A New Pricing Framework for Openreach

Reaction to TalkTalk's comments on Openreach's response to Ofcom's Second Consultation

30 April 2009

Executive Summary

This document provides a commentary on the document "TalkTalk's comments on BT's Response" dated 26 March 2009 as published on Ofcom's website.

Overall we find the TalkTalk document to be short on supporting evidence and justifications and, for the most part, it simply reiterates the unsubstantiated comments made in TalkTalk's previous submissions in response to Ofcom's consultation on a New Pricing Framework for Openreach.

We therefore broadly refer TalkTalk back to the analysis and evidence presented in our previous submissions, together with the results of Ofcom's own independent analysis. We consider that Ofcom must enable Openreach to fully recover its efficiently incurred costs on the Core Rental Services throughout the period of the proposed charge controls. We refer also to the executive summary (paragraphs 1-7) in the Openreach 6 March 2009 response ("Openreach Response") to Ofcom's Second Consultation document ("Second Consultation"), which provides a useful overview of Openreach's position.

We have not provided a systematic commentary on every individual point raised by TalkTalk – this should not be viewed as Openreach accepting those other TalkTalk comments and we reserve our position with respect to those other points. Rather, we have focussed on a number of TalkTalk's assertions that we consider are misleading or simply false, and that we concluded were therefore important for us to address by providing a short reaction so that our position on these issues is clear.

Detailed comments

Strength of evidence and transparency

It is unfortunate, although perhaps not entirely unexpected, that TalkTalk is “disappointed” with the Openreach Response. We note that they expressed a similar dissatisfaction with Ofcom’s own analysis.

We consider that the Openreach Response is based on considered analysis and strong evidence. We have sought to ensure that, to the maximum extent possible in light of business confidentiality, all necessary information and data to support our position has been presented in a transparent and accessible manner. We note that, for example, Cable & Wireless welcomed the fact that the Second Consultation “contains a lot of detailed information on BT’s costs”.[1]

Openreach has not deliberately withheld any non-confidential information from its Response as TalkTalk suggests. Moreover, Openreach has, both voluntarily and under the regulator’s formal information gathering powers, supplied considerable amounts of data and supporting materials to Ofcom. We strongly refute any allegation that Openreach has deliberately withheld any relevant information and note that Ofcom has the powers to act should it consider that we had done so.

Openreach’s Projected Returns

TalkTalk again asserts that, based on its view on changes to key input assumptions such as efficiency, Openreach would be making excessive returns on Core Rental Services in 2009/10 and in 2010/11. This comment is consistent with their response to Ofcom’s first consultation document. TalkTalk’s claims have not been substantiated in any of their responses with objective analysis.

In our Response to Ofcom’s Second Consultation, we explained that, despite a number of the cost assumptions having changed due to the passage of time, the underlying cost pressures remain and the data continues to support the need for an increase to the regulatory charge ceilings for LLU and WLR. Our analysis is supported by a detailed bottom-up build of regulatory cost stacks. It is unclear how TalkTalk reaches its conclusions on Openreach’s projected returns, but they appear to be basing them on a simplistic top-down analysis of Ofcom’s mid-case EBIT projections with some unclear adjustments. There appears to be little, if any, evidence or explanations for the estimates used by TalkTalk against each of the cost components (for example, the estimated £13m in 2010/11 that TalkTalk applies relating to the category “pay-freeze”).

We note that Ofcom’s own analysis has consistently supported the case that MPF prices should be increased.

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1 Cable & Wireless response, 5 March 2009, page 1.

Cost allocations

Openreach considers its approach to allocation of costs to be on a consistent, objective and transparent basis. It is also consistent with the principles underlying the regulatory financial statements. In its Second Consultation, Ofcom concluded that the allocation bases adopted by Openreach generally appear reasonable.

We note that the FAC cost allocations in the Financial Framework Review result in lower cost allocations to MPF compared with the BT Regulatory Accounts. Indeed, in its Response to Ofcom's Second Consultation, Openreach seeks a charge ceiling for MPF of £102.50, compared with the stated FAC in the 2007/08 Regulatory Accounts of £105.86. TalkTalk's suggestion that costs are arbitrarily loaded onto MPF is therefore completely unfounded.

We also note that in their response to Ofcom's Second Consultation, TalkTalk claims that the cost difference between MPF and WLR should be £38.31 in 2012/13. Their calculation includes costs which are wholly unrelated to the cost stacks for WLR and MPF rental services, such as backhaul (which is a separate regulated product provided by Openreach on an equivalent basis). Further, some of the costs that have been assumed or estimated in their response bear no relation to our known and understood costs, such as D-side copper or line cards (we can confirm that line card costs are not applied to MPF services).

It is also unclear why TalkTalk's calculation includes migration costs and tie cables on 21CN in comparing rental cost stacks. The inclusion of these costs (which relate to products other than LLU and which Openreach provides on an equivalent basis) appears to be inappropriate here, and it is not clear to us that TalkTalk has explained the basis for their inclusion or provided a justification for the amounts it has taken into account.

TalkTalk also seems to assert that the current higher frame costs allocated to MPF compared with WLR should be neutralised by 2012/13; this appears to be based on a significant assumption of all LLU CPs migrating to 21CN and using EvoTAMs and single jumper MPFs, and this somehow needing to be reflected into the rental cost stacks for LLU. We note that 2012/13 is outside the timeframe for the proposed charge controls. Significantly, TalkTalk has not provided any justification or evidence to support its assumptions relating to LLU CPs on 21CN and how this ought to impact the rental cost stacks for MPF.

Incentives to invest and economic analysis

We note TalkTalk's comments relating to the incentives to invest, and their assertion that maintenance of the existing charge ceilings would generate in excess of £100m of "benefit" in investment, cost savings and other. While we recognise that consideration must be of course given to "economic efficiency" in its various forms, TalkTalk does not present any empirical support for the alleged benefits it claims Openreach would realise.

The economic rationale of our pricing appears to be in question. The products under consideration fall within distinct relevant economic markets, and are individually subject to economic regulation (in the form of charge ceilings) and the obligation to be cost orientated.

In simple terms, this economic regulation correctly allows for the recovery of incremental costs, a proportion of fixed and/or common costs and of course a reasonable return. In the event that this were not the case, and a significantly increasing proportion of demand were being met by a service that is only recovering its marginal cost, it is intuitive that any incentive to invest or otherwise must surely be blunted. At the risk of saying the obvious, the fixed and/or common costs also need to be recovered from the regulated products, with a fair share being allocated across the relevant products.

We also note that products are regulated in this manner with a view to:

- preventing inefficient or anti-competitive cross-subsidy of the downstream markets (and market distortions that result from any such cross-subsidies);
- ensuring the appropriate and fair allocation of fixed and common costs across products; and
- ensuring that Openreach does not unduly or inappropriately favour a particular business model or customer.

These aims and objectives are reflected in the principles set out in BT's Undertakings to Ofcom such as the requirement that Openreach provides key products on an Equivalence of Inputs basis.

We further note that TalkTalk continues to refer to Ramsey pricing despite considerable focus on the appropriate costing approach being set out in Ofcom's first two consultation documents. Ofcom's own analysis provides strong support for CCA FAC as the basis for setting regulated charges, in addition to our own analysis (see also our Response at paragraphs 347-365).

Any change in the existing charge ceilings will be implemented in an equivalent manner. In both its responses to Ofcom's consultation, Openreach has clearly set out the reasoning and rationale for the proposed charge ceiling increases across its copper-based product portfolio. Our analysis is based on a consistent application of principles across LLU and WLR.

Openreach welcomes increased demand for MPF, *provided* this is based on prices that properly reflect the costs of providing the service and not prices which are effectively "subsidised" by Openreach and therefore market-distorting. Openreach was established to create a viable and sustainable access services business that would provide equivalent access for all CPs to key access and backhaul services, and it is widely recognised as helping to establish the UK access market as one of the most competitive and vibrant in the world.

Inflation and energy

Openreach believes it has taken a considered and measured approach to the estimation of inflation. The estimated measure is based on both reputable external sources, e.g. from Her Majesty's Treasury, and internal assessment of the likely profile of inflation over the period in question. In addition, careful consideration has been given to the proportion of costs and the actual components subject to inflation, and this has formed the basis of our view on exactly which costs would be affected by a reduction (or increase) in inflation.

Finally, Openreach confirms that it purchases energy through agreed forward-looking contracts; contrary to TalkTalk's assertions. Openreach considers itself to be an efficient buyer of energy and has evidenced this to Ofcom. The costs included by Openreach reflect the known costs that Openreach is and will be incurring through those contracts.

Comments on WACC

TalkTalk challenges Openreach's arguments on WACC on 3 fronts:

i) implicitly claiming that the differential between the Openreach WACC and the Rest of BT WACC is too narrow;
ii) that BT has not updated its WACC range for the fall in inflation; and
iii) that the Competition Commission method is flawed and inappropriate.

On the first point, Openreach is a significant proportion of BT as a whole, whether expressed in terms of employees, revenue, cash generation or asset base and, as a result, it is natural and appropriate that the difference between Openreach and BT Group WACCs is relatively small. There are other regulated products deemed to be in SMP markets outside Openreach that are also significant. It is inevitable that the risk characteristics of regulated products have a large impact on the observed risk characteristics of BT. The WACC estimated by BT and Ofcom has no alternative but to start from BT's observed beta factor.

On the second point, when looking at its WACC ranges, BT had reviewed its estimates of the components of WACC and concluded that the original estimates were on balance still reasonable taking a medium term view (see paragraph 23 of Annex B of our Response). BT concluded that volatility is so high at present that using a spot rate approach, as suggested by TalkTalk, was not reliable. A spot rate on the cost of debt would produce a much higher debt premium than that used by either Ofcom or BT. In the recent past, BT has experienced quotes for the debt premium at well in excess of 700 basis points. Such volatility in rates makes application of CAPM difficult if some parameters are used which are ostensibly current spot rates and others which are normalised over different time horizons. Switching to an analysis based on 'real' rates merely compounds these difficulties.

The medium term view takes into account the expectations that both inflation and interest rates will rise as evidenced by forward looking bond rates such as those published by the Bank of England. BT is of the view that it is appropriate to set a

WACC which is centred on ‘average’ rates of the components over the regulatory period but making allowance for investment incentives.

On the third point, although TalkTalk appears to consider that the Competition Commission method is flawed and inappropriate, it is noteworthy that TalkTalk does accept that the Competition Commission did “err on the side of caution” in its assessment so as to incentivise investment. BT provided substantive discussion on this issue in its Response (see paras 76 and following and in particular paras 87-92) and, contrary to what TalkTalk argues, BT’s analysis is not flawed but, rather, has been misrepresented by TalkTalk.

BT did not argue that the Competition Commission provided a ‘full analysis of the economic welfare results’. It is, however, an indisputable fact that the Competition Commission accepted – as have numerous other regulators – that setting a WACC above the mid-point of a range is likely on balance to be welfare improving. The degree to which it is above the mid-point is matter of judgement, but that it was set by the Competition Commission above the mid-point of the relevant ranges for all of the airports is a matter of fact and cannot be in dispute.

BT considers that such an “uplift” is entirely appropriate given the requirements on the industry as a whole to invest in NGA and copper. BT showed that using narrower values for the ranges of the parameters, as Ofcom does (e.g. for the ERP) would, using the Commission Competition methodology, still result in a WACC significantly above the mid-point of the range identified by Ofcom.

Pensions deficit costs

TalkTalk suggests that Ofcom must stick to its approach of “excluding pensions deficit contributions” from allowable costs but present no argumentation to support this position. In contrast, Openreach considers that these significant costs should be included in the cost stacks for its regulated products, including its Core Rental Services. Openreach commissioned the expert opinion of a firm of economists (Davison Yarrow – see Annex A to Openreach’s Response). This report concluded that Ofcom’s approach (to exclude pensions deficit costs) appears at odds with the conclusions of other UK regulators (which all include at least an element of pensions deficit costs) and that Ofcom needs to explicitly consider the principles that might be relevant in the treatment of these pensions-related costs.

Re-allocation of costs from regulated to non-regulated services

Openreach does not accept that there has been “a massive under-allocation of costs to some non-regulated services”. We also strongly reject the suggestion by TalkTalk that BT has provided materially inaccurate projections or that this was done deliberately or out of negligence.

We discuss at some length from paragraph 50 on of our Response our views on the allocation of costs across regulated and non-regulated services and refer to that.

We note that we consider our previous approach to the allocation of costs to be consistent with our regulatory obligations and principles set out in our regulatory financial statements. We accept, however, that there may be a case to reallocate some costs although we disagree with Ofcom about the scale and precise method for doing so. See paragraph 63 of our Response, in which we consider that the maximum possible cost reallocation from regulated to non-regulated products is approx. £46 million.

Ofcom is seeking to re-allocate costs from Core Rental Services to certain non-regulated services. They do not state that costs currently allocated to Core Rental Services are incorrect, rather, that certain non-regulated services do not appear to attract as much fixed and common cost as they might – which is quite a different issue. Our Response corrected Ofcom's analysis and showed that costs had in fact been omitted from Ofcom's analysis, as a result of which any re-allocation, if appropriate, should be at the lower end of Ofcom's proposed range. Finally, Ofcom is not yet clear as to where these costs should actually come from, and no rationale or specific justification for extracting the costs from one type of product or service as opposed to another has been provided by Ofcom.

We also note that Ofcom commissioned KPMG to review the cost allocations methods used by Openreach and their report appeared to be favourable of our overall approach. In particular, KPMG noted that:

- "On the basis of reflecting activities that could reasonably be associated with such products, the allocation of costs was reasonable.
- The distribution of costs via significant allocation methodologies was also reasonable based on the proportion of volumes associated with the products over the forecast period.
- In general, the allocation of costs to products was made on a consistent, objective and transparent basis."[2]

2 KPMG commissioned report for Ofcom, Review of Openreach Allocation Methodologies, 3 November 2008, page 3.

Efficiency

Openreach does not agree with TalkTalk's remarks regarding efficiency. Efficiency targets embedded in a charge control by a regulator are designed to be challenging in order to provide an incentive to the regulated entity to try to outperform those targets.

We have been transparent in our calculation of our proposed efficiency projections and have clearly acknowledged that a level of efficiency has recently been achieved in the order of the ranges proposed by Ofcom. This is not inconsistent with the illustrative estimates that TalkTalk has included in the schematic, e.g., of the order of 4%. However, as Openreach has outlined in paragraphs 110 to 118 of our Response, there are many reasons why such ranges are not achievable going forwards.

Fault Rates

Openreach does not accept the claims made by TalkTalk regarding estimates of BT's fault rate or the best practice level of fault rates. Openreach considers that TalkTalk's proposed fault rate reduction rates are not reasonable or proportionate, nor are they sufficiently justified by objective evidence or analysis.

First, TalkTalk asserts that the best practice fault rate is 0.06 per line per year based on dated and disparate information. This rate is obtained from TalkTalk's Appendix A1 and refers to the target fault rates of the Austrian and Belgian incumbent operators in 2002 and 2003 respectively. It is unclear however whether these fault rate targets relate to copper access lines, whether they were ever realised by the Austrian and Belgian incumbents, what the local prevailing circumstances at the time were[3] and, of course, they are 6 to 7 years old.

Second, TalkTalk have incorrectly attempted to calculate BT's fault rate, leading to their assumptions on fault rate improvements being incorrect and unsupported.

Third, we also note that TalkTalk appears to have misunderstood the concept of "cable fill", as it is not strictly related to the number of copper lines but rather to the increasing use of high bandwidth services and resulting interference this causes.

Openreach considers that the appropriate source of benchmarking information is the ETNO survey which provides actual data on the fault levels achieved by incumbent operators on copper lines across Europe. An external consultant has benchmarked this detailed 2007 ETNO data into comparative fault rates. The output indicates that Openreach is now in the upper quartile for fault rates, as

3 E.g. the level of penetration of data services and thus the level of resulting noise and interference on copper lines may have been quite different, which would impact on whether these Austrian and Belgian target fault rates are a relevant comparison for the UK. Further, we are aware that the UK has atypical housing stock compared to other European countries (less apartment blocks), while Europe typically has lower overhead network lines, fewer cables per dwelling, and fewer external distribution points, all of which will impact on fault rates.

shown in Confidential Appendix A of this document. Indeed, BT recently announced that the network faults have decreased from once every 10 years to once every 12 years.[4]

Openreach also detailed in its Response to the Second Consultation the many factors which support its forecasts for the fault rate to be flat over the duration of the charge control. While Openreach will continue to invest in maintaining the network, the benefits will be significantly reduced as the most prone areas, including those likely to flooded or to suffer repeat faults, have already been addressed. For Openreach to deliver fault rates of the order suggested by TalkTalk would require Openreach to significantly increase investment in transformational work as opposed to improvement programs of the type carried out since Openreach's creation.

Impact on MPF Prices

TalkTalk's response essentially argues that the MPF regulated charge ceiling should not increase despite the weight of extensive evidence which indicates the contrary. As stated in our Response to Ofcom's Second Consultation, it is imperative that Openreach be allowed to recover its appropriate and efficiently incurred costs in the provision of MPF services. As evidenced in our Response to the Second Consultation, we believe that the impact of the suggested price increases on MPF customers will be small. It is of course incumbent on all CPs to ensure that their business models, and marketing and customer acquisition strategies[5], are robust in light of input prices and other operating costs.

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4 Ian Livingston, CEO BT Group, speaking at BT's Q3 2008/09 results presentation on 12 February 2009.

5 We note for example that special broadband offers which might bundle accessories such as mobile phones or laptops will likely result in higher customer acquisition costs.

Confidential Appendix A

[Redacted]