convenience), which compared Ofcom's objectives with those proposed as an alternative by Openreach:

Ofcom's objectives	Openreach's objectives	Comments
Promote efficient, sustainable competition in the delivery of both broadband and traditional voice services	Ensure the regulatory framework incentivises and enables Openreach to respond to market demand and to invest and innovate in new and existing services.	Openreach considers efficient and sustainable competition to be one of the outcomes of providing the appropriate economic incentives – effective competition cannot be sustained absent the correct underlying price regulation across the Openreach SMP copper access portfolio. Openreach should be free to respond to market demand and have incentives to innovate and invest in new and existing services.
Prevent excessive charging and abuse of SMP by Openreach	To provide confidence to CPs that prices are not excessive and that Openreach is complying with its other existing SMP regulatory obligations.	Openreach agrees that the application of appropriate and proportionate regulatory remedies to the services under review (e.g. in the form of future-looking charge controls for SMP copper access and the other associated ancillary services) will help to underpin CP confidence. In addition, other non-price SMP regulatory remedies already in existence prohibit BT from partaking in other forms of abusive conduct.
Provide regulatory certainty for both Openreach and its customers.	Provide transparency and regulatory certainty to establish a stable, long-term regulatory framework for Openreach and our customers.	Regulatory certainty - including about what is to be regulated, and what is not to be regulated - is a pre-requisite not only for financial stability but also for investment and innovation, including by Openreach in services outside the set of core regulated services and for which market demand exists.
Ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred), including the cost of capital	Allow Openreach to immediately, and continuously throughout the charge control period, to fully recover its costs, including a return on capital employed in line with the cost of capital, across its regulated copper access portfolio throughout the charge control period.	Full cost recovery is vital if the copper access network is to be maintained and improved and so that Openreach can respond to market demand for new products and services.

189. In its Second Consultation, Ofcom has proposed the following revised objectives:

i. to promote efficient and sustainable competition in the delivery of both broadband and traditional voice services;

ii. to provide regulatory certainty for both Openreach and its customers and to avoid undue disruption;

iii. to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred), including the cost of capital; and

iv. to maintain incentives for Openreach to innovate and improve service quality.

190. Openreach's comments on Ofcom's objectives are as follows:

Openreach comments on Ofcom's first objective (to promote efficient and sustainable competition in the delivery of both broadband and traditional voice services) and on Ofcom's fourth objective (to maintain incentives for Openreach to innovate and improve service quality)

191. Openreach notes that Ofcom's first objective remains unchanged from the First Consultation. In its response to that consultation, Openreach had, as an alternative, suggested that the objective should be to ensure the regulatory framework incentivised and enabled Openreach to respond to market demand and invest and innovate in new and existing services. As a minor comment, we note that Openreach's LLU services are the building blocks for broadband services, but are not in and of themselves broadband services.

192. Openreach welcomes Ofcom's proposal to include a similar objective to that alternative proposed by Openreach as a new fourth objective in its list of objectives. It is vitally important to Openreach that a measured and proportionate regulatory regime exists to provide appropriate enduring certainty and confidence for Openreach to invest and innovate.

193. It is important to note that any outcomes which place Openreach in a position where it cannot fully recover its efficiently incurred appropriate costs would result in price levels which are not economic.

194. Section 88(1)(a) of the Communications Act 2003 stipulates that SMP conditions on prices can only be imposed if there is a risk of "adverse effects arising from price distortions" (and if other objectives are met – see subparagraph(b) of section 88(1)). It necessarily follows that any new charge control should avoid

setting prices at levels which would be uneconomic (by definition such price levels would not enable Openreach to fully recover costs incurred legitimately and efficiently) as to do otherwise would lead to market distortions, which the charge control is precisely intended to address.

195. Ofcom's approach of combining short term charge controls (over 1 or 2 years respectively) with a 4 year glide path will not enable Openreach to fully recover its costs throughout the charge control periods and we believe will lead to further market distortions. This means that to meet Ofcom's first objective of promoting efficient and sustainable competition, this includes addressing the current distortions in the market place. As a result, Ofcom's revised short term approach to charge controls means that it is only if this is accompanied by an immediate adjustment of the MPF rental and WLR Residential prices that Ofcom's first and fourth objectives can be met.

196. As noted in our response to Question 7.1, Ofcom's approach of combining complex proposed baskets with the imposition of sub-caps on certain services appears to Openreach to negate Ofcom's principles of flexibility and the ability for Openreach to align its charges with costs. Moreover, Ofcom's proposed imposition of sub-caps on certain products in addition to the generic constraint that prices for individual products within the basket can only flex by a small percentage will severely and unnecessarily restrict Openreach's ability to amend prices. Ofcom's current proposals to introduce sub-caps within the basket control will effectively set the current pricing in stone. As result, Ofcom's first and fourth objectives can only be met by removing the proposed sub-caps.

197. Therefore, Openreach believes Ofcom will only meet its stated first and fourth objectives for this review if it implements and immediate adjustment of the price ceilings for MPF and WLR Residential rentals, and by removing any sub-caps in proposed baskets.

Ofcom's second objective (to provide regulatory certainty for both Openreach and its customers and to avoid undue disruption)

198. Openreach maintains, as it did in its First Response, that any new pricing framework must provide transparency and clarity of policy to allow Openreach to earn a rate of return that includes its regulated cost of capital. With this in mind, Openreach welcomes the reference in this objective to providing regulatory certainty and reiterates the comments made in its First Response.

199. Openreach had indicated that it considered that the appropriate period for a charge control to give a desired level of regulatory certainty was 4 years. We note that Ofcom's approach is now to implement shorter (1 or 2 years respectively) charge controls, and refer to our comments in this response that a shorter charge control would necessarily need to be accompanied by an immediate adjustment of MPF and WLR Residential rentals.

200. As regards the new reference in Ofcom's second objective to avoiding "undue disruption", we assume that Ofcom is referring to the impact of any price increases on customers and on the market. We note that at present, the downstream market is distorted by the uneconomic price ceilings imposed on Openreach. Through our analysis of the customer and market impacts set out in paragraphs 143 onwards, we show that there will not be a material disruption of the market if price ceilings were increased to the levels proposed by Openreach.

201. Accordingly, Openreach believes that an immediate adjustment of the price ceilings for MPF and WLR Residential rentals is necessary to enable Ofcom to meet its second objective.

Ofcom's third objective (to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred), including the cost of capital)

202. Openreach notes that this objective remains unchanged from Ofcom's First Consultation. In response to that consultation, Openreach commented that full cost recovery is vital if the copper access network is to be maintained and invested in, and if customer service levels are to be improved. Going forward it is critical that Openreach is incentivised to invest in new products and services, is able to respond to customer demand, and through appropriate price levels, can send the correct economic investment signals to our customers.

203. It is important to note that Ofcom's objective in agreeing to accept BT's Undertakings in September 2005 was to create a *viable and sustainable* access services business. "Viable and sustainable" necessarily implies an ability to fully recover efficiently incurred costs and to invest in the future.

204. We refer to our comments in our response to Question 8.2. As noted above, Openreach considers that it is critical that it be enabled to immediately fully recover its relevant and efficiently incurred costs and therefore reach an economic price for its services. It is only when an economic price is reached that market distortions can be avoided or at least minimised.

205. We also draw Ofcom's attention to the consequences or "opportunity cost" of not enabling immediate price stability in paragraph 36, namely potentially jeopardising investment in existing services and in new services, with the consequence that proposed investment in new and wide-scale access technology may represent a very significant business risk for Openreach.

206. We refer to our comments in paragraphs 97 onwards on the effects on Openreach and its customers if the Ofcom proposed efficiency levels were required to be met, namely a material adverse impact on Openreach's ability to

meet the needs of its customers, maintain service levels and prevent fault rates from increasing.

207. In conclusion, we note that what Openreach is proposing is consistent with Ofcom's objectives, and that we consider that the only way for Ofcom to meet its objectives is to implement immediate adjustment of the MPF and WLR Residential price ceilings, removal of the proposed sub-caps in the baskets, and imposing reasonable and appropriate efficiency and fault rate targets.

208. Openreach welcomes Ofcom's removal of the proposed objective in its First Consultation which was to "Prevent excessive charging and abuse of SMP by Openreach", as this objective is already adequately addressed by other regulatory and legal mechanisms.

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?

QUESTION 3.2: How should we take account of these developments and future developments when developing our final proposals?

209. We answer Questions 3.1 and 3.2 together below.

Key developments have not changed

210. Broadly speaking, we consider that the developments we discussed in our response to the First Consultation have not fundamentally changed. In those areas where there have been changes since the First Consultation, those changes are not material. However, the worsening macroeconomic climate does have a greater downside risk for Openreach with respect to any volume/demand forecasts. None of this changes the need to address the market distortions resulting from Openreach's uneconomic prices, by implementing an immediate adjustment of the MPF and WLR Residential price ceilings.

211. Moreover:

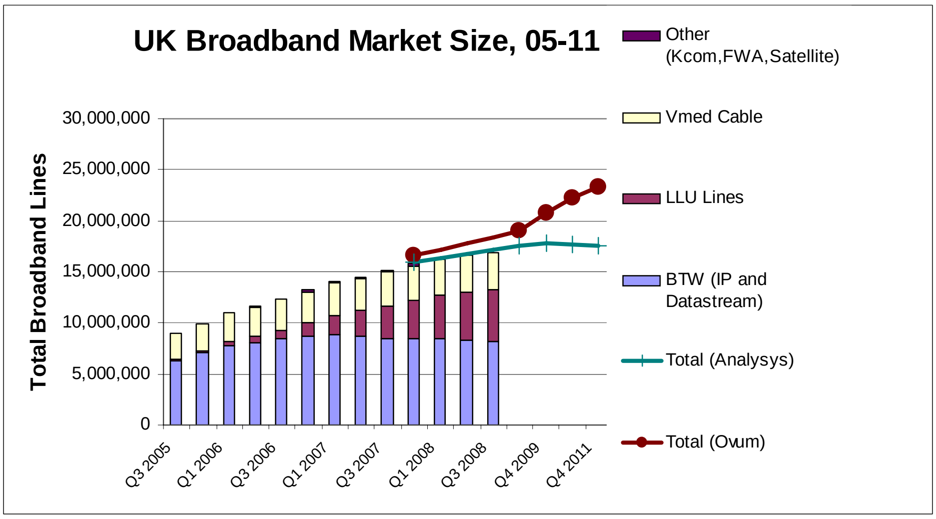
a) the creation of Openreach and the provision of services on an EOI basis continues to give our customers confidence to invest – see examples of Sky and Opal (see footnote 27) even though LLU rollout is approaching its economic limit of approximately 2,000 exchanges; and

b) there continues to be a threat to all fixed line business from alternative technologies such as mobile broadband and wireless technologies.

Continued growth of broadband

212. We expect the UK broadband market to continue to expand despite the worsening economic climate and this forecast is confirmed by many observers, as can be seen in Figure 9 below.

Figure 9: The UK Broadband Market will continue to grow

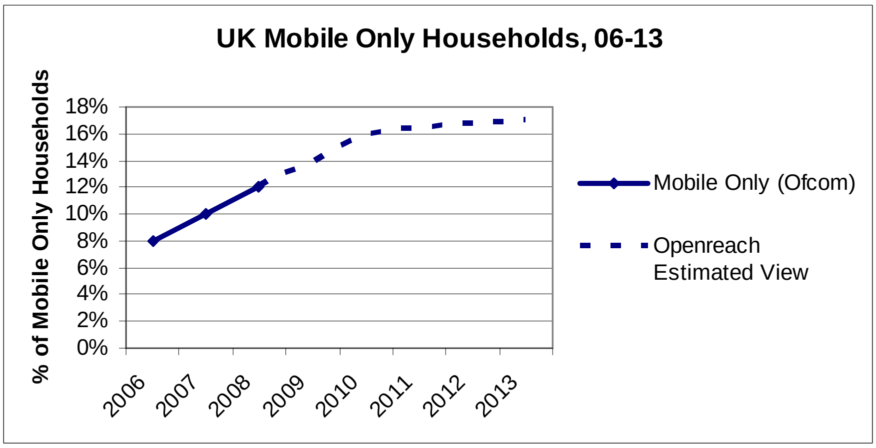


Sources: Openreach Internal Data; Virgin Media Quarterly Reports, Q3 05-Q3 08; Enders Analysis, Dec 08; Ovum, Dec 07; Analysys, Aug 08; BT Group KPIs Q2 08/09.

Mobile only households continue to increase

213. We also expect alternative technologies to gain an increasing hold, mobile only households for example will continue their increase in number. Openreach estimates that this growth will level off in the coming years, as can be seen in the figure below.

Figure 10: UK Mobile Only Households



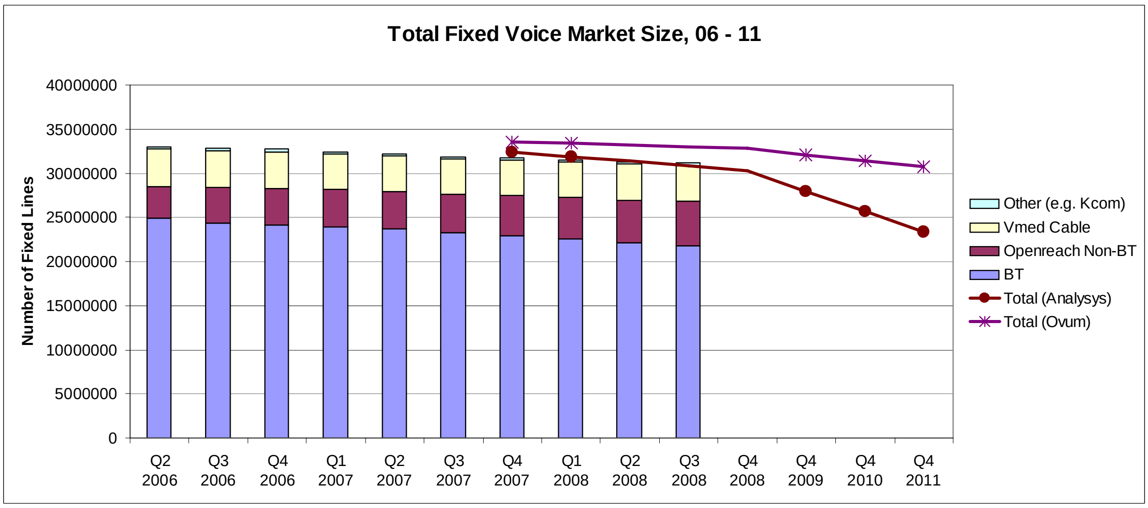
Source: Ofcom Nations & Regions, 06-08

New technologies are substituting fixed voice lines

214. This trend is confirmed by a generally accepted forecast reduction in the size of the UK Fixed Voice Market.

215. Both external analyst estimates and Openreach's own experience to date suggests a substantial reduction of the fixed line base, as is demonstrated in the figure below.

Figure 11: The Size of the UK Fixed Voice Market



Source: BT Quarterly KPIs Q2 08/09, Openreach Internal Data, Virgin Media Quarterly Reports Q2 06-Q3 08, Enders Analysis, Dec 08; Ovum Market Forecast, Dec 07; Analysys Market Forecast, Aug 08

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?

216. Openreach agrees that a review of historical financial performance is important to help inform any future financial assumptions. However, the basis on which this is done must be relevant to the scope of the review and consistent with accepted regulatory methods, and it is not always appropriate to mechanistically extrapolate from historical data on a linear basis (e.g. historical fault rate data or historical efficiency rates).

217. Ofcom's assessment of Openreach's historical financial performance is predicated on the inclusion of the entire Openreach business (see paragraph 4.12 in the Second Consultation). As a consequence, the financial data presented by Ofcom does not reflect a relevant basis upon which any future decisions can be made, given that the scope of this review is limited to the copper access portfolio.

218. Inclusion of products outside the portfolio defined for this review raises a number of concerns, including:

a) Openreach as a whole is not subject to a constraint on cost of capital of 10%;

b) the returns allowed for the non-copper products, such as Ethernet and ePPCs are higher (currently 11.4%); and

c) there are products that are not subjected to any SMP conditions, and therefore are not subject to constraints on regulatory return on capital.

219. In its Second Consultation, Ofcom frequently refers to both HCA and CCA based measures, when it is widely understood and accepted that CCA is the appropriate measure to employ in a determination of charge controls and related return on capital employed. See for example references to HCA in paragraph 4.12 and associated figure 4.1 in the Second Consultation but to CCA in paragraph 4.7 of the Second Consultation.

220. As Openreach as a whole is not subject to a constraint on cost of capital, the financial returns based on HCA that Ofcom refers to are neither directly relevant nor informative for their future decisions in relation to the pricing of a different, smaller product set namely the copper access portfolio.

221. Openreach does accept, however, that the assessment on the Core Rental Services has been done using the accepted methodology (CCA FAC), and Ofcom's conclusion that the charge ceilings need to be reviewed is welcomed.

222. Ultimately, Openreach believes that the final decisions for this review should be based on a clear and transparent set of principles relating to:

a) the estimation of the current and future level of costs for the products in scope of this review, that is, the regulated copper products on a CCA FAC basis;

b) the estimation of the level of risk inherent in the market and industry, and therefore the appropriate level of WACC; and

c) the anticipated levels of demand for the Core Rental Services.

QUESTION 5.1: With reference to Annex 11, what are your expectations for future levels of demand for fixed lines and the demand between MPF and WLR?

223. We answer Question 5.1 in five parts:

i) comments on Ofcom's approach;

ii) the key drivers of our overall demand for fixed copper lines;

iii) the current loss of lines experienced by Openreach;

iv) Openreach's latest assessment of the future level of demand for copper lines; and

v) Openreach's views on mix between MPF and WLR+SMPF.

224. As with our answers to Questions 3.1 and 3.2, our expectations for future levels of demand for fixed lines have not materially changed. In fact, the combination of lower new connections, mobile substitution and a generally weaker economy, means that Openreach's latest view of future demand for Core Rental Services is broadly the same in 2012/13 as in our response to the First Consultation, but slightly lower in the immediate years for 2009/10 and 2010/11.

First: Comments on Ofcom's approach

225. Openreach welcomes Ofcom's view that the volume of fixed lines is declining over time. However, it disagrees with Ofcom's assessment that the low end of a plausible range of the rate of decline would be half of Openreach's projection.

226. Openreach's response to the First Consultation (copper lines to reduce by 7% between 2007/08 and 2012/13) is based on customer substitution (to cable operations, wireless and mobile) and a slowing in the housing market (see our response to the First Consultation at both paragraph 2.5 and our response to Questions 4.1 and 6.7). These parameters have been modeled in the Openreach model provided to Ofcom.

227. In the Second Consultation Ofcom raises some doubt about the rate of substitution to mobile-only households (see A11.10-A11.11). However, Ofcom does not explain how its view of the rate of substitution to mobile-only households impacts upon the calculations of projected rate of decline of fixed lines set out in Openreach's model that it has provided to Ofcom, or the basis of Ofcom's estimated rate of decline.

228. Ofcom also states that its estimate of the low end of the range for rate of decline in fixed line volume (3.5%) is based on views of industry, telecom analysts and information gained from CPs and consumer surveys (see A11.13-A11.15 of the Second Consultation). However, Ofcom does not provide any detail as to:

a) what the industry views/analyst views are that it is relying on;

b) what the information gained from CPs is that it is relying on; or

c) what consumer surveys it relies on (or what these surveys ask and how they are conducted).

229. Furthermore, Ofcom does not explain how any of this information impacts upon the calculations of projected rate of decline set out in Openreach's model.

230. Further comments on Ofcom's approach in relation to the product mix are included below.

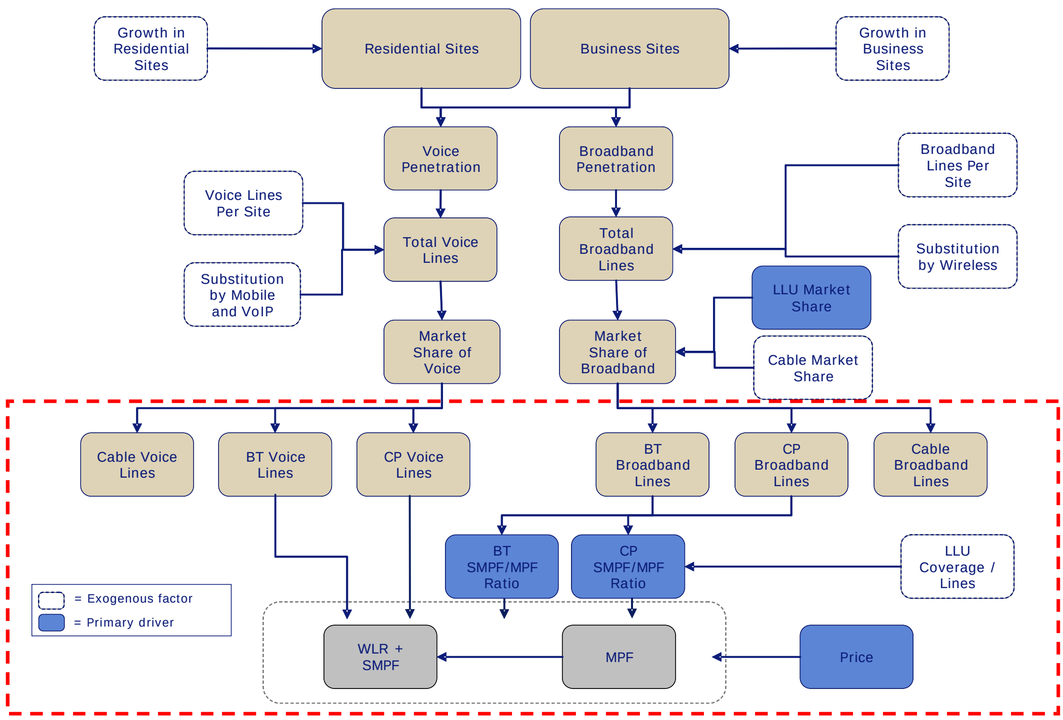
231. Openreach considers that its calculations are based on sound modelling and represent a sound projection for the decline in demand that it expects over the period. Ofcom has not explained why it considers that Openreach's calculations or model to be incorrect. Accordingly, Openreach considers that its volume projections should be used for the purposes of modeling costs and that the low end of the range provided by Ofcom should be disregarded.

Second: The key drivers of our overall demand for fixed copper lines

232. The basis on which our future levels of demand are forecasted is demonstrated in the process chart below (figure 12) below.

233. This process uses a variety of objective inputs and key drivers to determine what the expected levels of demand will be. We consider that this evidence-based process produces a considered approach to forecasting, and builds on our considerable knowledge and understanding of the relevant markets and market drivers.

Figure 12: Approach to forecasting overall demand for copper lines



Source: Openreach

234. In summary, the key drivers for Openreach's overall demand are:

a) general economic conditions, that is a slow down in new sites and increase in empty properties;

b) substitution by new technologies – e.g. mobile; and

c) substitution from cable.

235. We discuss each factor in turn.

(a) First driver: Downturn in new sites/housing

236. As we mentioned in the First Consultation, the new housing market is suffering due to financial constraints, property pricing and the general low level of confidence that has been widely evident in recent times. Major house builders are seeing short-term drops of up to 20% in sales when compared to 2007.[32] In addition, there are also significantly lower numbers of mortgage approvals for house purchases[33] (notwithstanding the low Bank of England interest rates) and actual home moves[34].

237. Economists and market commentators predict difficult overall housing market conditions until 2010, and Openreach's estimates take these conditions into consideration.[35]

238. To summarise Openreach's current views that feed into its forecast for copper lines:

a) Short term – lower demand due to price and availability of capital, impacts through 2009 (at least), Government stimulates demand with rent then buy scheme / social housing;

b) Mid term (i.e. 2010/11 to 2011/12)– More attractive pricing, reduced bottleneck with buyers (wider capital availability / savings for deposits) mean demand accelerates supply;

c) Longer term (by 2012/13) – Return to early / mid 2000s levels of build.

(b) Second driver: Mobile technology

239. We have described our views on the advent of mobile technology and Openreach's views in response to Question 3.1 above. Underlying trends reflect a continuing move from fixed lines to mobile technology and the growth in homes without fixed lines.

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32 As an example of demand, Redrow reported experienced a 49% drop in sales reservation in H2 08 vs. H2 07. These figures are similar for other operators in the sector (source: Redrow Homes, 24/2/09).

33 Also down 49% vs. 2007 (source: Council of Mortgage Lenders, 12/2/09).

34 Down by 51% vs. 2007 to 322k in 2008 (source: Council of Mortgage Lenders, 12/2/09).

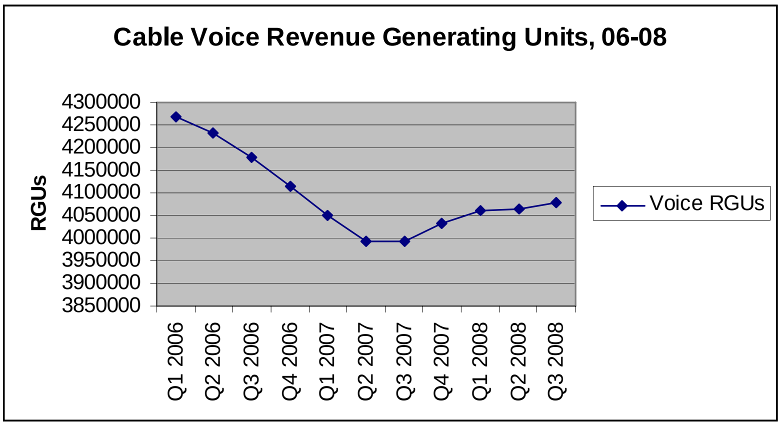
35 In December 2008, the Council of Mortgage Lenders suggested continued falls in market demand into 2010 (2009 forecast to see sales at circa 43% of those experienced in 2007).

(c) Third driver: Substitution to cable

240. Openreach previously estimated that there were more customers coming to copper from cable, than leaving copper to go to cable. Recent experience however suggests that this trend has reversed, as cable operators have markedly improved their service, offering and network reliability and have launched very aggressive customer acquisition marketing and promotional campaigns.

241. The figure below shows how cable voice revenue generating units have increased in 2008.

Figure 13: Cable voice is recovering



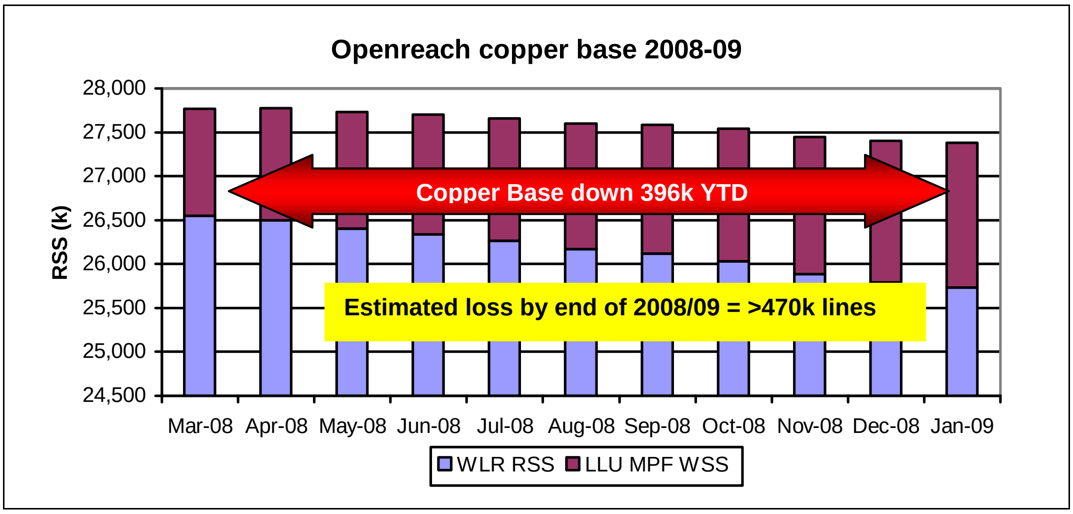
Source: Virgin Media Quarterly Reports, 06-08

242. Openreach estimates that the net loss of lines to cable will continue at current levels. Although the graph in Figure 13 suggests an increase in cable voice, we believe that some of this may be the result of end users moving between different cable offerings (e.g. an end-user upgrading from a double play bundle to a triple play bundle).

Third: The current loss of lines experienced by Openreach is the result of the combined effect of mobiles, cable and housing downturn

243. Openreach has experienced copper base reductions in 2008/09, as demonstrated in the figure below. By week 45 of 2008-9, the copper access working systems size has reduced dramatically (by 402K lines).

Figure 14: Copper base reduction in 2008/09

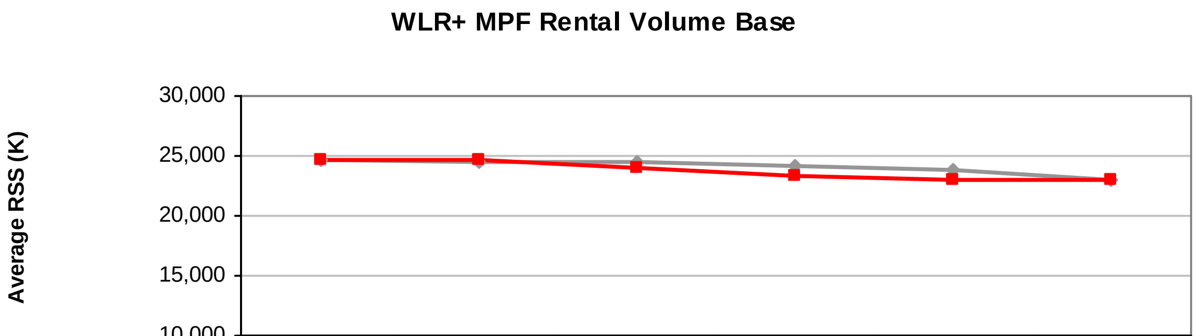


Source: Openreach Internal Analysis

Fourth: Openreach's latest assessment of the future level of demand for copper lines

244. Based on Openreach's latest analysis, the following figure demonstrates that Openreach's forecasts show a similar decline in overall copper lines by 2012/13, as presented in the Second Consultation. However, we now expect that the shape of the volume base to show a slightly steeper dip and aggregate loss of lines to come in between 2009 and 2011, with the 2012/13 figure being broadly consistent with our earlier estimates.

Figure 15: Latest view on Copper Rental Lines



	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
2nd Con Doc	24,709	24,538	24,521	24,176	23,770	23,049
Latest View	24,709	24,642	23,978	23,338	23,056	22,946

Source: Openreach internal analysis

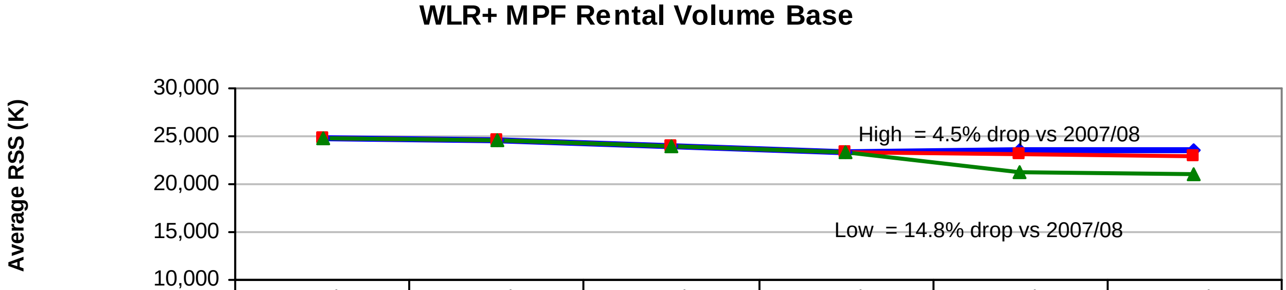
245. The volume drop from 2007/08 through to 2012/13 has not materially changed; it is still circa 7%, however 2009/10 and 2010/11 show lower volumes than previously estimated.

246. Ofcom has suggested that Openreach's estimate of volume loss is in the high end of a 'plausible range'. Ofcom has stated that their views are based on a combination of industry and analysts and CP surveys. The detail of these assessments has not been sufficiently explained in the Second Consultation.

247. Openreach maintains that its approach to estimating overall fixed line demand is based on robust principles and assumptions.

248. Therefore, Openreach strongly disagrees with Ofcom's assertion that a 7% drop is in the high end of a plausible range. In fact, the 7% decline over 4 years could be viewed as a mid case estimate.

Figure 16: Latest view on Copper Rental Lines



	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Optimistic	24,709	24,642	23,978	23,338	23,531	23,592
Latest View	24,709	24,642	23,978	23,338	23,056	22,946
Pessimistic	24,709	24,642	23,978	23,338	21,203	21,065

Source: Openreach internal analysis

249. As demonstrated in Figure16 above and based on our internal analysis, we believe that demand for fixed copper lines could decline by as much as 15%, when compared to 2007/08 levels.

250. As a result, Ofcom's assertion that the volume drop submitted by Openreach is at the high end of a plausible range is refuted by Openreach.

Fifth: Openreach's latest estimate on the demand mix between WLR and MPF

251. Openreach welcomes Ofcom's assessment that there is likely to be a significant switch in the mix in demand for copper products away from WLR/SMPF and towards MPF in the period to 2012/13. Ofcom has also accepted that this shift in demand will affect Openreach's finances as MPF makes a lower contribution to Openreach's fixed costs than a WLR/SMPF combination.

252. However, Openreach disagrees with Ofcom's assessment on the degree to which demand for MPF will increase. Openreach has provided demand forecasts based on our analysis of the markets and our customers' requirements (see our response to the First Consultation, response to Question 6.7). Ofcom does not dispute these factors in the Second Consultation.

253. Ofcom has raised a number of factors that lead it to a finding that the rate of migration of external demand to MPF should not be as high as suggested in the OTA2 survey (which predicts rates of migration higher than those forecast by Openreach) and could be around 25% below that suggested by Openreach. These factors are:

    a) caution in accepting forecasts of large increases in demand given that these increases are not yet committed;

    b) a degree of double counting;

    c) projections are based on current pricing levels and could therefore change, particularly as relative prices between WLR and MPF change – necessitating a cautious approach to projections of migration.

254. However, Ofcom does not explain why demand forecasts are affected by the fact that such demand is non-committed (and in particular, how this observation feeds into Ofcom's figure of 25% less migration than Openreach forecasts). Openreach's forecasts are aimed at projecting what level of, as yet, uncommitted demand it will face. Accordingly, it considers that the fact that this demand is not yet committed does not affect its projections. A general appeal to "caution" does not justify a departure from Openreach's views, which are based on modelled analysis.

255. In addition, Ofcom does not explain what the double counting is that it refers to in A11.19 of the Second Consultation or the level of double counting that it considers might have occurred. Moreover, Ofcom does not explain how any perceived double counting affects the forecast produced from Openreach's model. Although Ofcom raises a concern about the double-counting in its figures,

this should not lead Ofcom to discounting Openreach's figures (which we consider do not include any material double-counting) without further justification.

256. Ofcom has not explained how any potential change in prices might affect the projections provided by Openreach or exactly how it has derived the factor of 25%. For the reasons set out in paragraphs 143 onwards, we do not think that changes in the relative charges will have a material effect on demand for MPF.

257. For these reasons, Openreach considers that there is no reason why Ofcom should depart from the Openreach model in respect of the level of migration that will occur.

258. Furthermore, Openreach does not accept that BT migration should be treated as an internal transfer. As recognised by Ofcom (see paras A5.105 and A5.106, Second Consultation), the Undertakings require BT migrations to be implemented on an EOI basis. As noted above, demand by BT CPs of Openreach LLU and WLR products – on an EOI basis as required by the BT Undertakings – is and should be treated in the same way as demand by external CP customers.

259. Openreach has revised its views, when compared to the Second Consultation, on the total level of MPF demand for the years to 2012/13.

260. Previously, Openreach had estimated the take up of MPF by BT Wholesale, as inputs to its 21C products WVC and WBCC.[36] This consumption of MPF is no longer in Openreach's estimates to 2012/13. Consumption of MPF by other BT lines of business was estimated to be around 10.9m lines in 2012/13. Openreach's latest estimate for this is now less, at 0.4m, a drop of 10.5m lines.

261. Openreach has taken into consideration this latest view of MPF consumption in its price ceiling proposals. This also reflects increases in MPF demand from external CPs, e.g. Sky and Opal (see footnote 27).

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.

262. We refer to the comments provided in paragraphs 74 onwards and in Annex B.

36 See Consult21 Briefing C21-MG-015 of 15 January 2009 and "First System-X moves to 21CN" briefing of 23 January 2009

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.

263. We refer to the comments provided in paragraphs 93 onwards.

QUESTION 5.4: Do you have any comments on the absolute levels of costs or cost trends projected in Section 5 and Annexes 9 and 10?

264. Openreach is firmly of the view that the updated cost stack estimates it has most recently provided to Ofcom (and from which extracts are attached in Annex 9 of the Second Consultation) are reasonable and robust. While projections are of course not definitive, Openreach has taken into account what it believes to be a reasonable level of efficiently incurred costs.

265. Openreach's projections on the overall level of demand and demand mix for its regulated copper products reflect the most accurate and up-to-date views of the business at the time of submission. We discuss our views on the latest volume assumptions in detail in our response to Question 5.1.

266. The allocation of costs across the core copper products has been conducted on a basis which is consistent with the BT regulatory financial statements, which are agreed and accepted by external auditors and Ofcom. Indeed, Ofcom has noted that "Openreach's approach to its cost calculations appears to be logically sound".

267. However, as far as the overall trends are concerned, and prior to commenting on each of the individual assumptions, an overall explanation on the recoverable cost base is provided below. Specifically, we comment on the operating costs and the depreciation charges as presented in the Second Consultation.

268. Our response to Question 5.4 is focussed on why the Openreach costs are reasonable and the relationship with volumes; and why the increasing depreciation charges are reasonable.

i. Operating Costs (Opex)

Openreach's overall opex level is flat in nominal terms, and marginally declining in real terms

269. Openreach is forecasting maintaining Opex costs around the £3.5bn mark, despite inflationary pressures. The decline in real terms is a result of a combination of efficiency gains and the assumption that costs will decrease with volume declines.

Costs decrease with volumes

270. Openreach has a large number of fixed costs (such as network costs) and its "variable" costs are generally labour related. This forecast assumes an inherent level of efficiency and flexibility in managing the cost base partly on the basis of reducing volumes - which may be difficult to achieve in practice. Reducing variable costs effectively means reducing labour costs which would be both expensive and challenging.

271. It should also be noted that one of the principles being adopted by the forecasting model being used by Openreach is that the rental cost stacks, or indeed any cost stacks, will accurately reflect the costs of the activities of the business, e.g. fluctuating demand in FTE resource. Redundancy costs are only included when the scale of FTE reductions in any given year exceeds an assumed reasonable natural attrition rate (i.e. which includes normal "business as usual" departures from the business).

272. Openreach has carried out a detailed analysis of its costs, identifying which cost items are fixed and which are variable, and which items vary with volume movements. As a result of this analysis, Openreach considers that approximately 55% of its costs are variable, and these are mostly labour or labour related costs.

273. The forecasting principles adopted for this Financial Framework Review imply that any effects resulting from changes in demand/volume are factored into the model first, and that any efficiency measures are only applied in a second stage. This means that the efficiency measures reflect "pure" efficiencies, and not merely scale effects.

274. The impacts of applying further efficiencies on top of volume reductions is not discussed further in this part of the response, but can be seen in the figure below.

[CONFIDENTIAL FIGURE 1 CONTAINS OPENREACH BUSINESS SECRETS AND HAS BEEN REDACTED]

Source: Openreach Cost Forecast model

ii. Depreciation

275. Depreciation charges projected by Openreach form a significant part of the product cost stacks and, in relative terms, are also one of the faster growing cost lines.

276. The reasons for this increase are explained by Ofcom in paragraph 5.15 of the Second Consultation, however at an overall level, the following observations merit further explanations.

Depreciation will equal investment in the long run – but at the moment it is significantly below current investment levels

277. Openreach expects to spend circa £1.0bn in capex in the current financial year. It has done so consistently for the years preceding 2008/09. The current level of depreciation, at an HCA level, is well below £1.0bn, at circa £0.7bn.

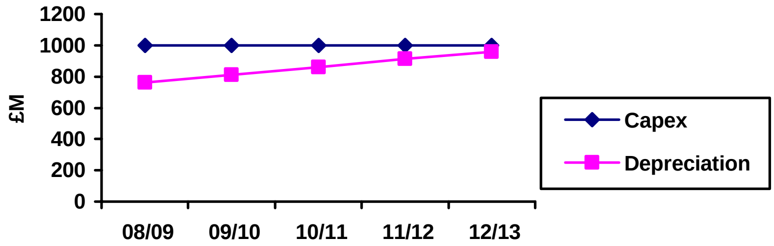
278. The reasons for a lower than normal level of depreciation are varied, but the most significant reasons are set out below.

   a) Firstly, the dropwire costs started being capitalised from 2000, and with an assumed 10-year life, are yet to reach their steady state level. There are another 2 years before the balance of the dropwire assets reach their assumed full steady state value.

   b) Secondly, there have been significant IT systems developments over the last two to three years to meet legal, regulatory and customer requirements, a proportion of which are therefore new assets, and as a result, current levels of depreciation costs being accounted for are rapidly rising due to these new assets.

279. If Openreach were to continue to invest in its network and systems at current levels, then it would be reasonable to expect depreciation to rapidly catch up to the £1.0bn mark. A graphical demonstration of this is given below in Figure 17, and also represents the underlying trend for Openreach, regardless of whether the accounting methodology is CCA or HCA.

Figure 17: An illustrative Capex versus Depreciation comparison



Source: Openreach internal estimate

Previous regulatory decisions had artificially lowered the value of assets, and this is now unwinding.

280. The regulatory statements revalue all assets on CCA basis using a Modern Equivalent Asset methodology (asset volumes *x* modern replacement cost).

281. However, for the purposes of price controls, Ofcom require BT to use a Regulatory Asset Valuation ("RAV") that only revalues assets installed since 1997, with pre-1997 assets carried forward at conventional accounting "book values" to 2005 and indexed using RPI thereafter.

282. This adjustment moves the costs from full CCA to the RAV. It represents a decrease in depreciation costs (compared to full CCA) and a decrease in holding gains (since fewer assets are being revalued on this basis).

283. As we move further away from 1997, the mix of pre-1997 assets naturally falls, and therefore the RAV values for MCE and Depreciation move closer to the full CCA value. This results in a faster increase in depreciation charges than one would expect to see.

284. The impact of the RAV adjustment is further addressed in our response to Question 5.5.

The underlying capital expenditure and depreciation charges are reasonable

285. As has been explained thus far, the key reasons for the depreciation charges accelerating at a significant rate are as a result of accounting and regulatory decisions.

286. The underlying capital expenditure programs and depreciation charges are reasonable.

287. As a result of lower volumes, the requirement for capital expenditure on the existing network will decline because of both gains made from efficiency, and also the inter-relationship between capital programs and decreasing volumes.

288. Therefore, while we discuss in further detail the specific elements of the cost forecast in our response to Question 5.5, it must be noted that on an overall basis, the cost forecasts, both at an Opex and depreciation level, are not unreasonable.

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.

289. We set out our responses on each of the assumptions highlighted by Ofcom in Section 5 and Annex 10 below.

290. Where we have responded to some assumptions as part of another question, we have referred to those sections.

291. Where relevant, we have summarised a revised set of parameters for the purposes of building an alternative price ceiling proposal to the one presented by Ofcom in the Second Consultation.

292. This alternative price ceiling proposal takes into account some assumptions that Ofcom have used in their modelling, and in other cases takes into account updates to some of the original Openreach assumptions.

1. Aggregate volumes

293. Openreach's detailed views on aggregate volumes are set out in the response to Question 5.1. The latest estimates of the overall demand for copper lines remain unchanged by 2012/13.

2. Change in Mix

294. Openreach's detailed views on the demand between WLR and MPF are set out in the response to Question 5.1. The initial views on MPF consumption by Rest of BT have been revised downwards by circa 10.5m lines in 2012/13. Openreach anticipates its overall demand for MPF to be circa 6m lines by 2012/13 taking into account both decreases and increases to various CPs' forecast consumption of MPF.

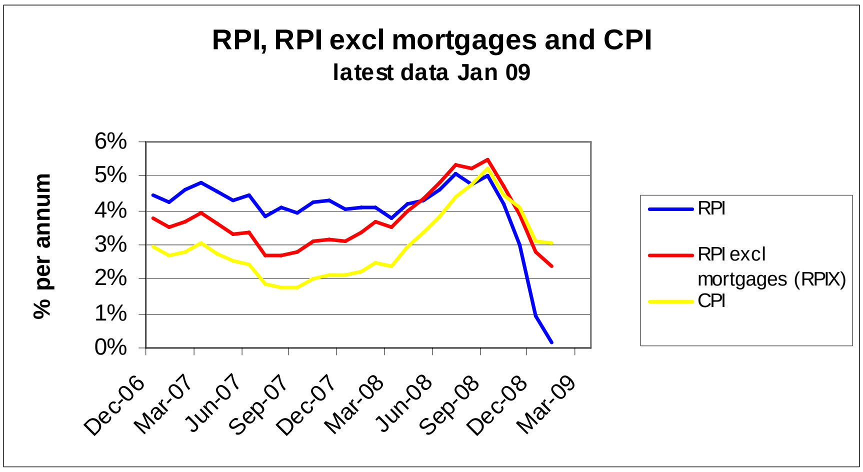
3. Inflation

295. Openreach welcomes Ofcom's acceptance in the Second Consultation of Openreach's view on inflation levels and Ofcom's assessment that, for the purposes of the model, Openreach's assessment of general inflation represents a reasonable assessment and should be used for the purposes of cost modelling.

296. As explained in our response to the First Consultation, Openreach's copper access business is susceptible to inflation, and it is necessary to understand the impacts of inflation movements, in particular given the current economic conditions.

297. Recent press coverage on inflation levels suggests that in 2009, RPI could become negative, and certainly has reduced significantly in recent months, as is demonstrated in Figure 18 below.

Figure 18: Recent inflation index trends



Source : Office of National Statistics, 2009

298. Openreach assumes RPI is the driver for nominal cost inflation, with pay costs increasing 1% in real terms. Asset inflation is calculated as 0.5% in real terms.

299. The impact of lower inflation on Openreach's cost base and therefore the relevant CCA FAC cost stacks for the Core Rental Services in 2009/10 is discussed further below.

300. There are two contrasting impacts on Openreach's cost base.

   a. First, the impact of lower inflation on the operating cost base is, as one would expect, to reduce these costs. For our modelling purposes, we have assumed that approximately 60% of Openreach's operating cost base is directly impacted by inflation. This assumption has been accepted by Ofcom as being reasonable (paragraph A10.25, Second Consultation).

   b. Secondly, there is a directly opposite impact of lower inflation on the value of the regulatory asset cost base which increases. As a result, a 1% drop in inflation adds costs to the net cost of "depreciation less holding gains", which outweigh the reduction in operating costs.

301. Openreach has taken a more considered view of the appropriate assumption to use over a reasonable period of probably 4 or more years so as to avoid the impacts of market volatility of the current estimates for RPI and the effects of significantly lowering RPI assumptions. Accordingly, for our modelling assumptions, Openreach is using an average RPI of circa 2% per annum.

302. The figure below summarises the assumptions used for the revised price ceiling proposal.

Figure 19: Openreach inflation assumptions used in its price ceiling proposal

	2008/09*	2009/10	2010/11
RPI	3.0%	2.0%	2.0%
Pay inflation**	4.0%	4.0%	3.0%
Asset inflation***	3.5%	3.0%	2.5%

* Original assumption
**Assuming previous year's RPI + 1%
*** Assuming 50/50 labour non labour mix of capital assets, and is the normalised index used for CCA valuation

303. In conclusion, Openreach expects that the appropriate long term view to take on RPI is now reduced to 2%, with the resulting pay and asset inflation figures adjusted accordingly (even though a lower inflation rate would lead to higher cost stacks).

Negative RPI

304. We are now entering an extraordinary economic period in which the RPI index may become negative, which would mean that nominal prices of the services subject to RPI indexed charge controls would be required to fall by the recorded decreases in retail prices.

305. Openreach believes that were RPI to be less than zero, the charge control should not include a negative value for RPI but that this value should instead default to zero. This would mean that the charge control in nominal terms would never be larger than X.

306. Openreach considers that this is justified because, as discussed above, our costs will not decrease in nominal terms even if inflation, as measured by the RPI is negative. Such costs include, for example, property rentals which have "upwards only" reviews and fixed rate capital financing of debt. Staff pay costs may also be difficult to reduce in nominal terms. In effect, because of the asymmetry which occurs when RPI is negative and not positive, a negative RPI is not a good measure of the nominal movement in costs.

307. If RPI becomes negative, these factors combine to make it far more difficult to meet any charge control formula, and at the same time maintain a fair return on capital employed. Were the charge control to be set on the basis suggested above (no negative RPI), this detrimental effect (which is clearly not intended by Ofcom) would be avoided.

4. Efficiency target

308. Openreach's detailed views on the appropriate efficiency target are set out in paragraphs 93 onwards.

309. Openreach believes that any application of efficiency over the next 4 years should be approximately 2.5% per annum (on a tapered basis). This is derived as follows: starting at 4% from 2009/10, then 3% in 2010/11, 2% in 2011/12, and 1% in 2012/13.

5. Fault rate reduction

310. Openreach's detailed views on the appropriate level of fault rate reductions is set out in paragraphs 119 onwards.

311. For our modelling, we continue to consider that a reasonable assumption is to keep fault rates flat over the duration of the charge control.

6. Cost Allocation

312. We refer to paragraphs 50 onwards.

313. Openreach considers that both the level of costs associated with products and the allocation of costs between non-regulated and regulated cost bases should be conducted on a more objective and considered basis, as is explained below. As explained below, Ofcom has not sufficiently explained its approach.

Engineering Services

314. TRCs, SFI and Other are broadly in one category of products which require engineering services to be performed that are otherwise outside of a normal rental or provision tariff. In general, these services are requested by Openreach's customers to fulfil additional work requests such as testing broadband health, excess construction, extended provision or non-network-fault related repair works.

Figure 20: Non Regulated Services - Engineering

Non Regulated Services	Revenue in 12/13	Openreach's view of apportioned Costs
TRC	100.0	
Other	35.0	
SFI	39.4	
Engineering services	**174.4**	**81.6**

Source: Openreach estimates

315. The costs added to these products as a whole is broadly representative of the hours spent by engineers performing these specific activities. Openreach therefore considers that no further costs should be allocated to this group of products.

Other Line Rental uses

316. Openreach's comments are:

a) **Redcare:** This constitutes the supply of copper lines to BT's Redcare division. Therefore, it should attract about the same amount of cost as a normal line rental. The appropriate EBIT margin could therefore be similar to a WLR line rental, which is currently around 20%, therefore the extra costs to be allocated could be up to 80% of the revenue base.

b) **Enhanced Care:** This product generates value to customers, and has costs associated with resource availability and service management. However, an assessment of direct costs in terms of cost stack analysis, driven in part by how cost stacks are constructed, makes this difficult to extrapolate further. Given the commercial nature of this product, Openreach should be allowed to price accordingly, and earn a commercial margin. With that in mind, we have included in the region of 50% of the revenue base as costs.

c) **Own Use:** At the time of the creation of Openreach as a separate line of business, an internal trade was set up to cover Openreach's costs in providing services to BT staff within BT buildings. The charge is calculated using Openreach standard prices.

The split of revenue between Copper Rentals and ePPCs are:
Copper = £14.6M (40%)
ePPCs = £20.4 M (60%)

The relevant cost allocation from the copper Core Rental Services should be limited to the appropriate proportion of copper costs (40%). The costs for the lines should be similar to those of a WLR line rental, and therefore the extra cost to be allocated could be up to 80% of the revenue base.

317. The following figure sets out Openreach's view on how much cost should be allocated from Core Rental Services to this group of products.

Figure 21: Non Regulated Services - Other line rental uses

Non Regulated Services	Revenue in 12/13	Openreach Cost Reallocation		
		Proposed Costs % of Revenue (as above)	Proportion of costs to be reallocated away from Core Rental Services	Openreach's view of apportioned Costs
Enhanced Care	40.0	50%	100%	20.0
Redcare	18.0	80%	100%	14.4
Own-use	35.0	80%	40%	11.2
Other Line Rental Uses	**93.0**	**--**	**--**	**45.6**

Source: Openreach internal analysis

318. In Openreach's view, the maximum possible cost reallocation is approximately £46m and we believe this should be attributed across Enhanced Care, Redcare and Own-use, in the proportions shown above.

319. For our modelling purposes in the revised price ceiling proposal, we have reallocated £50m from the Core Rental Services.

7. Group costs

Allocation of Group Overheads

320. Openreach considers that it has chosen the most appropriate method of allocation of costs in respect of all five of Ofcom's categories and agrees with Ofcom's conclusion that no changes are required to be made to the Openreach allocation.

Energy costs

321. Openreach has considered its assumptions around energy prices going forward and considers that this view is reasonable in light of information currently available. The increases shown by Openreach reflect the move from previously low charges to those more reflective of the current market. Openreach maintains that a £15m increase in energy costs for 2009/10 is reasonable because Openreach pays forward-looking contractually agreed prices, not prices based on more volatile (and sometimes lower) spot rates.

IT Costs

322. Ofcom has not accepted Openreach's estimates of future IT spend and, for its low case, has deducted 40% of Openreach's non-recurring spend from 2009/10 onwards. Ofcom's rationale is that Openreach has not provided a detailed list of projects to justify this level of ongoing spend.

a) Firstly, Openreach does not accept that its predictions in this respect are unreasonable. Openreach's discretionary IT spend is based on ongoing request for new products, enhancements and updates to existing products, as well as compliance with legal and regulatory requirements.

b) Every year, Openreach prioritises its pipeline of IT projects, and depending on affordability, capital and capacity constraints, determines which projects to continue. It is not feasible to have a detailed 4-year plan on IT projects, given the discretionary nature, the process of prioritisation and the timescales within which customer-driven systems developments typically occur. What needs to be acknowledged is that demand for enhancements, updates and new products rarely declines. This is why Openreach has submitted a flat forecast for IT capital spend from 2009/10 onwards.

c) Secondly, Ofcom have disallowed 40% of discretionary spend, based on 08/09 levels. This amounts to approximately £42m of capital spend (40% of £110m – paragraph A10.25, Second Consultation).

d) However, Ofcom also acknowledged (paragraphs A10.50) that Openreach has reduced its IT capex forecast by £35m in 2009/10 as compared to the 2008-9 actual level (the actual discretionary IT spend forecast submitted to Ofcom is £75m i.e. £110m minus the £35m we have already reduced – the £75m is the level on a going forward basis over the period of the charge control). This reduction, as submitted to Ofcom, relates to the discretionary spend.

e) Third, it is not clear to us on what basis Ofcom has set its 40% figure. We have not seen any rationale for this.

323. As a result, Openreach is not clear why Ofcom is proposing to make any adjustments from 2009/10 onwards given the discretionary IT capital spend was reduced by almost the same amount Ofcom asserted. Moreover, if any adjustment were to be made to the discretionary spend (which Openreach thinks would in any event be unreasonable for the reasons set out above), any such adjustment ought to be in relation to the correct figures not to the figures as used by Ofcom in its proposal (in this case, on the £75m after the reduction we have already made, and not on the £110m initially forecast).

324. For the reasons stated above, Openreach considers that its estimate is reasonable and should form the basis for IT cost allocation.

325. For our modelling purposes, we have not assumed any revisions to the previously submitted Group overheads or IT costs.

8. Pension costs

326. We refer to paragraphs 65 onwards and Annex A.

327. For our modelling purposes, we have assumed these costs are fully recovered.

9. Line Cards

328. Openreach welcomes Ofcom's conclusion that the line card allocations are reasonable and that Openreach's proposed approach is the appropriate methodology for recovering the costs of line cards.

10. SLG payments

329. Openreach welcomes Ofcom's assessment that Openreach's costs should allow for the level of SLG payments that would be expected to be incurred by an efficient operator. However, Ofcom has calculated a different figure to Openreach for the level of SLG payments that would apply to an efficient operator.

330. Openreach disagrees on the approach for implementing the target SLG levels. Openreach considers that it is reasonable for targets to be introduced over a glide path, with target payments decreasing to the level of an efficient operator over the period. Ofcom's approach focuses on the level of payments in the final year but it is not clear how this is phased in. Accordingly, Openreach considers that Ofcom's implementation of target SLG payments is not based on a reasonable approach.

331. Openreach's view is that the "efficient operator" benchmark, and the extent of recoverable costs, should be determined by reference to current actual metrics and Openreach's targeted service measures, many of which have already been presented to and agreed with industry. The recovery of SLGs costs would then be set relative to these measures. In the event that for certain services the actual metrics show that Openreach is already operating at the "efficient operator" benchmark, then that measure would continue to hold for the duration of the charge control. The level of allowable recovery must also take into account the fact that CPs purchasing products from Openreach suffer no effective contractual consequences for inaccurate forecasting or inaccurate provision of data.

332. Ofcom has not explained why Openreach's approach is unreasonable.

333. Openreach has revised its assumptions in relation to SLGs and considers that an efficient level of costs is circa £10-15m per annum.

334. For our modelling purposes, we have used £10m as an appropriate level of costs to be recovered.

11. Light User Scheme

335. Ofcom proposes to remove the cost of supporting the Light User Scheme ("LUS") — the product used to help underpin the Universal Service Obligation ("USO") — from the Openreach cost stack.

336. Ofcom bases its proposals on what Openreach considers to be an incorrect assumption – namely that the net cost of the USO is relatively small.

337. In particular, Openreach does not consider that it should simply absorb the cost of the LUS going forward, and that this should be shared across UK CPs. Ofcom needs to give due consideration to how and where LUS costs will fairly be recovered, and we would suggest that this should be addressed as part of Ofcom's upcoming USO review.

338. We acknowledge that Ofcom has disallowed the recovery of LUS from the regulatory cost stacks presented in BT's 2007/08 regulatory financial statements. Therefore, for our modelling purposes, to be consistent with the RFS, we have excluded the costs of LUS.

12. RAV

339. Openreach takes note of Ofcom's decision to accept Openreach's calculations for RAV.

340. As has been widely noted by Ofcom and in our response to the First Consultation and to this consultation, the RAV adjustment continues to unwind, and is a major driver for both increasing depreciation costs and asset-based cost movements against certain assumptions.

341. Further explanations are provided as part of our response to question 5.4 and above in response to the latest views on inflation.

13. Dropwires

342. Openreach takes note of Ofcom's adoption of the dropwire adjustment based on our estimates and Openreach's proposed approach on the amount of dropwire costs that should be included in the cost assessment based on applying appropriate accounting treatment to these assets according to the period in which expenditure was incurred.

343. For our modelling purposes, Openreach has adjusted dropwire costs in line with our original proposal to Ofcom.

14. Line Length

344. In Figure 5.4 (Annex 10 of the Consultation), Ofcom concludes (see "Line Length Adjustment") that Openreach's approach to line length adjustment "provides a reasonable basis for determining the line length adjustment." Accordingly, no additional line length adjustment is proposed by Ofcom.

345. We refer to our response to Question 6.6 from the First Consultation for further details on our original proposal.

346. For our modelling purposes, we have not made any further adjustments to line lengths at this point in time.

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 views on the most appropriate approach.

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.

347. We combine our answers to Questions 6.1 and 6.2 below.

348. Ofcom has presented an extensive description of the considerations which might be taken into account in the setting of new MPF charges. We have summarised below what we understand the main conclusions of this assessment to be.

349. First, the Ofcom assessment provides strong support for CCA FAC, as long as these costs are efficiently incurred, as the basis of wholesale charges. This is because:

a) CCA FAC is a widely understood concept and has been the anchor for many previous price controls;[37]

b) CCA FAC is based on public data and which has been reconciled to the audited regulatory financial statements;[38]

c) in terms of 'static efficiency', charges set in line with costs consistently across the portfolio avoid creating competitive distortions (e.g. as between WLR and SMP-based competition and MPF-based competition), nor do they encourage the use of a higher cost resource over a lower one;[39] and

d) a fully cost-reflective MPF charge ensures that competition is not founded on special protection for a particular type of entrant and hence is likely to be better for 'dynamic efficiency'.[40]

350. Ofcom also notes that the alternative of LRIC+EPMU is not conceptually superior to CCA and is less practical and transparent.[41] Given the difficulties in applying "Ramsey prices" for services in the Openreach product set (on which we have commented before), and the shortcoming of HCA approaches, we consider that CCA FAC must be the right cost standard for MPF prices.

351. Ofcom's conclusions summarised in the bullets above also point to the implementation of a CCA FAC charge without delay. However, Ofcom also stresses that it attaches high importance to the need to avoid taking steps which have the potential to undermine investment incentives, and that making a step

[37] Paragraph 6.7 of the Second Consultation

[38] Paragraph 6.7 of the Second Consultation

[39] Paragraph 6.38 of the Second Consultation

[40] Paragraph 6.44 of the Second Consultation

[41] Paragraph 6.12 of the Second Consultation

change in the MPF rental to its CCA FAC level might have such an effect. This is set out for example in paragraph 6.47:

> *"In particular, it is important to avoid a situation in which changes in regulation undermine the viability of investments previously made partly in response to the regulatory regime. The need to provide investors with a stable regulatory background is an important consideration. In Ofcom's view this means we should give weight to how we have set charges in the past, and to stakeholders' reasonable expectations for charges in the future. It also argues for avoiding excessive volatility in pricing. This would tend to argue for any increase in prices necessary to achieve full cost recovery to be smoothed so as to allow investors' reasonable expectations about the regulatory regime to be realised. The need for regulatory certainty, therefore, tends to provide support for a CCA FAC basis for determining charges in the longer term, but with any increase being phased in gradually."*

352. This is, in effect, largely a description of the regulatory "hold-up" problem, in which the regulator can be tempted by short term benefits to change the basis of charges (usually in lowering mandatory rates) after suppliers have sunk investments. For example, as long as charges are above avoidable costs, it will still be worthwhile for a supplier to provide services even if it is no longer covering its sunk costs. This is sometimes described as a 'hold-up' on the basis that the change was unanticipated and, had it been known (or expected) at the outset, then the sunk investment would not have been made in the first place.

353. Second, whilst the action looks to be costless to the regulator – the sunk investment cannot be removed and services will still be supplied – this is only true in the short term. This is because, having been subject to a 'hold-up' once, investors will be far more cautious in future and thus further investment in sunk assets is likely to be reduced. As a result, investment incentives are damaged by opportunistic or inconsistent regulation.

354. In the context of MPF charges, Ofcom states that this implies that actions should not be taken which would (i) have a significant impact on the returns expected by CPs at the time their investments were made or (ii) that would represent a departure from previous regulatory practice.[42] This leads Ofcom to conclude that charges should be brought into line with CCA FAC (as long as these are at efficiently incurred levels) but only after 4 years.

[42] Paragraphs 6.54 and 6.55 of the Second Consultation

355. Openreach fully supports Ofcom in building a regulatory regime in which infrastructure investors can have confidence, including Openreach in relation to NGA. We accept that this implies stability needs to be at the heart of the regime. Where Openreach fundamentally disagrees with Ofcom is that we do not believe MPF charges set in line with efficiently-incurred costs would either represent a departure from previous regulatory practice or significantly impact CPs relative to their reasonable expectations in 2006.[43] Put simply, for the reasons given below, a stable regime is *consistent* with one which authorises immediate - or near immediate - increases in the MPF charge to the CCA FAC level.

A move to CCA FAC in 2009/10 is consistent with reasonable expectations in 2006

356. The impression given in the Second Consultation is that a material increase in the MPF charge might be viewed (by purchasers of MPF) as representing Ofcom behaving in an unpredictable way and that this would damage investment. This is based on the supposition that, "[b]ased on this past behaviour, the most reasonable expectation may therefore be for Ofcom to set the MPF charge ceiling on the basis of a glide path so as to reach the FAC level at the end of the control period."[44]

357. Ofcom is not specific as to past actions to which it refers, but certainly it is true that at the end of one charge control regime Ofcom usually (there have been exceptions) avoids imposing one-off price reductions. However, the current situation is not one which is at the end of one price control regime and moving to a subsequent price control. Instead, Ofcom is introducing a new price control of defined duration to replace a determined charge (which was not set for a defined duration). Moreover, given how low the initial price was, industry should have expected to move towards a more economic path and faster given the shorter (1 to 2 year) periods of the proposed charge control.

358. In ensuring consistency, consideration must be given to the past actions which are most relevant. Ofcom, perhaps understandably, is thinking in terms of consistency with price caps, because this type of control is the likely outcome of the current review. However, what is relevant are expectations of regulation when the investments were made. This being the case, BT's belief is that the right reference is the November 2005 Statement[45] in which Ofcom set the current

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[43] 2006/7 is relevant as Ofcom has focussed on investments made in 2006/7 these representing a considerable proportion of total LLU investments – see A5.127 of the Second Consultation.

[44] See paragraph A5.112 of the Second Consultation

[45] "Local loop unbundling: setting the fully unbundled charge ceiling and minor amendment to SMO conditions". Ofcom, 30 November 2005.

MPF rental charge. This ought to have been the prime document for MPF purchasers to base their expectations of future regulation of this product.

359. It is quite clear from the 2005 Statement that Ofcom used CCA FAC as the basis for setting the MPF charge in 2005,[46] and this is therefore the past action to which Ofcom should give weight. In fact, the content of the Statement is almost entirely concerned with cost adjustments to ensure the CCA FAC charge was based on efficiently-incurred costs.

360. The 2005 Statement has very little explanation about Ofcom's likely approach in the future. There was a discussion about the possible use of a charge control rather than a single ceiling being set, but Ofcom did not think there was sufficient information to set a sufficiently robust charge (in other words, that the future level of unit costs was not clear to Ofcom at the time).[47] In effect, the regime introduced in 2005 was of a determined price which would be re-determined at some time in the future, and when Ofcom said it would also consider possibly using a price control. There is no discussion at all as to whether, if a price control was used in future, there might be reasons not to start any control from CCA FAC.

361. The expectations which purchasers might reasonably have made is that the same approach as that in 2005 would be followed when the charge was re-determined, not that a price control with a glide path would be introduced. A move to CCA FAC in 2009/10 is therefore not inconsistent with previous regulatory practice. In terms of predictability, there is no reason to consider that a 4-year price control with a glide path would have appeared more likely (in 2006) than a re-determined cost.

362. The second plank of Ofcom's concern about a one-off increase in MPF charges is that it would cause commercial harm CPs who use MPF as a key input. (There is no 'hold-up' if no harm is done). Ofcom's quantification of the effects, however, suggests otherwise with LLU operator costs increasing by an estimated 1.8% under Ofcom's "Immediate rebalancing" scenario.[48] Ofcom suggest that such a cost increase, although appearing modest is, likely to be material given that broadband margins are very tight.

46 Paragraph 3.10, "Local loop unbundling: setting the fully unbundled charge ceiling and minor amendment to SMO conditions" - FA6 and FB6. Ofcom, 30 November 2005.

47 Paragraph 3.17, "Local loop unbundling: setting the fully unbundled charge ceiling and minor amendment to SMO conditions" - FA6 and FB6. Ofcom, 30 November 2005

48 Figure A5.9 of the Second Consultation. The 1.8% is net of announced BES prices.

363. In fact, margins are likely to be tight primarily because of the large reduction in retail charges over the last 2-3 years which is due itself to the strength of competition in the market.[49] In such circumstances, a relatively small increase in the price of an essential input need not have any impact on margins as it is likely to be passed through to customers (in the same way as are higher commodity prices).

364. Nor need such increases be large – assuming full pass-through, our proposed immediate adjustment of the MPF rental price would add, for example, approximately 2.5% to the lowest cost broadband option from Sky and about 4% to that of Talk Talk.[50] Average price rises would be lower, but even these maximum increases are significantly less than the real terms reduction in the MPF rental since the charge was fixed in nominal terms in late 2005. Were such price increases to occur, and margins be protected, a move to CCA FAC in 2009/10 would not undermine CPs' profitability at all, and it is difficult to see how there could be anything other than the most minimal impact on investment incentives.

365. More generally, we refer to our analysis of customer and market impacts at paragraphs 143 onwards which demonstrate that an immediate adjustment of MPF and WLR Residential rental price ceilings would not have a material adverse impact on customers or markets.

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.

366. With respect to Ancillary Services, we do not consider that Ofcom's proposals meet the stated objectives of being easy to understand and straightforward to implement.

a) Openreach believes that Ofcom's proposals will restrain any rebalancing of prices and institutionalise business models built on uneconomic charges.

49 The two largest non-BT customers of LLU have in fact both introduced 'free' broadband services, which does not make tight margins particularly surprising.

50 Based on retail prices as at June 2008, reported in 'The Communications Market 2008', Ofcom, Figure 5.58.

b) Openreach's preferred alternative approach is for a single larger basket incorporating all non-Core Rental Services[51] (i.e. all Ancillary Services relating to MPF, SMPF and WLR), without any sub-caps or individual constraints, and a separate Co-Mingling basket.

c) We believe Openreach's alternative is necessary in order that Openreach is properly able to meet its customers' expectations and demand.

367. Our response to Question 7.1 is structured as follows:

(i) Openreach's proposals in our response to the First Consultation

(ii) Ofcom's proposals in the Second Consultation

(iii) Openreach's views on Ofcom's proposals

(iv) Openreach's proposed alternatives

(i) Openreach's proposals in our response to the First Consultation

368. In response to the First Consultation, we suggested that the best way of allowing Openreach to respond to market demand and maintain competitive pricing was to group together related services into a basket to which a price control would then be applied. As stated in response to Questions 8.2 and 8.3 of the First Consultation, this would provide flexibility within each basket to adjust prices in response to market demands, subject to the overall price cap and cost orientation obligations.

369. We suggested that the most appropriate way of doing this was to group together into single baskets each of the Core Rental Services, together with other SMP products that CPs need to purchase from Openreach in conjunction with those services.

370. We accordingly proposed separate baskets for MPF, SMPF and WLR, each comprising rentals and connections together with certain SMP ancillary services CPs need to buy from Openreach. We also proposed a separate basket for co-mingling products.

(ii) Ofcom's proposals in Second Consultation

371. Openreach welcomes Ofcom's comments at paragraph 7.12 of the Second Consultation that a basket approach "…allows for more flexibility so individual

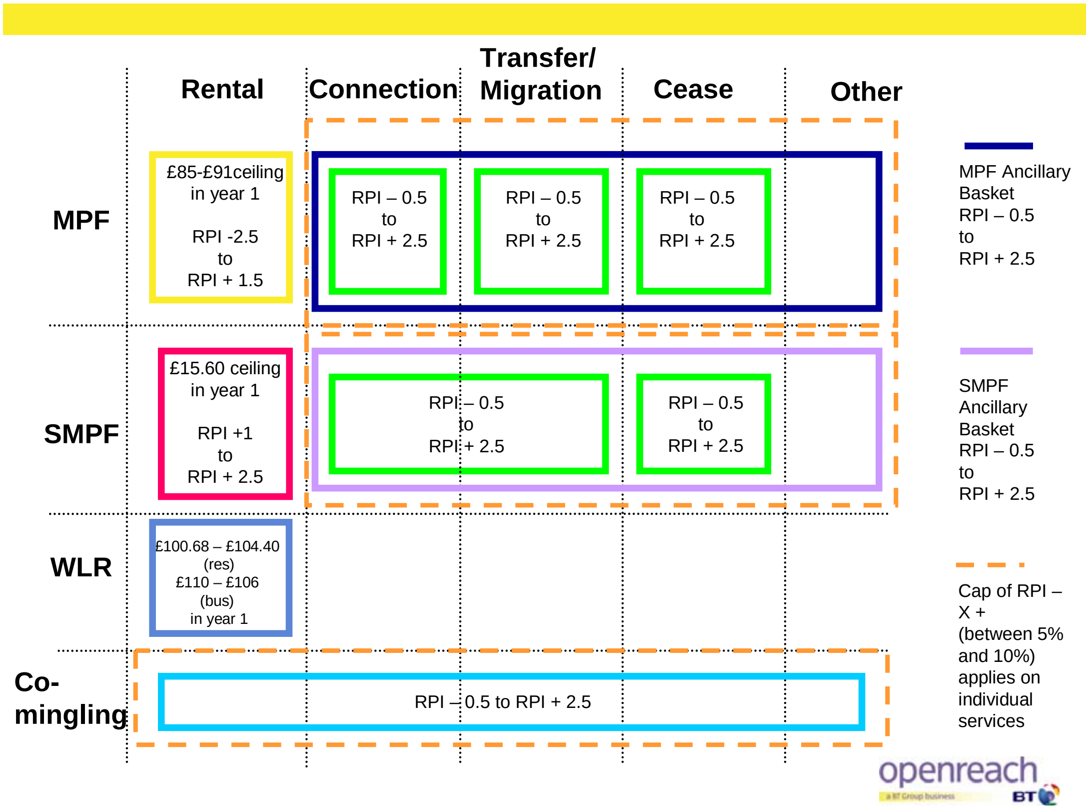
51 "Core Rental Services" as defined in the Second Consultation

charges can reflect cost and demand changes, and can also provide incentives to recover common costs efficiently".

372. Paragraph 7.23 of the Second Consultation indicates: "Specifically, we propose that in any year no price can change at a rate that is a defined percentage above or below the average rate that is allowed for the basket overall. We propose that the percentage 'sub caps' should be between 5% and 10% (so, for example, if the basket control allows average increases of RPI + 0, and the sub-cap is 5% no individual price can move by a rate that falls outside of the range between RPI +/- 5%."

373. We have interpreted Ofcom's proposal as set out below. In particular, the Figure below depicts Ofcom's proposals across all of the relevant Openreach products and services encapsulated in this review.

Figure 22: Ofcom's pricing proposals in the Second Consultation



374. The dotted beige lines reflect constraints. The green solid lines reflect sub-caps. The solid yellow, red, light blue, dark blue, turquoise and violet lines reflect individual baskets.

375. Outside of the Core Rental Services baskets, Ofcom's proposals include three sets of controls of the product prices within the baskets:

a. A series of "sub-caps" (of RPI –0.5% to +2/5%) on some individual Ancillary Services within the proposed baskets, notably on MPF transfers, new provide and cease charges and SMPF transfer and cease charges;

b. A cap on each individual basket (also of RPI -0.5% to +2.5%) and

c. An additional constraint on the movement of the price of any individual product within a given basket by more than +/- 5% to 10% compared to the controlling percentage.

(iii) Openreach's views on the Ofcom proposals

376. Openreach's primary objective is to reach economic prices for its key products and, as a result, to enable Openreach to fully recover efficiently incurred costs. This is also one of Ofcom's stated objectives. There are a number of ways in which this objective can be met. Our comments on Ofcom's proposals and our alternative proposals should be assessed against this primary objective.

377. Openreach welcomes Ofcom's proposal to have charge control baskets in relation to Ancillary Services for MPF, SMPF and Co-mingling, but it is the shape and structure of those baskets on which we have some comments (see paragraphs 385 to 395).

378. Basket controls should be bound by measures that, as Ofcom has said, strike the correct balance between allowing enough flexibility for rebalancing and commercial innovation to take place while ensuring appropriate control to prevent abuse of that flexibility.

379. It is Openreach's belief that Ofcom's proposals are imbalanced towards control and do not allow meaningful flexibility. For example, by not placing any rental products in the basket, the ability for Openreach to reset the prices of any of the smaller products, in terms of the controlled revenue, is much more limited.

380. Indeed, Ofcom's proposals do not just propose a limit on the products in each basket but instead propose a series of "sub-caps" on some individual Ancillary Services within the proposed three large baskets for Ancillary Services (relating to MPF, SMPF and Co-Mingling respectively) with price caps, plus five sub-caps.

381. We note that Ofcom indicates at paragraph 7.4 of the Second Consultation that any regulations should: (i) be easy to understand and straightforward to implement; (ii) contribute to efficiency in service provision; and (iii) ensure that controls cannot be manipulated by Openreach in a way that puts other CPs at a disadvantage.

382. We think Ofcom's current proposals fail on the first two tests:

a) We do not think that Ofcom's proposals are easy to understand or straightforward to implement; conversely we believe that the Openreach proposals are significantly easier to understand and implement.

b) Similarly, Openreach's proposals will go some way to achieving Ofcom's second principle of contributing to efficiency in service provision. We are not convinced that Ofcom's proposal will achieve this goal, as it makes rebalancing impossible.

383. With respect to Openreach being able to manipulate the controls, we consider that Ofcom's proposals are excessively restrictive – and therefore disproportionate - and set at the wrong levels. We consider that Openreach's proposed controls meet the other two tests, while still being subject to appropriate oversight by Ofcom to prevent abuse.

384. Our specific comments are as follows:

(a) Shape of the baskets

385. Openreach's original proposal included broader baskets. As mentioned above, it is critical that baskets be defined in such a way as to enable sufficient flexibility for rebalancing and commercial innovation to take place (albeit subject to sufficient control to prevent abuse of the controls). The aim of including both rentals and connections/migrations within each basket was to enable flexibility to rebalance prices.

386. As the volumes of the products in the Ofcom proposed baskets are different, any small change in price in a high volume product will need similar opposite changes in price for other high volume products or large price changes to small volume products to enable the overall basket to be balanced.

387. This is because if you have one high volume/high revenue generating product for which you want to increase – or decrease – the price by say 5%, you would need to decrease (or, as the case may be, increase) the overall revenue generated by the rest of basket to compensate for that 5% change. However, if all of the other products in the basket generate significantly lower revenues, then it may not actually be possible to rebalance their prices to compensate for the hypothetical 5% change. In these circumstances, Openreach would be prevented from aligning its prices more closely with its underlying costs.

388. Ofcom's proposed baskets each include only one product which, by virtue of its volumes, attracts a large proportion of revenue in that basket:

a) For MPF : migrations

b) For SMPF: migrations

c) For WLR: connections

389. It is only if the price cap range on each basket was broader that you would be able (using the example above) to compensate for a hypothetical price change of +/-5% in the largest revenue generating product in the basket.

390. As a result, we consider that the baskets as currently shaped would not enable Openreach to adjust prices so that they are fully cost oriented within the time period of the charge controls.

(b) Sub-Caps

391. Ofcom has proposed sub-caps on the "high volume" products within each basket. Most products that are not subject to a sub-cap are low volume products. The Ofcom-proposed sub-caps apply to MPF transfer, new provide and cease charges and SMPF transfer and cease charges, at the same level as the controlling percentage for their respective baskets.

392. The effect of this is *de facto* to remove any ability on Openreach's part to increase or decrease these prices relative to the other products in the basket.

393. This has the following effect.

a) to rebalance prices across the portfolio would mean that some prices would need to rise relative to the other products and some would need to fall; and

b) as the volumes of the products in the baskets are different, any small change in price in a high volume product will need similar opposite changes in price for other high volume products or large price changes to small volume products to enable the overall basket to be balanced.

394. We believe that this approach will restrain activity to align prices with underlying costs; something that would be especially the case for a short-term charge control period because only very small percentage changes in prices will be possible each year under the sub-cap.

395. A good example of the combined effect of the baskets as they are currently shaped, plus a price cap on the basket, combined with sub-caps, is set out in the chart below.

Figure 23: Illustrative worked example of Ofcom's proposal

CP = Controlling percentage RPI + "X"	Existing Price	Existing Cost *	Existing Revenue	RPI + "X" basket Controlling Percentage	RPI + "X" Sub cap	Ideal Revised Price	Ideal Revised revenue	Status under Ofcom proposal	Controlled Price	Controlled revenue
Product "A" priced too low	20	40	2,000	2%	2%	22.4 (10% increase above Controlling Percentage)	2,240	Not allowed due to Sub Cap	20.4 (Controlling Percentage -2% increase)	2,040
Product "B" priced too high	100	60	1,000	2%		82 (18% decrease)	820	Not allowed due to price change control	102 No reduction possible because of need to maintain overall revenues	1,020
Total			3,000				3,060 **			3,060 ***

* Suggests Price increase to Product "A" and decrease to product "B"
** Overall Revenue increased by Controlling Percentage
*** As Product "A" price rise is capped at +2% there is no scope to reduce Product "B" price without

396. Openreach is of the view that the combination of the basket control combined with individual sub-caps and the additional control of price movements, significantly reduces any scope for any rebalancing of product price to costs. Indeed, Ofcom's proposals mean that such rebalancing is likely only to be possible over a time span that is longer than the duration of the control. As the approach effectively prevents rebalancing, it does not meet Ofcom's stated objective for basket controls.

397. Our view is that this tight control is self defeating – and amounts to individual price controls albeit within a defined basket.

(iv) Openreach's proposals

398. Openreach considers that the restrictions proposed by Ofcom in their Second Consultation will have the practical effect of maintaining the *status quo*, a situation Ofcom itself acknowledges is not satisfactory (see Section 7 of the Second Consultation). Openreach believes that Ofcom's proposals will restrain any rebalancing of prices and institutionalise business models built on uneconomic Openreach prices, leading to market distortions and harm to the sustainability of the telecommunications industry in the UK.

399. As set out above, Openreach's primary objective is to have price controls which enable Openreach to fully recover efficiently incurred costs, in particular on high volume products. If prices are set at uneconomic levels, this will result in market distortions.

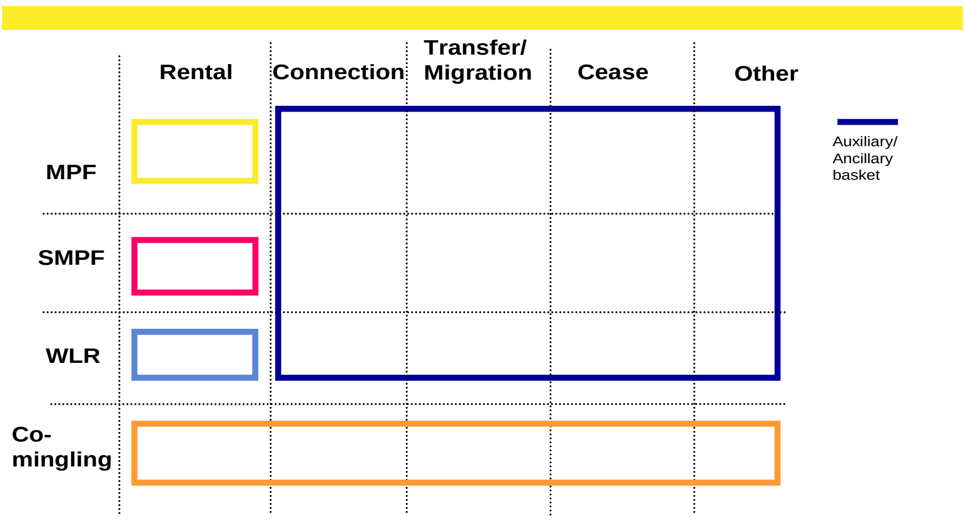
400. We believe that there are a number of ways of reaching this objective:

Option 1:

401. Recognising that Ofcom does not favour our initial proposal, Openreach's preferred alternative approach is to have a single larger basket which includes all non-Core Rental Services (i.e. all Ancillary Services relating to MPF, SMPF and WLR), and a separate Co-Mingling basket. Each of these two baskets would be subject to a price cap of RPI +/- X%, but without any sub-caps on individual products. This would give Openreach the necessary flexibility to adjust prices within the larger basket so as to reach economic prices. Any price adjustments would of course be subject to Ofcom's scrutiny through the normal dispute resolution and complaint processes in the event that Ofcom or any CP was to have concerns about the prices set not being cost oriented.

402. A diagrammatic representation is set out in Figure 24 below:

Figure 24: Openreach's pricing proposals



Option 2

403. Openreach has sought to identify another way of reaching the primary objective of enabling Openreach to fully recover its costs, and to accordingly be able to reset prices to economic levels where required. This alternative appears to us to be somewhat more burdensome – and therefore less attractive – but do achieve the same economic result.

404. An alternative approach would be to use the Ofcom proposed baskets, caps and sub-caps - **provided** however that this is only after any necessary immediate adjustment of prices for the following products:

a) MPF transfer/migration,

b) MPF new provide/connection,

c) SMPF transfer/migration,

d) SMPF new provide/connection,

e) WLR new provide/connection.

405. This immediate adjustment would be to reach economic price levels, using the same methodology as for the calculation of the Core Rental Service price ceilings. Absent such an immediate adjustment, it will not be possible for Openreach to align prices more closely with costs across all of these products within the period of the relevant charge controls.

406. In light of the fact that the charge controls are for a very short duration, and that Ofcom will be carrying out market reviews on these products in 1 to 2 years, Openreach's preferred and recommended approach is to implement the first option above.

407. Ofcom mention that some CPs are concerned that Openreach might structure prices for ancillary products in such a way as to favour downstream businesses (see paragraph 7.13 of the Second Consultation). However, this fails to recognise the general cost orientation obligation that applies to these services. It is our belief that Ofcom already have sufficient regulatory instruments to intervene in the event of such price restructuring, and that further control in the form of narrower baskets, basket constraints or sub-caps, is not required.

Co-mingling products

408. It is proposed by Ofcom that the co-mingling products be regulated using a price control basket of between RPI -0.5 and RPI+2.5. We note, however, that the

same set of prices is proposed to be regulated under the Leased Lines Charge Control.[52] Since the prices for co-mingling products are the same for LLU and Ethernet services, we believe that there needs to be a single basket for these prices, rather than separate baskets resulting from two consultation exercises.

QUESTION 7.2: Do you have any comments on our proposed set of LLU charges subject to specific or basket charge controls?

409. We refer to our comments in response to Question 7.1 on the LLU related basket and specific controls, and to Section 2 of this response on LLU charges.

Question 7.3: Do you agree with the statements on cost orientation and the proposed baskets for the services set out in Annex 7? Is the list comprehensive?

410. Concerning the proposed products and services, Openreach proposes that the following products are removed from the list or changed for the reasons stated.

Product	Page in the Second Consultation	Reason for change
Provision of co-location: Operator Equipment Room : Co-location order rejection – no space available	147	Charge no longer raised.
Provision of co-location: Operator Equipment Room : Co-location full survey	147	Charge no longer raised.
Forecast administration charge	148	To be re-defined as an order cancellation charge during the Co-mingling survey stage.
Ancillary Service Structure	148	No longer provided
Non-essential Service system supply	152	Needs to be identified as ‘Y’ or ‘N’
HDF Cabinet Doors per pair provided at Initial Build	150	An optional product and therefore we propose is not in the co-mingling

[52] “Ofcom Leased Lines Charge Control Framework for Wholesale Traditional Interface and Alternative Interface Products and Services”, 8 December 2008

		basket
Extra power sockets, runways, lighting, cooling, standby power connection	151	Bespoke prices - and therefore we propose is not in the co-mingling basket
Operator Equipment Room – Non-standard Equipment Servicing Charge – Bespoke Room	151	Bespoke prices - and therefore we propose is not in the co-mingling basket
Ancillary Bolt On POP Enhancements	152	Bespoke prices - and therefore we propose is not in the co-mingling basket
MPF Order rejected at initial Validation	142	Not charged
MPF Order rejected at detailed evaluation	142	Not charged
SMPF Order rejected at initial validation	140	Not charged

411. Ofcom has excluded from the co-mingling basket various other charges, and we agree with those exclusions.

QUESTION 7.4: Other than the core rental services and the MPF & SMPF services identified for a sub-basket cap do you believe there are other charges which require specific attention?

412. Openreach does not believe there are other charges which require specific attention, other than as set out throughout our response.

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.

413. We refer to paragraphs 143 onwards on our analysis of the impact of Openreach's proposed price ceilings on customers and markets.

414. We have proposed our own view of the price changes that should be implemented in this response together with our reasons as to why these changes are necessary and valid. Our view and Ofcom's view on the level of proposed price increases do not align. However, our analysis suggests that even if charge controls at the higher end of Ofcom's proposed price ranges were introduced, these would not result in undue disruption to the market or specific customers, and the controls would not have a material negative impact on margins or the incentive to invest.

415. As set out in paragraphs 143 onwards, even with the price increases at the level proposed by Openreach, investment in MPF will remain more attractive to CPs than WLR+SMPF. It will then be to a CP's benefit to maximise utilisation of their assets, and as they increase the volume of their customers and enjoy economies of scale, their profits will continue to increase over time. (At lower price levels, we believe there would continue to be market distortions as Openreach's prices would not be set at economic levels).

416. Furthermore, for many CPs the impact on the market of copper price increases will be offset materially by decreases in the price of Ethernet.

417. Also, as indicated throughout this response, if this review does not enable Openreach to fully recover its prices by setting economic prices, this will perpetuate market distortions. In particular, absent an increase to the MPF and WLR Residential rental charge ceiling, and assuming (flat) nominal prices, there would appear to be a form of "transfer" occurring whereby Openreach is effectively "cross-subsidising" profits in the downstream markets and, as a result, supporting business models based on these market distortions. Openreach's role is not to provide funding or subsidisation for downstream customers but, rather, to operate as a viable and sustainable access services business to the benefit of consumers and customers through effective downstream competition. As set out above, it would be perverse if the introduction of a new charge control led to market distortions, when the purpose of a charge control is precisely to address market distortions (see section 88(1)(a) of the Communications Act 2003).

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?*

Power to modify or revoke SMP conditions and directions

418. Under section 86 of the Communications Act 2003, Ofcom is entitled to modify or revoke SMP service conditions without carrying out a full market review where certain conditions are met.

419. In order to revoke or modify an SMP service condition, Ofcom is required pursuant to section 86(4) of the Communications Act 2003 to satisfy itself that there has not been, since the condition was set or last modified, a material change in the market identified or otherwise used for the purposes of the market power determination by reference to which the condition was set or last modified.

420. In its First Consultation (under the section "Legal framework for this review" – paragraphs 2.18 -2.30), Ofcom concluded (at paragraph 26) that there had been no material changes in any of the markets subject to review under the consultation.

421. In the Second Consultation, Ofcom has published the results of its 'Impact Assessment' at Annex 5, as well as the results of a review of the 'Wholesale local access market' at Annex 6.

422. Ofcom's review of the wholesale local access market in Annex 6 has led it to conclude that "… there have been no material changes in the finding of BT having SMP" (paragraph A6.109) and its review has also lead Ofcom to conclude that there has been no material change in the wholesale local access market within the UK.

423. Openreach believes that the reviews and analysis conducted by Ofcom satisfy the tests under sections 86 and 87 of the Communications Act 2003 and accordingly allow Ofcom to propose amendments to the relevant SMP conditions without conducting full market reviews prior to implementation. We do not think that a further market review at this stage is required to enable Ofcom to implement the measures that Ofcom is proposing in terms of the specific charge controls contemplated.

Objectives for the review and statutory duties

424. Paragraph 2.13 of the Second Consultation specifies the following objectives for the review:

> "- to promote efficient and sustainable competition in the delivery of both broadband and traditional voice services;
>
> - to provide regulatory certainty for both Openreach and its customers and to avoid undue disruption;
>
> - to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred), including the cost of capital; and

- to maintain incentives for Openreach to innovate and improve service quality."

425. In setting the new pricing framework, Ofcom must satisfy the duties imposed by section 88(1) of the Competition Act 2003, which provides that:

> "Ofcom are not to set an SMP condition falling within section 87(9) except where –
> (a) it appears to them 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; and
>
> (b) that the setting of the condition is appropriate for the purposes of –
> (i) promoting efficiency;
> (ii) promoting sustainable competition; and
> (iii) conferring the greatest benefits on the end-users of public electronic communications services."

426. As Ofcom notes in Section 8 of the Second Consultation, its proposals also need to align with the tests set out in Section 47 and 49 of the Communications Act 2003. Importantly, Ofcom may not set or modify any condition unless it is satisfied that that the condition (or as the case may be modification) satisfies the tests in subsection (2) of Section 47. Namely:

> "(i) That test is that the condition or modification 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 the condition or modification is intended to achieve; and
> (d) in relation to what it is intended to achieve, transparent."

427. However, the proposed price control specifies only the first two (or, in some cases, one) year of the glide path that Ofcom has identified in order to bring Openreach's prices to the underlying FAC by 2012/13.

428. The consequence of the approach proposed by Ofcom in the Second Consultation is that even at the end of the currently proposed price control periods, Openreach's prices would remain out of line with its FAC. For at least two more years after that Openreach would be unable to recover all of its relevant and efficiently incurred costs. The distortion of competition and the distorting arbitrage between the pricing levels for MPF and WLR+SMPF would be maintained, rather than eliminated.

429. Instead of ameliorating the "risk of adverse effects arising from price distortion" as section 88(1) requires, Ofcom's price controls would, if implemented, perpetuate those effects, by setting a price control that Ofcom itself acknowledges will entail price distortions throughout its entire period, and the inefficiency and distortion of competition that this would entail.

430. Openreach questions (were such an outcome to be implemented) whether that outcome would meet the tests set down by Section 47 of the Communications Act 2003:

a) We do not believe that Ofcom's proposal of a 4 year glide path, whilst imposing a 1 and 2 year charge control period for WLR and LLU services respectively, is proportionate. It neither provides the necessary certainty for Openreach nor does it enable Openreach to achieve full cost recovery throughout the charge control periods. Openreach queries how this can be objectively justifiable, absent the modifications Openreach has proposed in particular in relation to the timing and level of the MPF and WLR Residential charges and to the shape and structure of the baskets.

b) The transparency test relates to the requirement that Ofcom be sufficiently transparent as to what it intends to achieve. The combination of (i) a 4 year glide path with shorter charge control durations (1 and 2 years), and (ii) the shape and structure of the baskets and related controls, make the analysis of Ofcom's proposal rather complex. However, broadly speaking, Ofcom has been clear about its intention, which is to reset Openreach prices to appropriate levels (see Section 1 of the Second Consultation).

431. Openreach accepts that in principle it is open to Ofcom to specify that prices may be adjusted to the level of FAC over a glide path. However, Openreach does not accept that a glide path is either necessary or appropriate in this particular case. The immediate step adjustment in question is not large enough to cause "undue disruption" to its customers.

432. Openreach therefore considers that in the circumstances, the appropriate response to present conditions is to require an immediate adjustment of the price controls to the levels needed to enable full cost recovery throughout the charge control period.

QUESTION 8.3: Please provide any other comments you may have in response to the proposals set out in this document.

433. We have included below a number of comments that we have that did not readily fit into other Questions Ofcom raised, namely:

a) Effective date of price increases

b) The situation with respect to WLR ISDN30

c) Service and price differentiation on WLR

d) Promotional prices and bundling

e) Non-regulated engineering services

(a) Effective date of price increases

434. In paragraph 8.75 of the Second Consultation, Ofcom proposed a start date for the new controls of 1 April 2009 with a one-week notice requirement for BT. Ofcom indicated that it believed that this is objectively justifiable as CPs are aware of the proposal to change charges and will be given formal notification of the new charges in the final Statement.

435. Ofcom set the 1 April 2009 start date based on its current proposed timeframe for implementation, but stated that this is subject to this consultation and Ofcom would note the need to amend the start date in the event that Ofcom is not able to prepare the final statement in reasonable time for an 1 April 2009 start.

436. Openreach notes that in the relevant SMP conditions pertaining to notification period, there is scope for Ofcom to waive the relevant notification period. Section 49 of the Communications Act 2003 imposes obligations on Ofcom when considering whether to give a consent that affects the operation of a condition, including SMP conditions. In particular, Ofcom must publish a notification setting out its proposals to give consent and must provide an opportunity for interested parties to comment on the matter. While section 49(5) provides that the consultation period must be not less than one month after the day that Ofcom publishes the notification, where Ofcom is satisfied that there are exceptional circumstances justifying the use of a shorter period then the period may be whatever shorter period it considers reasonable in those circumstances.

437. A shorter consultation period would also be consistent with the Ofcom letter of 11 October 2004 that was sent to BT and other CPs to explain how Ofcom intends to apply the provisions of section 49 of the Communications Act relating to consent for shorter notification periods. Ofcom stated:

> *"In the circumstances of a proposed consent to a waiver of a 28 day notice period, it would not be appropriate to consult on the proposition for 1 month, and unhelpful even in the context of a 90 day notice period. In*

such cases, Ofcom will take into consideration its duties under Sections 3 and 4 of the Communications Act, in particular the promotion of competition, in deciding whether a case is justified. Ofcom also notes that proposals to implement a price change with shorter than usual notice may not be likely to affect trade between member states. The period for consultation may vary according to the significance or complexity of the proposed price change, but in most of these particular cases, Ofcom will consult for 5 working days only, unless there are particular reasons for allowing a longer period. Ofcom will endeavour to adopt a very concise and standardised format for such consultations, to minimise the time which it will take for interested parties to consider the proposition. Ofcom will also aim to consider responses and publish its consent, or a refusal, within a few days of the consultation period ending unless, the nature of the responses received requires more extended analysis."

438. Openreach considers that in this particular case, ample notice to industry has been provided through the current review, including awareness of Ofcom's stated intention that the new prices should take effect as of 1 April 2009.

439. As a result, Openreach believes that the new price ceilings should take effect as of 1 April 2009, irrespective of when the final Statement is published by Ofcom. This is because to do otherwise could encourage CPs to "game the process" and introduce delays into the Ofcom consultation process, so as to delay Ofcom's final decision and the consequent increase in Openreach's prices.

440. On the basis of the above, Openreach does not believe that a one-week notification is necessary but notes that, if a notification is required, then a one week notification period would be acceptable to the extent that new price ceilings take effect as of 1 April 2009. Neither of these approaches (immediate notification or one week notification, both with an effective date of 1 April 2009 for the applicability of new price ceilings) would result in discrimination in favour of downstream BT and, accordingly, it cannot be argued that there would be any detrimental impact on the overriding purpose of the relevant SMP conditions.

441. It is important to remember that the reason why Openreach needs to set the new prices as soon as possible is both:

a) to enable Openreach to fully recover its legitimately incurred costs, and

b) to address the downstream market distortions that exist as a result of the current uneconomic prices (which is one of the underlying rationales supporting the imposition of charge controls pursuant to section 88(1)(a) of the Communications Act 2003).

(b) The situation with respect to WLR ISDN30 and ISDN2

442. As a consequence of Ofcom's revision to the timescales for the review, i.e., proposals for short-term charge controls, the "scope" of the review has now changed. Having indicated in the First Consultation that non-core services would be included within the scope of the review, ISDN2 and ISDN30 services have now been omitted from the Second Consultation, which Openreach welcomes.

443. Openreach therefore assumes that these services will now fall to be considered in the forthcoming Wholesale Narrowband Market Review. In advance of that forthcoming review, Openreach reiterates below its comments in the response to the First Consultation, namely that Openreach is advocating a "light touch" regulatory approach for these services.

444. ISDN2 remains subject to strong supply competition, especially from broadband services, which are increasingly seen as a substitute product. The rate of substitution away from ISDN2 has increased since the start of the economic downturn and Openreach cannot see this trend reversing. Price (charge) controls are accordingly not required for this product.

445. Openreach also believes that no changes are required to the remedies imposed upon ISDN30. Previously, Ofcom found that ISDN30 was subject to strong supply side competition from leased line services and especially 2Mb circuits. It also noted the potential substitution with ISDN2 at low levels of ISDN30 utilisation.

446. Over the medium term, Openreach expects very significant decreases in ISDN30 volumes as a result of substitution to IP-based services and other alternatives. Openreach will shortly review the strategy for this product which may also include consideration of its withdrawal. Therefore, any increases in the level of regulation for ISDN30 would be both premature and disproportionate.

(c) Service and price differentiation on WLR

447. We note Ofcom's statement in Section 1 of the Second Consultation (paragraph 1.35), which makes reference to a blended (Business and Residential) WLR rental product. This is further discussed in Annex 5 of the Second Consultation in the context of the charge control options, where it is stated that any differential between residential and business should be removed by 2012/13. Ofcom also indicate that, were the services to be combined such that there is a "common" cost-stack and the mid-point of Ofcom's proposed range(s) were adopted, this would result in a single charge control at a rate of between RPI +3% and RPI - 3%.

448. Openreach notes that consideration of this particular issue and related questions of market definition etc. will be a matter for the forthcoming Wholesale Narrowband Market Review ("WNMR"); accordingly, we will make our more detailed comments on this matter in the context of the WNMR consultation. However, irrespective of the outcome of the WNMR, Openreach's intention is to continue to supply a differentiated WLR service into the market, as between premium (business) and basic (residential).

449. Material differences between Basic and Premium WLR lines and the markets for these services remain. These differences are manifested in the customer experience; service levels, product functionality, operational practice and the associated service level guarantees. Openreach's premium WLR product continues to deliver benefits to end-users that are in addition to those provided as part of the basic WLR product.

450. While Premium lines tend to be purchased by businesses, and Basic lines by residential customers, this is not always the case and there is growing appetite for higher and differentiated levels of service "wrap". The continued demand for a separate Premium oriented product is attested to by the significant volume of consumption of this product, both via BT and Non-BT CPs. In addition, while "service harmonisation" continues to be an Openreach objective, demand continues to grow for premium oriented service levels rather than any merging of service and product at a lower common denominator.

451. Supporting this continued demand is the value that CPs and their customers continue to derive from a differentiated premium product; one that recognises the extra service needs of the highly competitive end user business market.

452. For example:

a) Engineering visits are required in most instances for Premium related orders to enhance certainty. (The complexity of business premise wiring schemes and NTE locations continues to make this a necessary condition);

b) Speed of provision and repair (actual times are faster on Premium services relative to the basic residential product);

c) Service Level Guarantee (SLG) mechanisms (more aggressive timescales and higher rebates, reflecting the higher rental charge);

d) Promotion of enhanced speed of repair/provision, through prioritisation in systems and operational teams supporting the Premium product; and

e) Directory entries: Premium lines benefit from an optional Business Directory entry.

453. Currently, the key differentiator in terms of the basic and premium WLR cost stacks is that, premium lines tend to have a lower proportion of faults and shorter line lengths; this results in a slightly lower unit cost stack for premium (business) lines.

454. To the extent that differences do exist at a unit cost stack level, the difference is largely a consequence of cost allocation methods and the modelling of those specific costs. The cost-stack cannot, however, properly reflect current market practice and developing demand, nor can it adequately capture the benefits associated with the premium (business) related product.

455. In terms of the current review and for the period under consideration, Openreach believes that the premium (business) WLR product should continue to be charge controlled at the current level. This approach is broadly consistent with Ofcom's own analysis, which would reject a temporary downward price adjustment in the context of long-term projected cost (and price) increases (see Annex 5 of the Second Consultation, "Impact Assessment", and at paragraph 8.20 of the Second Consultation).

(d) Promotional prices and bundling

456. Openreach considers that pricing flexibility is essential to the ability to respond commercially in the market. Regulation in different forms can inadvertently act to constrain pricing flexibility.

457. Broad pricing baskets provide greater pricing flexibility when not combined with strict cost-orientation obligations. Cost-orientation obligations, where each and every price point is required to be priced on LRIC + common costs+ ROCE are imposed in the WLR and LLU markets. A broad pricing basket would mean that Openreach has the flexibility to price particular component products at levels below LRIC and others higher in response to market demand. Innovative pricing structures would be completely removed if Ofcom's proposals on the shape of baskets were coupled with sub-caps and additional constraints on individual products.

458. Broad pricing baskets would also increase the ability for Openreach to undertake promotional pricing offers. Such initiatives are generally welcomed by our CP customers as it means that we can respond to their needs. It also enables greater levels of competition at the retail level as CPs respond in different ways to the Openreach offers.

459. Narrow pricing baskets would restrict Openreach's commercial responsiveness. CPs generally do not buy particular individual components such as connection (or migration) and rentals. Rather, CPs necessarily purchase them together. Therefore, Ofcom should construct broad baskets which reflect the demand

patterns of CPs (and in turn, the economic market) rather than arbitrary and inflexible baskets at a component level.

460. Openreach also notes that price notification periods can also reduce the ability for Openreach to respond rapidly to changes in market conditions and demand. Recently, Openreach sought to respond to CP demand and the economic downturn by introducing a 3-month "special offer" on WLR new connections. However, regulation requires 3 months notice of both introducing and withdrawing the offer. Should the offer prove to be very popular, Openreach will be unable to extend it given the notification period. This constraint on Openreach's de facto ability to make short term promotional offers because of the lengthy and rigid 90 day notification periods mean that Openreach is unable to meaningfully respond to market demand and trends, and places Openreach at a material competitive disadvantage compared to CPs offering competing products or bundles supported by aggressive marketing and customer acquisition campaigns.

461. Last, it should be noted the European Commission has recently published its Guidance Paper on Article 82,[53] as a result of which the European Commission recognises that even a dominant (or SMP) firm is entitled to offer bundles and promotional prices.

(e) Non-regulated engineering services

462. Openreach notes that the further one moves away from standard, regulated services, the greater flexibility Openreach should have in terms of pricing and product offering and the less *ex ante* regulation should apply. See more generally our response to Question 8.6 in our response to the First Consultation.

463. To the extent that non-core regulated engineering and other activities do not adversely impact on Openreach's core business, Openreach ought to be able to pursue commercial opportunities, as is indeed anticipated in section 5.11 of the BT Undertakings. This provision expressly recognises that when considering requests for new non-regulated products, Openreach should treat those requests *"as would any other commercial organisation", taking into account such criteria as (i) fit with the assets, skills and resources and terms of reference of Openreach, (ii)* ***commercial attractiveness to Openreach****, and (iii) opportunity cost to Openreach"* [Emphasis added]. This clearly demonstrates that when Openreach was created, it was always intended that Openreach would be active in non-regulated products and would handle these "as would any other commercial organisation".

[53] "Guidance on the Commission's Enforcement Priorities in Applying Article 82 of the EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings", 9 February 2009, European Commission

464. As noted above, the cost stacks for Openreach's regulated WLR and LLU products are linked to the volumes. In other words, the cost stacks only reflect activities actually incurred in those areas (and costs linked to under-utilised capacity).

465. As a time when Ofcom expects Openreach to meet efficiency targets, and when, as a result of volume reductions, there may be engineering resource which is not fully utilised, and it is important that Openreach be able to fully explore such commercial non-regulated opportunities as may exist, with a view to contributing to the costs of those engineering resources. Such a contribution would enable Openreach to realise efficiencies without having to reduce headcount which, as set out in paragraph 114, we believe could have adverse impacts and is in fact difficult to realise (certainly within the period of the proposed charge control) given redundancy and leavers' payments.