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10 March 2008

Dear Andrew

Review of Ofcom's calculations of costs in its consultation document: *A New Pricing Framework for Openreach – second consultation*

I am attaching a copy of our report reviewing cost allocation issues in Ofcom's consultation document: *A New Pricing Framework for Openreach – second consultation*.

You will see that our report concludes that we have been unable to determine whether or not Ofcom's calculations provide a sufficiently robust basis on which to set future prices.

The purpose of this letter is to set out why we have been unable to come to a conclusion on this important point.

The key difficulty we have faced in our review has been the lack of visibility of Ofcom's model and supporting calculations.

As you know, in our review we relied not only on published information, but also worked alongside your team in discussions with Ofcom to better understand their calculations. I would like to stress that at all times during our review, Ofcom attempted to answer our requests for further information and maintained a very open and constructive dialogue with us. However, we were not given access to a number of key documents during our review which, in effect, meant that we were unable to conclude on the reasonableness of Ofcom's calculations. In all cases the issue appears to have been that BT refused to release the information requested on the ground of confidentiality.

In particular, we have not had access to:

- (a) BT's 'OAK' model which calculates costs.
- (b) BT's 'RAV' model which calculates the cost of fixed assets.¹

In addition, we have not received full responses to our queries regarding:

- a) The reconciliation of revenues and costs in BT's model to those in its Regulatory Accounts; and
- b) Explanations for variations in forecast unit trends.

¹ Although we note that a meeting has been arranged for Wednesday 11 March for us to view the RAV model at Ofcom's office.

In our view, without access to the outstanding information and queries, it is not possible to come to a conclusion as to the reasonableness or otherwise of the unit costs set out in the consultation document.

The second major issue we identified in our report relates to the allocation of costs in BT's Regulatory Accounts. In particular, we have identified a number of areas where it is possible that BT's Regulatory Accounts unreasonably over-allocate costs to either Openreach, or to Local Loop Unbundling (LLU) services. These include:

- (a) The treatment of corporate overheads.
- (b) The treatment of internal LLU type services.
- (c) The allocation of shared duct costs.

In our view, these items require further investigation before we can conclude on the reasonableness or otherwise of Ofcom's estimate of LLU costs.

We understand that Ofcom has offered to continue to discuss our information requests after the deadline for submission of responses, and we will, of course, be willing to do so if you think that this would be helpful.

Yours sincerely



Hugh Kelly
Director of Regulatory & Competition Finance