Appendix B3 - Ofcom's approach to the glidepath determining charge ceilings for Openreach Core Rental Services

In its recent consultation paper[1] Ofcom set out a range of ways in which it might determine future charge ceilings for Openreach for its Core Rental Services ("CRS"). From this range Ofcom has selected its preferred methodology. This note examines the merits of Ofcom's preferred methodology and raises a number of issues that do not appear to have been considered in Ofcom's consultation paper.

The remainder of this note is comprised of the following sections.

- A summary assessment of Ofcom's use of a glide path.
- A stylised illustration of Ofcom's preferred methodology and an alternative methodology that Ofcom has not, at present, considered.
- A set of criteria that can be used to assess the merits of these different methodologies.
- An assessment of the methodologies against these criteria.

SUMMARY

On the basis of Ofcom's analysis of Openreach's current and projected costs and revenues from CRS, Openreach earns excess returns today and will continue to do so in 2009/10 (and possibly beyond) even if the current charge ceilings are unchanged. However, Ofcom currently proposes to revise the charge ceiling on the basis of a methodology that would allow Openreach to increase prices in 2009/10 (with further increases to follow), before such increases are justified by underlying cost projections. Ofcom's currently favoured approach will therefore allow Openreach to earn increased excess returns in the short term to the clear detriment of Openreach's customers.

Ofcom has failed to consider the full set of possible approaches to determining the path of future charges and therefore favours a methodology that strikes an inappropriate balance between Openreach and its customers. Below we propose an alternative approach, which provides consumers with better protection from unwarranted excess returns, is consistent with regulatory precedent thus ensuring regulatory certainty, allows Openreach to earn at least its cost of capital from CRS, and is not expected to have a material impact on Openreach's incentives to achieve efficiency savings.

1 "A New Pricing Framework for Openreach", Ofcom, 5 December 2008

METHODOLOGIES FOR SETTING CHARGE CEILINGS

In this section we provide a stylised overview of Ofcom's proposed path for the charge ceiling[2]. We then present an alternative proposal that we believe strikes a better balance between the interests of Openreach and its customers.

Stylised illustration of Ofcom's approach

In Figure 1 we present a stylised illustration of the expected change in Openreach's aggregate average costs for CRS (i.e. across all 4 products) as suggested by the analysis presented in Ofcom's consultation paper, together with our understanding of Ofcom's proposed glide path approach (using the central estimates of its proposal[3]).

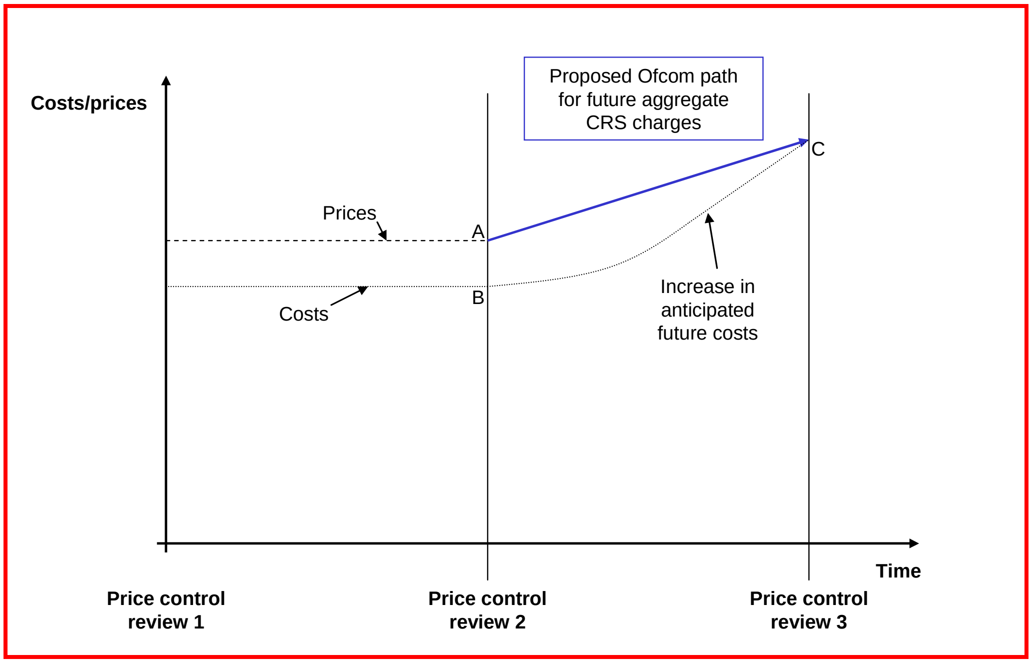

Figure 1: Illustration of a glide path in the presence of rising costs, presuming the presence of excess returns

Figure 1 contains the following essential features:

- in aggregate, prices currently exceed costs (i.e. CRS have been and are earning excess returns even at prevailing prices); but

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2 In illustrating Ofcom's proposal we are using the projected costs of Ofcom which are above the current level of charges – TalkTalk is responding separately on whether Ofcom's costs projections are justified. Were the cost projections or period of price control in the final decision to be modified such that no increase of charges is required, then TalkTalk would wish to re-visit the consideration of the most appropriate glide path approach.

3 Our understanding of Ofcom's proposal is drawn from Section 6 of the consultation document, particularly the discussion on pages 56 and 57, together with the more detailed discussion presented in Annex 5.

- costs are expected to increase beyond the level of existing prices in due course.

The darker (blue) line illustrates Ofcom's proposed path of aggregate average prices across the CRS services, with prices converging on the future expected level of costs by the end of the next price control period. As a consequence of this path of aggregate prices, Openreach continues to earn excess returns throughout the period following the second price control review. The extent of these excess returns for CRS is illustrated by the area ABC in the diagram[4].

On the basis of the information presented by Ofcom in its consultation document it is possible to estimate the additional revenues that Ofcom is proposing to allow for CRS, and hence the levels of excess returns that will arise under Ofcom's preferred methodology (see Table 1 below). The information in the table illustrates that the level of excess returns under Ofcom's preferred glide path methodology is material.

	2009/10	2010/11
Excess returns based on prevailing prices (inferred from Tables 5.5 and 5.6)	£31mn – £111mn	(£158mn) – £16mn
Increase in returns from proposed price change (Table A5.7)	£75mn – £76mn	£169mn – £174mn
Total excess returns under Ofcom's preferred methodology	£106mn – £187mn	£11mn – £190mn

Table 1: Assessment of excess returns to CRS

Source: Frontier Economics analysis of Ofcom's consultation document (Tables 5.5, 5.6 and A5.7)

As we explain below, Ofcom has not provided a robust justification for allowing Openreach to earn such substantial excess returns. Consequently, we regard Ofcom's preferred methodology as striking an inappropriate balance between Openreach and its customers.

4 In practice the returns of Openreach from CRS will exceed those represented by the area ABC in the chart. The purpose of a multi-year price control, where a delay in price resetting allows Openreach to earn excess returns, is to motivate Openreach to achieve higher efficiency savings than those underpinning Ofcom's projections. Since some level of outperformance is anticipated, it follows that future excess returns will exceed those illustrated.

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Alternative approach

Ofcom should consider the merits of an alternative glide path for Openreach's charge ceiling, illustrated in Figure 2. We argue that this represents a superior methodology on which to determine the path of future prices, since it affords consumers with better protection from unwarranted excess returns.

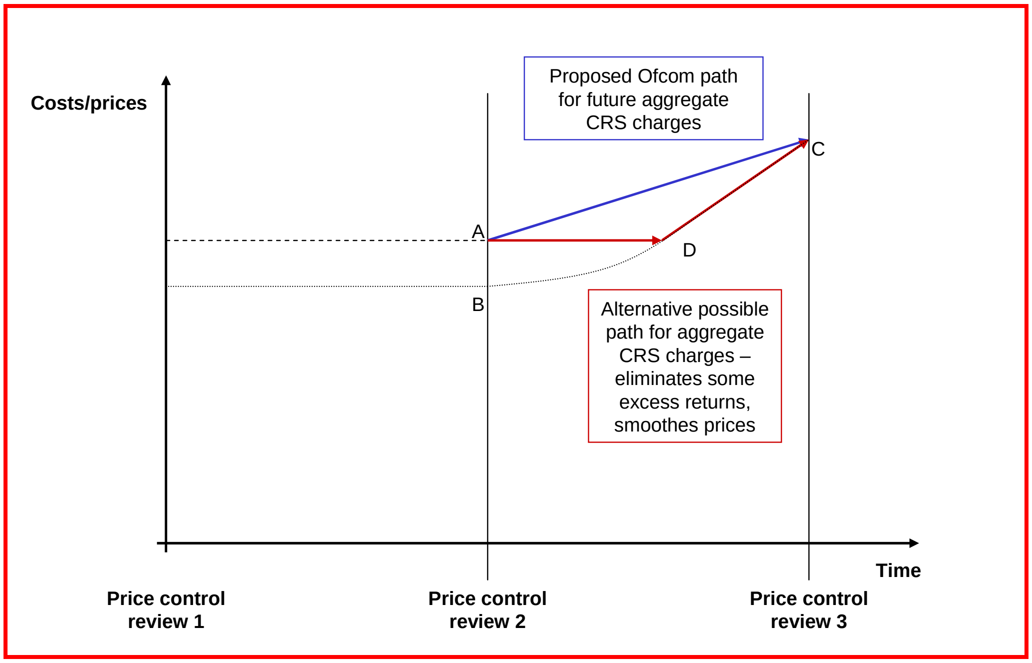

Figure 2: Illustration of an alternative path for Openreach's charge ceiling

The main feature of this alternative methodology is that it does not allow Openreach to increase its charges until such increases are justified by underlying cost projections. Once projected costs increase to the point where the prevailing charge ceiling would result in an insufficient rate of return, charges are increased at a constant annual rate to reach the efficient projected level of 2012/13 costs.

Under this proposal, therefore, Openreach will still earn excess returns (illustrated by the area ABD) even under the (extreme) presumption that they are unable to achieve any further cost savings against the projections presented by Ofcom. This proposal should therefore be regarded as generous to Openreach. Having established an alternative option we discuss in more detail below the reasons why this alternative path of prices should be preferred.

CRITERIA FOR ASSESSING PROPOSALS

In order to assess the merits of each of the proposals above, it is necessary to establish a set of criteria. Below we set out a list of relevant factors. Although Ofcom has not explicitly identified the set of criteria it has used to make its judgement on the use of a glide path, the proposed set of criteria is consistent with the set that implicitly underpins the assessment set out in paragraphs 6.72 to 6.80 of Ofcom's consultation document.

Incentive power versus protection from excess returns

Ofcom will wish to provide Openreach with appropriate incentives to achieve ongoing efficiency improvements. Regulatory regimes typically provide incentives of this kind by fixing prices for some time, thereby allowing the regulated company to earn additional returns if they are able to reduce costs below the levels anticipated. However, Ofcom also has a duty to protect the customers of Openreach from excessive prices and excess returns. This creates a clear trade off. It is necessary for the regulator to strike an appropriate balance between the provision of financial incentives for efficiency improvements and the protection of customers from excess returns. As we explain below, we believe that Ofcom's currently favoured proposal is not achieving an appropriate balance.

Smooth prices

All other things being equal a smooth profile of prices should be preferred to a volatile profile. However, while we regard this as a relevant and useful criterion, we do not consider it to be the overriding consideration here.

Regulatory stability/predictability

Regulators should strive to create a stable and predictable regulatory regime in order to provide both the regulated company and its customers with an environment in which investment decisions can be taken with a reasonable degree of confidence.

Ensuring continued investment

It is obviously in consumers' interests to ensure that Openreach is provided with an overall package of arrangements and incentives that continue to encourage it to make the necessary efficient investments in infrastructure.

Promotion of economically efficient consumption decisions

Finally, regulators should strive to ensure that the tariffs for regulated services faced by customers are reflective of the relevant costs. The last criterion is more relevant to the debate on whether and how to rebalance the charges for each of the four CRS products, which is not the subject of this note. Given this reasoning, our assessment of Ofcom's glide path compared to the TalkTalk alternative focuses on their performance against the first four criteria. However, we do provide a brief commentary on the extent to which our proposal changes the nature of the arguments over whether to rebalance or otherwise.

ASSESSMENT OF THE TWO APPROACHES

Increased incentive power versus protection from excess returns

Ofcom has not taken account of all relevant trade offs that arise when deciding whether to make use of a glide path. Below we first present a generic analysis on the merits of using a glide path (i.e. a phased convergence of revenues with costs) to determine charges compared to a regulatory framework that resets prices to costs at each regulatory review (i.e. a more immediate alignment of revenues to prevailing costs). Following this generic analysis we then turn to the specific case of Ofcom's proposals with regard to CRS.

Generic analysis of glide paths

Setting future prices using a glide path that allows a level of excess returns will have the effect of increasing the incentive power of the regulatory regime as it increases the proportion of any saving made that is retained by the regulated company. Specifically, where the regulator makes use of a glide path, the regulated company will know that it will be able to retain cost savings made during the present regulatory period – as it would under a regime with an immediate reset - but that it will also be able to continue to benefit from those savings during the following regulatory period[5]. A glide path will therefore provide a stronger incentive to a regulated company to achieve efficiency savings and should therefore stimulate the regulated company to make incremental efficiency improvements beyond those that would be achieved under a regulatory regime with no glide path. These additional efficiency improvements can, in the long run, be of benefit to customers.

However, there is a cost to customers arising from the use of a glide path. With a glide path customers face a longer wait before efficiency savings are passed through to them. This creates a trade off. Increasing a company's rewards for making savings will increase the level of savings made, but will delay the time at which customers benefit from those savings. It is not unambiguously the case that it is always in consumers' interests to increase incentive power. To illustrate this, if a company is allowed to retain the benefit of all efficiency savings (i.e. prices are never reset) then efficiency savings should be maximised, but this would never be of any benefit to customers.

In order to assess whether it is in consumers' interests to increase the incentive power of some existing regulatory regime, it is necessary to take a view over the incremental savings that enhanced incentives might stimulate, compared to the savings that would be delivered if the incentive power of the existing regime was not strengthened. We illustrate this in Figure 3 below, building on the stylised illustrations we presented above.

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5 We assume here that the use of a glide path will be repeated in future price control reviews. We return below to the question of whether a glide path in the first price control period is necessary, if the regulator can commit to a glide path in future price control periods.

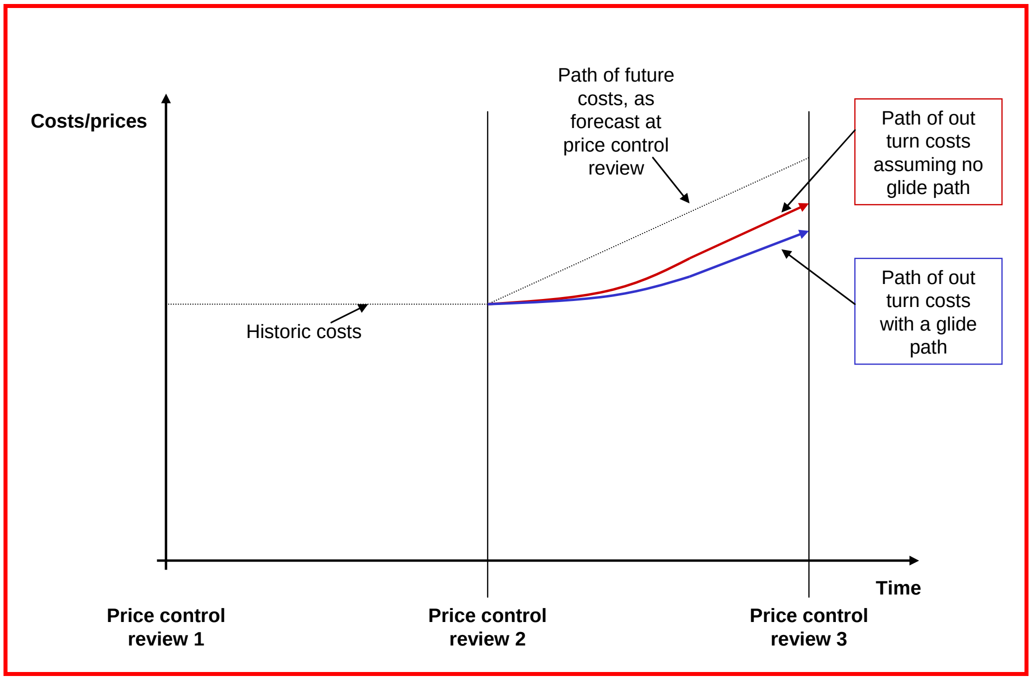

Figure 3: Illustration of the possible effect of increasing the incentive power of a regulatory regime

In Figure 3 we show three possible pathways for costs. The uppermost line shows the ex ante cost projection established at a price control review. While this projection is typically intended to be a central estimate of likely outturn costs, it is generally expected that in practice the regulated firm will out perform this projection by making additional efficiency improvements. We illustrate this in our simple stylised example, showing (in red) the path of costs that we presume would arise under a set of arrangements that aligned prices to projected costs at each price control review (i.e. no glide path). If, however, the regulator committed to using a glide path this would strengthen the incentives faced by the company and would in general be expected to prompt further efficiency savings (cost reductions). We illustrate this in blue, showing in this example a further decrease in costs.

At this stage it is worth noting a further trade off that arises with the use of a glide path. As explained above, a regime that embodies a glide path gives rise to stronger incentives for efficiency improvements as it puts in place a commitment on the revenues that the regulator intends to allow at the next price control review (i.e. in Figure 3 it is a commitment over the methodology to be used at Price control review 3, not Price control review 2). It follows that, in principle at least, a regulator could bring about the same increase in incentives at Price control review 2, by simply committing to use a glide path at Price control review 3, even if it did not do so at Price control review 2. Under these circumstances

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customers would benefit from the increased incentive power without the need to fund excess returns in the short term.

The effective increase in incentive power under this approach would depend on the extent to which the company believed that the regulator would stand by its commitment at that future review. For example, if the regulator had previously committed to use a glide path and then failed to deliver on this, any promises over future use of a glide path might lack credibility from the perspective of the company and might therefore bring about little increase in incentive power from the perspective of the company. Conversely, it also follows, that current use of a glide path does not necessarily guarantee that this policy will continue to be implemented in future.

On the basis of the generic analysis above, a regulator contemplating the use of a glide path must consider the following questions:

- whether the benefit of the additional savings achieved by the company when offered a glide path, which would be passed on to consumers in the long run, are sufficiently large to justify the cost of the additional excess returns that must be funded by customers in the short run, and
- does the provision of the incentive to achieve additional savings require the setting of a glide path in period 2, or would it be sufficient at the outset of the price control period 2 to commit to some sort of a glide path for control period 3.

Ofcom's use of a glide path for CRS

On the two questions identified above Ofcom has, to date at least, brought forward no evidence with which to justify its view that its proposed glide path is the appropriate way forward. Although it has made no explicit reference to the trade offs identified above, Ofcom appears to assume that the incremental efficiency savings stimulated by this extra reward for Openreach would be sufficient to produce a net benefit for customers and also that it is necessary for it to implement a glide path now, rather than deferring implementation, in order to secure those future savings. As Ofcom has not provided any analysis to support this position, there is a concern that Ofcom is simply allowing Openreach to enjoy a prolonged period of excess returns from its CRS with little benefit.

The choice of how to strike the appropriate balance between strong incentives and protection from excess returns is case specific. It is not sufficient to rely on the approach adopted by Ofcom in the past, or other regulatory proceedings, as sufficient justification for Ofcom to adopt the same approach in relation to CRS. For example, when the Competition Commission reviewed Ofcom's 2001 decision on MTRs (Mobile Termination Rates), it decided to implement an approach to the glide path to align them closer to costs, contrary to Ofcom's original proposals.

There are good reasons to suppose that the use of the proposed glide path in the current price control period would have little or no effect on the incentives for Openreach to seek out further efficiency savings:

- the power of the regime will depend on the length of the period of the price control (i.e. the period before charge ceilings will be re-examined). If Openreach expect that the price control will be reviewed again with new cost information in 18 months time, then seeking to increase the power of the regime by allowing Openreach to make further excess returns in the next 24 months will have only a limited impact on Openreach's incentive to make efficiency savings.
- where regulated prices are set for a set of products offered in a market that is, or could become, competitive, then the benefits of having a more powerful regulatory regime through adopting the type of glide path approach proposed by Ofcom are much reduced,
- Openreach has indicated, and Ofcom seems to accept, that there is a material proportion of Openreach's costs that is 'non-compressible', in the sense that Openreach's ability to reduce such costs over the period of the price control is non-existent. Whilst TalkTalk strongly disagrees with this assessment, if Openreach and Ofcom maintain this view, any case for allowing Openreach additional excess returns to incentivise efficiency savings is further reduced,
- Ofcom can draw (and has drawn) on a very wide range of sources of information with which to discipline the conduct of Openreach, such as expert reports on the appropriate level of costs, benchmarking studies in which the costs of Openreach are compared to those of peers, Openreach's own projections of its costs, its historic performance, and evidence provided in the responses of Openreach's customers. Information of this kind can substantially increase the incentive power of a regulatory regime without the need for customers to fund substantial excess returns.

In the light of these considerations, we believe that the alternative proposal described above, which still allows Openreach to retain some excess returns into the forthcoming price control period, strikes a more appropriate balance between efficiency incentives and consumer protection.

Ofcom's commitment to a future glide path

The second issue that Ofcom needs to consider is whether a commitment to the deployment of a glide path in the next (and future) price controls would be sufficient in order to incentivise additional efficiency savings. As indicated above, there are good reasons to expect that the efficiency savings that could be achieved by applying Ofcom's proposed glide path in this case are unlikely to justify the cost of higher prices for Openreach's customers.

Even if Ofcom came to the view that such potential efficiency savings could justify the use of a glide path, there is still the question of whether Ofcom needs to follow the proposed glide path in the current price control period, or whether a commitment to using such glide path in the next (and future) price control periods would be sufficient to incentivise BT. This will in turn depend on the extent to which BT can believe that Ofcom would stand by this commitment at future reviews. There are a number of reasons for which in this case, this could be expected to hold:

- This is the first multi-year price control set by Ofcom for these services, and therefore there should be no prior expectations from BT as to how prices could be expected to be set specifically in this context – up until this review, it was not clear if costs would be increasing, staying constant, or falling. There is also sufficient precedent of authorities adopting a different approach to the one proposed by Ofcom.
- There is significant uncertainty over this first price control review about a number of key drivers of the potential profitability of CRS, including the overall economic environment – such uncertainty is likely to be much reduced by the time of the next price control.
- Whilst Ofcom's previous approach to the setting of charges can provide evidence as to how it may act in the future, the choice of the appropriate approach to the setting of charges will need to reflect the specific circumstances under consideration. It is possible, and indeed desirable, for a regulator to modify the approach it follows to reflect the specific circumstances faced at the time a price control decision is taken. For example, were BT to be found to be making significant excess profits in 2012/13, as a result for example of a projected fall in demand for lines not materialising, then Ofcom should consider whether it should allow BT to keep all of the excess profits for a longer period. In such case, following a different glide path from the one followed during the previous period would be justified and desirable. For the same reason, deploying a different path for charges for the current price control period is consistent with Ofcom adopting a different glide path during the next price control period, if this is justified.

Smooth prices

As one of the consumers of Openreach's products that Ofcom is charged with protecting, we understand that TalkTalk believes that Ofcom is placing too much importance on this criterion. In our view, it is not necessary for prices to be as smooth as possible. It is sufficient that the future path of prices is known with a reasonable degree of certainty and that prices are not unnecessarily volatile (e.g. increasing only to decrease again, or vice versa, over a short time span). While we would not advocate a volatile profile of price for its own sake, we understand that TalkTalk would much prefer to face a future price profile that was less smooth, but embodied a lower level of excess return for Openreach. It is not clear how it can be in the best interest of either Openreach's wholesale customers, or of the final customers that ultimately make use of these wholesale services, to begin increasing charges in anticipation of future cost increases merely to ensure a smoother path of prices.

In the light of this, we take the view that both the Ofcom glide path approach and the alternative set out in this note perform equally well on this criterion.

Regulatory certainty and consistency with previous Ofcom methodology

We do not believe that there is a sufficient history of regulation of CRS to allow Ofcom to claim that it must stick rigidly to some well established methodology.

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In particular, and as explained above, we do not believe that, based on previous Ofcom and related Competition Commission decisions, Openreach will have had cause to expect that its future prices would embody this type of glide path. As such there is a strong argument that allowing this type of glide path at this stage, simply allows Openreach to earn unmerited and unexpected excess returns.

Ofcom also seems to be arguing that allowing this type of glide path at this stage will influence Openreach's future conduct, but a similar effect could be achieved by an alternative approach that allows existing excess returns to be kept, without the need to allow an increase in such excess returns in the next one to two years.

Again we do not regard this criterion as giving rise to a reason to prefer the Ofcom approach over our alternative.

Encouraging investment by Openreach

Openreach must be provided with a sufficient level of return to stimulate it to make the necessary investments. For the avoidance of doubt, we do not advocate a regime that would result in Openreach under-recovering its efficiently incurred costs. The issue for TalkTalk is that Ofcom's current glide path proposal provides for additional unwarranted and excess returns, with no justification provided by Ofcom for its choice. Both the Ofcom proposal and our alternative can satisfy this criterion.

Promotion of economically efficient consumption decisions

Ensuring that customers face prices that signal appropriately the costs arising from their consumption decisions is an issue most directly related to the question of whether there is a requirement to rebalance charges for the four products contained within CRS. Whether there is a need to rebalance will depend on the extent to which there is a belief that current product prices do not (for some products at least) match the efficient costs of providing the services. This in turn will depend upon the methodology used to estimate the product by product level of efficient costs. As indicated in the main body of the response and a separate Annex, the methodology Ofcom is currently proposing to use to estimate efficient costs at the product level is inappropriate and incomplete.

However, the alternative aggregate glide path proposal put forward in this note would not change materially the assessment of whether such rebalancing should be undertaken. The proposal is that tariffs should converge to projected efficient costs by 2012/13, consistent with Ofcom's approach. The main argument for Ofcom favouring rebalancing, is that to the extent that there is an imbalance, this may distort the choice of input for the provision of broadband and voice services in favour of MPF. However, as Ofcom recognises, that choice will effectively be based on the assessment by CPs of the Net Present Value of the costs of the different options for offering voice and broadband services. As under our proposal the final prices would be the same, the potential distortion from delaying the commencement of any rebalancing until (average) nominal prices need to rise to cover costs, is negligible, if any at all. Arguments over the use of a glide path are therefore largely separable from any arguments over rebalancing, as there will be no, or an immaterial distortionary impact, from delaying any required rebalancing until average prices fall short of (average) costs, even under Ofcom's cost benefit assessment.

Summary assessment

In summary, the alternative proposal as illustrated above, is superior to the Ofcom proposal since it limits BT's excess profits without harming efficiency incentives. Furthermore, it performs as well or better in terms of regulatory predictability and the provision of incentives to invest for Openreach. Finally, we do not regard the alternative proposal put forward here as having a substantive impact on the debate over whether to rebalance tariffs or otherwise.

On this basis, Ofcom should consider adopting the proposed methodology we have set out above when taking its final decision on the future charge ceiling for CRS, and implement it by applying a freeze to the nominal or real prices of all CRS services.