Ofcom Consultation – A New Pricing Framework for Openreach

Sky's response

1. Summary

1.1. In our response to Ofcom's first consultation on a new pricing framework for Openreach (the **First Consultation document**), in August last year, we pointed out that:

- In accordance with Ofcom's duties, the financial framework under which Openreach operated should encourage competition and provide the right incentives for ISPs to continue to invest in their broadband businesses

- Any changes to the current charge control needed to be supported by evidence to the relevant legal standard;

- The level of information that was available did not allow us to interrogate BT's data properly, but nonetheless there were a number of aspects to the data (such as the rate of migration to MPF, and BT's efficiency targets) which gave rise to significant doubts about the data's reliability

- BT has an incentive to over-state its current costs and the extent by which those costs would rise in future

- Because of these factors, we encouraged Ofcom to analyse Openreach's evidence very thoroughly

1.2. All of these considerations remain as true today as they were five months ago. However, the events during the past few months, and the evidence that Ofcom has presented in its second consultation document (the **Second Consultation document**), give rise to a further set of considerations which Ofcom must take into account, in accordance with its statutory duties, before it makes its final decision. In summary, they are:

- The world has changed dramatically in the period since Ofcom carried out its analysis. Five months ago the world was concerned about a scarcity of natural resources and increasing inflation; since then inflation expectations and commodity prices have fallen to historically low levels. As an evidence-based regulator, Ofcom should (and, in fact, has a duty to) take these changes into account in its analysis as they are likely to have a very material impact on Openreach's overall level of costs. (See Sections 3 and 4 below.)

- Based on its own evidence, Ofcom's range of expected efficiency improvements for BT is insufficiently ambitious. Ofcom has based its calculations on a range of 2-4% of compressible costs. KPMG's report, commissioned by Ofcom, suggests a range of over 4% on compressible costs, which is outside Ofcom's range. Ofcom's projection of the improvement in Openreach's fault rates is also likely to be conservative. BT itself has indicated to investors that it has significant scope for further efficiencies. (See Section 5 below.)

- Developments have come to light since Ofcom carried out its analysis which shed further doubt on Openreach's MPF migration assumptions. We showed in our August response why BT's migration assumptions were too rapid. Since then, BT Wholesale first further delayed its roll-out of Wholesale Voice Connect (WVC) and Wholesale Broadband Connect Converged (WBCC) products, and more recently put its entire strategy for future voice products under review. These changes make both Openreach's and Ofcom's estimates of the rate of MPF uptake look highly implausible. (See Section 6 below.)

- BT has also argued that it needs to earn higher returns on its current generation network in order to fund next generation access roll-out. This is not only irrelevant to the evidence that this analysis is supposed to be based upon; it is also wrong. If anything, higher returns on today's network would reduce BT's incentives to invest in a next generation access network. (See Section 7 below.)

- We think that the ancillary baskets structure proposed by Ofcom may allow Openreach to introduce new services, that had previously been part of another service within an ancillary baskets, but which would sit outside a basket. Such behaviour would allow Openreach systematically to exceed the return on capital anticipated by the charge control. We are already seeing evidence of this through increased Event Charges and the introduction of new services that are outside of the proposed ancillary baskets. (See Section 8 below.)

- In our response to the First Consultation document, we explained that BT had an incentive to over-allocate common costs to regulated products. Subsequently, Ofcom, within the Second Consultation document,[1] has identified some non-regulated products which do not pick up a proportionate share of common costs. [2] Clearly, this is contrary to common cost allocation principles and should be rectified immediately. Ofcom should properly scrutinise all non-regulated services to ensure that they contribute a fair and reasonable share towards common costs. (See Section 9 below.)

- As Ofcom itself acknowledges, Ofcom needs to take account of the expectations it set when encouraging companies to invest in LLU in the first place. Significant shocks to the cost level faced by all players in an industry except BT's own downstream division could have a profound effect on downstream competition and investors' appetite for future investments in the sector. (See Section 10 below.)

- We note that in November 2008, BT announced several material changes to its pension fund. The proposals were subsequently accepted by union leaders and are expected to realise £100m in savings per annum. These changes were announced after Ofcom and Openreach prepared their original analysis and, as such, Ofcom will need to adjust its base year and forecast cost projections to ensure that the new charge controls properly reflect these savings. (See Section 11 below.)

---

1 See page 220, paragraph A10.41: "*However, in Openreach's cost projections, there are a number of smaller services to which little, or no, cost is allocated, even though they were generating revenues.*" And paragraph A10.42 "*As a result, we consider it likely that costs which may reasonably have been allocated to those services have instead been allocated to other services – including the regulated services.*"

2 For example, time related charges, Redcare and Enhanced care

1.3. We have structured our response to address each of these considerations. We then address a number of other points of detail relating to Ofcom's analysis.

2. Legal basis and objectives of the Review

2.1 In its First Consultation document, Ofcom indicated (in paragraph 2.14) that the objectives for this review and for the establishment of a new Pricing Framework for Openreach should be to:

- Promote efficient, sustainable competition in the delivery of both broadband and traditional voice services;
- Prevent excessive charging and the abuse of SMP by Openreach;
- Provide regulatory certainty for both Openreach and its customers; and
- 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.

2.2 These objectives reflect the general duties to which Ofcom is subject, as Ofcom notes in section 2 of the Second Consultation document. Under sub-sections 3(6) and 3(7) of the Communications Act 2003 (**CA03**), Ofcom is required to resolve any conflict between its general duties in the manner that it thinks best in the circumstances – under section 3(8) CA03, such resolution must be in writing and reasoned.

2.3 Under s.47(2) CA03, where Ofcom is modifying any conditions, it must be satisfied that the modification (or condition itself) is, *inter alia*, objectively justifiable and transparent (in relation to what it is intended to achieve).

2.4 For Ofcom to act in accordance with its general duties, the resolution of any conflict between its duties (and thus how it intends to achieve the objectives it has set for this review) must therefore be based on a cogent evidence base, to ensure that its analysis and ultimate decisions are reached on a transparent and accountable basis. Only through reliance on a strong base of evidence, and by articulating why particular evidence is, or is not, relevant (e.g. based on concerns about materiality or likelihood of occurring), can Ofcom (and stakeholders) ensure that its decisions are objectively justifiable, and have been reached through appropriate analysis.

2.5 The obligation to take such an approach to evidence must continue throughout the course of a review period, to ensure that analysis is undertaken, and decisions reached, in light of the best evidence available at the time (or based on reasonable expectations of future occurrences). Otherwise, there is a risk that Ofcom will misdirect itself as to the appropriate interpretation of its general duties, if the evidence on which it is basing its analysis is no longer accurate, with the result that its decisions are not sound (and so not objectively justified).

2.6 The evidence set out in this submission is intended to supplement that provided in our response to the First Consultation document on this review. We focus on a number of specific areas, which we consider are highly relevant to this review, and should accordingly inform Ofcom's decisions.

3. Dealing with uncertainty

3.1. In the Second Consultation document Ofcom recognises the challenges that the current macroeconomic outlook and capital market crisis pose for setting long-term, forward looking charge controls. In a rather opaque statement, Ofcom concludes that it will "*closely monitor the effectiveness of our new controls, and intervene if* [required]".[3]

3.2. In Sky's view, Ofcom must give further consideration to these issues and explain clearly its policy going forward. Ofcom's statement appears to suggest that it would re-open charge controls partway through a charge control period. Such an approach could have serious implications for BT's incentives to improve efficiency inherent in the current price control approach, as well as creating uncertainty for both BT and purchasers of BT's services. On the other hand, it is clearly necessary to consider carefully the implications for charges of outcomes being dramatically out of line with the assumptions on which price controls are set, with the possibility of charges being either too high (thereby delivering unwarranted windfall gains to BT), or too low relative to costs. The rapidity with which assumptions about costs made last year have become out of date, discussed in the following section, indicates clearly the potential for such effects.

3.3. One option which Ofcom should consider seriously is shortening the period for which charges are set. While this would have consequences for the efficiency incentives delivered by the charge control, and certainty in relation to charges, it would have the advantage of reducing the risk of forecasts being substantially out of line with outturns, and – potentially – enabling a reconsideration of the appropriateness of regulated charges in a situation in which more normal economic conditions might be anticipated.

4. Ofcom should not use input assumptions from 2008 as the basis for forward-looking price controls

4.1. Ofcom carried out the analysis that it presents in the Second Consultation document in the last quarter of 2008. Much of this analysis is based upon information that Openreach made available to Ofcom in the period up to summer 2008.

4.2. It is clear that it would now be wholly inappropriate to use projections of the values of key inputs into Openreach's cost base derived from this period. In particular, as described below, the assumptions about future energy costs, staff costs, and commodity prices are far above those that should now be expected during the next charge control period, and similar considerations may also apply to BT's WACC. To continue to use the assumptions from the pre-recessionary period as the basis for the next charge control period would confer wholly unwarranted windfall gains on BT.

(a) Energy prices

4.3. In the fifteen days running up to the Bank of England's August 2008 Quarterly Inflation Report, Brent crude oil prices averaged $124 a barrel. The Bank of England wrote "*the factors associated with high oil prices over recent years may persist for some time*". By its November inflation report, oil prices averaged only $64 in the run up to its report – half the level only three months earlier.

[3] Paragraph 1.11 of the Second Consultation document.

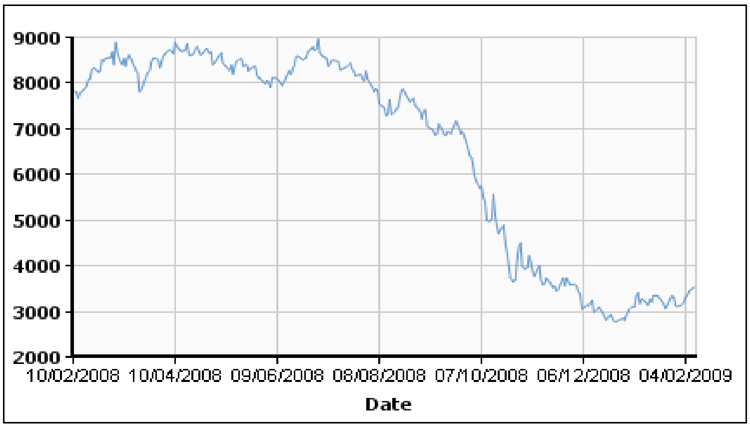
The Bank wrote "*energy prices are assumed to evolve broadly in line with the path implied by futures markets… average oil futures prices were nearly 40% lower than at the time of the August report*". In other words, not only had energy prices nearly halved, but that price was expected to prevail for the foreseeable future.

4.4. Openreach's assumption on energy costs in its cost estimates was that they would increase by 50% in 2009/10 (above the already near-record prices in mid-2008), before following general inflation. The assumption that Ofcom has made in its analysis is not clear; the Second Consultation document states that "*Wholesale energy prices have been volatile over the last three years. We will revisit the long term assumption in our final assessment of costs*"[4]. It is, however, clear from subsequent events just how far out of line Openreach's assumptions now are.

(b) Commodity Prices

4.5. The same story is true for other commodity prices. The cost of copper itself is a significant factor in a CCA accounting model, such as used by Ofcom. The chart below shows how copper commodity prices by December 2008 were around a third of those in June 2008, and a half of those in September 2008. As in the case of oil, copper futures prices indicate that the market expects no return to the higher prices on which Ofcom's analysis will have been based.

Copper grade A prices, January 2008 – January 2009



Source: London metals exchange

(c) Wage Costs

4.6 More significantly, the same is true for wage expectations going forwards. In its August 2008 inflation report, the Bank of England wrote "*a key issue is whether high inflation outturns at the end of 2008 will lead to a rise in settlements in early 2009*". By November 2008 it was much more subdued: "*the risk to nominal earnings growth… that was identified in previous Reports is judged to have diminished*". Once again, this change is unlikely to be reversed any time soon; unemployment projections have risen rapidly and policy-makers have identified the principal threat to the economy to be deflation, not inflation. Openreach's cost assumptions, prepared over the summer, assumed pay costs increased at 1% above general price inflation (despite its most recent pay settlement being only 0.5% above inflation). Given the labour market at the time, it is

4 Page 217 of the Second Consultation document.

possible to see how such an assumption might have been made. With the labour market softening so rapidly and expected to remain weak, it is again clear how out of line this assumption now is.

(d) Conclusions

4.7. These examples serve to make two points:

4.7.1. First, it is clear how much has changed since Ofcom carried out its analysis. Ofcom summarises its analysis in five bullet points at the start of the Second Consultation document; the very first bullet says "*The impact of general price inflation has – and will continue to – put upwards pressure on the costs of providing the regulated services*".[5] This conclusion now needs to be revisited. As stated above, carrying out Ofcom's duties appropriately in this review involves revising its analysis to take account of the lower starting value of many of Openreach's costs. It should also take account of lower expectations of wage cost inflation for the period of the charge control. Given such a lowered starting point, Sky considers Ofcom's assumption of 3% commodity price inflation to be more reasonable.

4.7.2. Second, in almost every other sector of the economy – commodities, many retail products, wages, or at the factory gate – price rises are simply no longer taking place. Often prices are falling. Against this background, Ofcom is proposing an immediate rise in MPF rental, for example, of 7.7%,[6] followed by an annual increase of between RPI+0% and RPI+5%. In an environment where other prices are falling or stable, such significant rises in input costs are likely to have a much more substantial impact on ISPs' ability to invest and innovate and, therefore, on competition.

4.8. Also in this period, financial markets have shown unprecedented volatility. This means that the input assumptions necessary to calculate BT's cost of capital have varied very considerably. In Sky's view, the most pragmatic and reasonable approach to this continued volatility is to use the input assumptions from an earlier, more stable period. Unlike for example commodity prices, where there is a clear consensus that lower prices are here to stay, it is not clear how many of these input assumptions will change in future.

5. Partly based on its own evidence, Ofcom's range of efficiency improvements for BT is insufficiently ambitious

5.1. Ofcom considers that efficiency gains in the range of 2-4% per annum should be achievable on costs controllable by Openreach (and that these costs themselves make up about 70% of Openreach's total costs). There is strong evidence that this is insufficiently ambitious, for six reasons.

(a) Ofcom's own evidence suggests a higher efficiency target is appropriate

5.2. Ofcom bases its assumption on a benchmarking study carried out by KPMG. KPMG's study found that Openreach would need to make efficiency gains of 3.2 – 3.5% cumulatively per annum between 2008 and 2013 on its total operating cost base to bring it into line with an organisation

---

5 Page 6, Second Consultation document.

6 Based on an increase in MPF prices from £81.69 to £88, the mid-point of Ofcom's proposed range.

operating in a competitive environment. This translates to over 4% annual efficiency on controllable costs which is above the upper bound of Ofcom's proposed range.

(b) Length of current task times

5.3. The KPMG report itself is likely to understate scope for savings. KPMG's report specifically excludes the possibility of current task times being too long.[7] This is merely a methodological approach and does not imply the KPMG considers task times cannot be reduced further. Given this approach, we think that the real target efficiency range should be much higher. Indeed, in the same report, KPMG modelled alternative scenarios on the basis that task times are currently longer than they should be and found that their proposed efficiency range could be even higher.[8] The KPMG range is still below the current target level of annual efficiency savings across the BT Group. It is also considerably lower than the ranges achieved by various other communications providers, as set out in their respective responses to the First Consultation document.

(c) Past levels of efficiency are likely to be repeatable by Openreach

5.4. Both Ofcom and Openreach assume that it will not be possible to repeat Openreach's historic levels of efficiency improvement in the future.[9] No evidence is, however, presented in order to substantiate this assumption. Ofcom has stated that, first the rapid growth of wholesale broadband, and then LLU have, to date, enabled BT to make much higher efficiency gains than the future levels now being proposed by Ofcom.

5.5. We agree that there can be opportunities for increased efficiency when there is considerable growth in a particular product or service. However, we differ from Ofcom in that we consider that Openreach's historical efficiency levels could still be replicated over the next 4 years, as a result of growth in MPF volumes (whatever one believes is the exact rate of migration to MPF).

(d) Fault rate assumptions are too conservative

5.6. Ofcom's fault rate assumption is likely to be too conservative. We understand that the way Ofcom and KPMG have calculated their efficiency projections is to assume a constant fault rate, and separately to calculate the impact on Openreach's costs of a declining fault rate. But the 4-6% fault rate reduction assumed by Ofcom is too conservative. This is because as MPF becomes more widely adopted, it seems inconceivable that process industrialisation will not realise considerable gains in MPF fault rates. More generally, BT places great store in its service improvement and "right-first-time" initiatives to deliver tangible improvements. We also note that Ofcom and BT are discussing the possibility of delaying or relaxing some of BT's OSS separation obligations that were set in the Undertakings. The OTA is already brokering industry sessions aimed at identifying alternative initiatives on which Openreach could focus its freed-up resources. We expect much effort to be diverted away from OSS separation and into fault rate improvement programmes that will deliver material improvements in fault rates.

(e) Significant scope for further efficiencies

---

7 KPMG "*BT Openreach Efficiency Review for Ofcom*", November 2008 – page 5, states "*This range specifically excludes the possibility of Openreach's current task times being too long (which could imply excess field staff)*".

8 *"We have modelled alternative scenarios to see what would happen to the required efficiency gains if current task times are longer than they should be, and therefore that there are more field staff than necessary. If BT Openreach has 10% more field staff than it should, this excess cost would mean our range (3.2 to 3.5%) would shift up by 0.5% (to 3.7 to 4.0%)".*

9 Paragraphs A14.47 – A14.48, page 273, Second Consultation document.

5.7. BT itself is indicating to its investors that it believes there to be significant scope for further efficiencies. In November 2008, it announced 10,000 staff redundancies – 4,000 of them had already been made, with a further 6,000 due by March 2009. It was not clear from BT's announcement what proportion of these redundancies were to be in Openreach. BT has stated its intention to achieve 4.6% efficiency savings for 2008/09. In its interview with Michael Rake (BT's Chairman) on 25 January 2009, the Sunday Times wrote "*Will there be more redundancies at BT? Yes,* [Michael Rake] *says. BT's already losing 4,000 of its 110,000 salaried workforce, and there will be more, though he's hoping for "imaginative" solutions rather than straight lay-offs*". It is important that Ofcom understand the impact of this efficiency drive on Openreach's costs.

(f) More thorough scrutiny of efficiencies at Group level is required

5.8. Even were Ofcom to conclude that the bulk of BT's future efficiencies will occur outside of Openreach, this conclusion is still pertinent to Ofcom's analysis. A substantial proportion of Openreach's costs are an allocation from Group. Yet Ofcom has seemingly accepted BT's projections of certain Group costs significantly in excess of this year's group-wide target of 4.6% efficiency. For example, corporate overheads (£180m allocated to Openreach in 2008/09) are assumed to inflate at 3% per year with only 1% efficiency savings. Accommodation costs (£105m allocated to Openreach in 2008/09) are similarly assumed to inflate at 3% per year with only 1% efficiency savings (in spite of the dramatic slump in the commercial property market). This begs the question: if the BT Group-wide 4.6% target is not coming from Openreach, nor from many of the Group costs allocated to Openreach, where is it coming from? It does not seem plausible that it would all come from outside these areas. Ofcom should therefore look more critically at its assumptions for efficiency savings in Group costs allocated to Openreach.

6. Developments have come to light since Ofcom did its analysis which shed further doubt on Openreach's MPF migration and total lines assumptions

(a) Product Mix

6.1. In our response to Ofcom's First Consultation document, we questioned both Openreach's and Ofcom's projected MPF volumes and presented alternative estimates based on our own modelling. We have revisited our analysis and consider that there is justification for a further downwards adjustment in forecast MPF lines. As Ofcom cites, the mix of products is fundamentally important to the returns that Openreach can expect to make over the next four years.

6.2. In its low case estimates, Ofcom revised down forecast MPF volumes in 2012/13 from 14m to 10m, thus contributing a further £65m to forecast EBIT. We consider that even this forecast is too aggressive.

6.3. The main driver of forecast MPF adoption is BT Wholesale's purchase of MPF from Openreach as it moves to 21CN. Clearly, the decision whether BT Wholesale should purchase MPF is entirely within BT's gift and, given that Ofcom's calculations result in a faster uptake increasing MPF prices for all communications providers, there is an obvious incentive on BT to overstate forecast internal MPF lines.

6.4. We consider a range of 4.5m to 8m MPF lines by 2012/13 to be more plausible:

- The low end of this range is based on all external LLU operators completing their MPF roll out plans but that BT does not consume any additional MPF itself.

- The high end of the range is based upon the same level of external demand but with significant internal MPF consumption by BT, albeit at a lower rate than Ofcom low case estimate.

6.5. The low end of our range is entirely credible given the uncertainty surrounding the 21CN programme.[10] This is not something new; ever since its inception, the 21CN programme has been beset by delays, as the following table demonstrates:

Timing	***BT Communication***	***Cumulative Launch Delay***
December 2004	Pathfinder will conclude in March 2006, PSTN national migration will commence in April 2006 and complete by March 2010	
February 2006	Pathfinder migrations could begin in November 2006	12-18 months, assuming 4-10 months for Pathfinder
October 2006	National rollout to commence in January 2008	21 months
December 2006	A new consultation is issued on VLA, which states the intention to launch in March 2008	23 months
June 2007	National migration due to start in July 2008, although WBCC launch scheduled for September 2008 is at risk	27-29 months minimum
January 2008	National rollout status has been reclassified as TBC, following a re-communication of the "Principles of Deployment Strategy". Pathfinder is to be restarted.	?
June 2008	Pathfinder restart scheduled for July-08, to be followed by Pathfinder 2 serving 12k customers by summer 2009	39-41 months
November 2008	Upgrade to call servers to support national migration is slated for late 2010. Pathfinder 1 is scheduled for completion in May 2009	52 months +
December 2008	Overall strategy to be re-evaluated	?

6.6. Notwithstanding issues on timing, we question whether BTW will launch products based on MPF in any scale. There are a several reasons why internal MPF adoption maybe relatively small.

- Given the considerable challenges for BT Retail in meeting the WLR3 Installed Based Migration Complete (IBMC) milestones laid out in the Undertakings and the limited incremental benefits offered by the proposed 21CN product set, there will be little incentive for BT Retail to migrate again in any material volume from WLR3 to MPF based products in the foreseeable future.

- Instead of using MPF, BT Wholesale's 21CN voice product, Wholesale Voice Connect (WVC) may require xMPF as an input. This would result in a material reduction in the forecast volumes of MPF adoption provided by Openreach.

[10] In December 2008, BT announced yet another delay to the 21CN programme. As part of the delay, BT will re-evaluate their voice strategy and consider scaling back overall 21CN deployment plans.

- Openreach's fibre to the cabinet, Generic Ethernet Access (GEA) product is to be made available to 40% of UK homes by 2012. As GEA will initially be based on SMPF, its success will further suppress MPF growth.

(b) New entry

6.7. Additionally Openreach and Ofcom's projections for growth of external MPF appear to assume a significant entrant such as Sky. We consider that the low case should, in fact, assume that no such entry occurs, should commercial conditions be unfavourable. In such circumstances, MPF external growth would be confined to a percentage of total market growth, i.e. switching from business WLR to MPF and the conclusion of existing operators' MPF migration plans.

(c) Total fixed lines

6.8. In relation to total line numbers, Sky concurs with Ofcom that Openreach's projections for a decline in total volume of fixed line numbers is overstated. Indeed, we consider that the annual decline may be closer to 0.8% than 1%.

6.9. Openreach has proposed that its forecasts take into account substitution due to the upsurge in Mobile Broadband connections. We currently consider the impact of this trend is likely to be overstated, at least for the charge control period i.e. until 2012/13. There are several reasons for this position, including:

- A continuation of the current trend towards complementary use rather than substitution. In Ofcom's Communications Market 2008 report,[11] around 70% of mobile broadband users maintained fixed broadband in the home. We think this level of complementary use is likely to persist in the short-medium term.

- The increased network bandwidth required to serve growing mobile broadband adoption in the home is likely to push mobile operators towards smaller cell sizes and, ultimately, Femtocell deployment which will use the fixed line for "backhaul" and, thus reduce the amount of fixed lines that are ceased as a result of mobile broadband penetration.

- Mobile broadband speeds are currently too slow, and throughput too expensive, for consumers of certain increasingly popular services, such as *iPlayer* and *SkyPlayer*.

- According to Ofcom's Communications Market 2008 report, current mobile broadband data usage caps are likely to prove too low for many internet users and compare less favourably to fixed line broadband services.

All these factors suggest that BT has overstated the likely decline in fixed lines over the next charge control period.

11 http://www.ofcom.org.uk/research/cm/cmr08/

7. BT's arguments that it should be allowed to earn greater returns on current generation broadband to fund NGA attempt to hold Ofcom to ransom, yet are logically wrong.

7.1. In its response to the First Consultation document, BT wrote that "*a settlement which does not look at the sustainability of all elements in the telecoms value chain will inevitably raise significant questions for the very substantial ongoing investment demanded to support the existing infrastructure as well as the financial viability of any future large scale projects such as the deployment of NGA networks*" .

7.2. More recently, BT has made a connection in public between the achievement of a favourable settlement on the Openreach Financial Framework, and its willingness to invest in NGA.[12] Whilst it is of course perfectly appropriate that Openreach be allowed to make returns that give it a fair return on its investments, such an approach (as suggested above by BT) of apparently holding Ofcom to ransom is inappropriate and must not be allowed to sway Ofcom's judgement on this review. This is because:

- the economics are wrong. Ultimately NGA is a replacement for the current access network. Therefore, in deciding whether to invest in NGA, BT would look at the relative returns on NGA and its current access network. Anything therefore that increased the return on capital from the current access network would *reduce* BT's incentive to invest in the next generation infrastructure.

- even if BT had stronger free cash flows, there is no reason why it should be expected to use those to invest in NGA. BT could be expected to invest in NGA if, and only if, the returns from that investment exceeded its required "hurdle" rate. If BT's free cash flow was higher, yet nothing took place to change the expected return on the NGA investment, BT could be expected to do something else with its cash, like reduce its pension fund deficit, or increase its dividend.

- BT is not the only operator assessing the case to invest in NGA. For example, Virgin Media has made a significant investment and Sky is itself considering various investment possibilities. An increase in access prices for BT's copper network is simply a transfer from other ISPs to BT. So even if BT's argument was sound that higher free cash flow increased the prospects of NGA investment (and we indicate above why this is not so), it would follow that reducing other ISPs' cash flows would reduce their incentives to invest.

- it is clear from BT's trading update on 22 January 2009 that any financial weakness stems primarily from its Global Services division. In that update, BT indicated that it was taking a £340m charge to reflect a review of its Global Services business, and that EBITDA from Global Services was expected to be negligible. However, BT also indicated that EBITDA for the quarter to December excluding Global Services is expected to be up 5% year-on-year. It is now clear that if BT's capacity to invest in NGA is any less than it might be then it is in large part due to its foray into the global IS consultancy market. It would therefore be absolutely inequitable and inefficient were LLU operators to be obliged to bail out BT for its business failings on the pretext of providing funds to enable NGA investment.

---

12 For example, as reported in the Financial Times on 13 February 2009.

- increasing NGA penetration is not the only public policy objective pertinent here. The Government's Digital Britain review confirms that driving broadband adoption among the 40% of households that don't have broadband is an initial and even more important step in realising the benefits of the digital world in our society. Yet allowing Openreach to raise prices on the pretext of NGA investment would result in higher retail prices for today's broadband – a significant backwards step in any attempt to increase adoption of today's broadband.

8. Ancillary baskets

(a) Openreach will be able systematically to exceed the anticipated return on capital by splitting 'event' charges out of the baskets into unregulated charges

8.1. We are concerned that Openreach is disaggregating certain activities currently subject to an ancillary basket and moving some of them outside of the basket control. The structure of ancillary baskets proposed by Ofcom will allow Openreach to introduce new services outside of a basket control but where the activity in question was previously conducted as part of a service that is within the basket. As a result, the risk that Openreach will be able systematically to exceed the anticipated return on capital is created.

8.2. For example, Openreach has recently introduced a new Network RWT charge at £70.42 per event that, on the face of it, will not fall within the relevant ancillary baskets. [13] In the past, this activity would have incurred a Standard Line Test (RWT) charge of £3,75 which is within the ancillary basket control.

8.3. We have also noticed an increase in aggregate event charges levied against Sky, indicating that Openreach may be looking to generate significant additional revenue from services outside the ancillary baskets. However, these activities - such as Special Fault Investigations (SFIs) and Time Related Charges (TRCs) are intrinsically tied to the SMP products that they support, and are fundamentally important to CPs.

8.4. The table below shows the growing contribution that event charges make to Sky's overall bill for SMPF services – core rental, ancillary services and event charges. This growth cannot be explained merely by changes to Sky's processes and products.

[13] Access Charge Change Notice (ACCN) Number ACCN OR107 - LLU MPF / SMPF Right When Tested Price Review and New Network Right When Tested Charge.

[**TABLE REDACTED – CONFIDENTIAL**]

(b) Many services within the proposed baskets would be better subject to individual caps

8.5. Notwithstanding these concerns, we consider that there are many services within the proposed baskets that should instead be subject to individual controls. This is because of the sensitivity of CPs' business models to certain charges within the baskets and the scope for discrimination that stems from individual price changes - even within the proposed +/-5% cap.

8.6 For example, the MPF and SMPF ancillary baskets will allow the rebalancing of cease charges relative to connection charges. Clearly, should cease charges reduce at the expense of higher connection charges, then a CP that is growing its customer base will lose out relative to a more mature business. Similarly, if charges for new line installations rose relative to transfers, then those CPs that require proportionately more new lines installed (say, because they win relatively more cable customers) will be disadvantaged.

8.7 In our response to Ofcom's First Consultation document we outlined those services that we consider warrant individual charge controls – such as ceases, transfers and new line provides. We urge Ofcom to reconsider the case for setting individual controls for these services instead of placing them within the proposed ancillary baskets. At the very least, we consider that the proposed +/- 5% sub-cap on individual price changes is too wide. Narrowing the sub-cap to +/- 2.5% instead would help alleviate the potential for discriminatory outcomes from individual price changes.

9 Common Cost allocation for non-regulated services

9.1 As mentioned in Section 1 of this submission, Ofcom has already noted that certain services – such as Enhanced Care and Time Related Charges - do not pick up a proportionate share of common costs. As such, Ofcom has made adjustments to Openreach's cost projections in order to reallocate common costs to these services but we think that Ofcom should go further by laying out the principles that it expects Openreach to apply when allocating common costs to non-regulated products.

9.2 BT's approach to common cost allocation and non-regulated services in this instance reinforces our view that Openreach is incentivised to over-allocate common costs to regulated products and, as such, Ofcom needs to be vigilant. It is common accounting practice to allocate common costs consistently to all products, therefore it is alarming that BT has not been applying these principles in these circumstances. The sums involved are material and Ofcom needs comprehensively to review all of Openreach's non-regulated services (including those associated with other markets such as Business Connectivity) to ensure that common costs are shared fairly by all services.

10. Expectations of companies investing in LLU

10.1. Where there is significant market power, as in the wholesale local access market, and where access is mandated and prices set by regulation, the level of investment in downstream infrastructure is critically dependent on the confidence that these conditions will stay in place for an appropriate period of time (i.e. whilst such market power persists).

10.2. Ofcom's success in fostering an environment in which the build-out of LLU in the UK has been successful is reflected by providing certainty to investors in LLU, i.e. that regulation would remain in place that would protect their investment from the exercise of market power by BT. Ofcom maintains that it understands the importance of such confidence and certainty of regulation. For example, in its document on Next Generation Access in September 2008, it wrote, "*it is also important that the regulatory regime we adopt is clear and in place for a reasonable period of time, to allow investors the clarity that they need to invest with confidence*".[14] This is reflected in paragraphs A5.109 – A5.113 of the Second Consultation document.

10.3. If Ofcom wishes to maintain a regulatory environment which is conducive to such investment in the future, it is critical that it honours the expectations that it set in the past. A sudden, significant change to the costs of such investment, soon after investments have been made and without objective justification such as significant changes to the market (notably market power), is exactly the kind of shock which will harm such investor confidence (including that of BT), and so undermine Ofcom's credibility. LLU is just such an investment: most of the industry's LLU infrastructure has been put in place in the last three years and has yet to pay back.

10.4. In the case of Openreach's financial framework, it is appropriate that charge controls should be reviewed as it is likely that costs change over time. However, Ofcom needs to be sure though that any changes in costs faced by BT are genuine, supported by evidence. Most importantly, if Ofcom is to maintain shareholders' confidence, any rebalancing must be carried out gradually over time, rather than as a sudden, one-time change. We therefore support Ofcom's proposal to rebalance over a four year period.

11. Other points of detail

(a) Group costs

11.1. It is appropriate that a share of BT Group costs should be allocated to Openreach. Because they are incurred outside of Openreach, neither the level of these costs nor their future projection has received the same level of scrutiny in this review as Openreach's own costs.

11.2. As we set out in our response to the First Consultation document, BT has an incentive to allocate costs to the regulated part of its business. Given recent weakness at Global Services, BT also has an incentive inappropriately to allocate costs from Global Services into Group, so that that they

[14] Para 2.16, page 12 http://www.ofcom.org.uk/consult/condocs/nga_future_broadband/main.pdf

may in part be allocated to Openreach and included in BT's regulated cost base. We have insufficient evidence to allow us to judge whether BT is acting on this incentive, but where we do have evidence, it suggests that BT may be. For example, we pointed out in Section 4 the contradiction between BT Group's overall efficiency target and the efficiencies assumed to apply to those elements of Group costs allocated to Openreach.

11.3. For all these reasons, it is appropriate for Ofcom to be diligent in its assessment of Group costs, and to conduct a further review of these costs before making its final determination.

(b) SLG Payments

11.4. During 2007-08 Ofcom, the OTA, industry and Openreach worked very hard to deliver a new SLG regime that properly incentivises performance. The work was undertaken in response to serious concerns at the low performance levels at Openreach and relatively weak SLG terms. A central principle that underpins the regime is that Openreach is not able to recover SLG costs when performance is worse than that which would reasonably be expected from an efficient operator. To allow BT to recover costs related to continued poor performance undermines this approach.

11.5. We accept this principle, and therefore the pertinent question is "what is a reasonable level of performance?" Whilst this is not an easy exercise, we are generally supportive of target performance levels that have been set by the OTA and support Ofcom's proposal to adopt these in relation to SLG cost recovery. Payments made by Openreach above these benchmarks should not be recoverable. Reduced payments as a result of performance below the threshold can be recovered as this will exact as an additional incentive of Openreach.

11.6. Any argument that all SLG payments above the threshold should be recoverable in order for Openreach to invest further in service improvement is clearly flawed as there is no guarantee that recovered costs will be ploughed back into service improvement programmes especially absent any financial incentives on Openreach to do so.

(c) Pension Costs

11.7. In November 2008, BT announced a number of changes to its pension fund, which it expected to realise up to £100m a year of cost savings. On 11 November 2008, union leaders announced support for these changes.

11.8. BT is to increase retirement ages, calculate pension based upon average rather than final salary, and increase the number of contributions required. In its evidence – submitted before these changes - Openreach accounted for pension costs at 19.5% of pensionable pay, and this forms the basis of Ofcom's calculations too. This is clearly a material change – representing around £1 per line per year.

11.9. It is important that Ofcom considers the impact of these changes on pension costs before finalising Openreach's regulated prices.

Sky **February 2009**