

A New Pricing Framework for Openreach

Tiscali UK response to Ofcom consultation – March 2009

Tiscali is responding to the second consultation on this subject and comments are organised into areas of focus below. Reference should be made to Tiscali's previous submission and any input provided by UKCTA, of which Tiscali is a member.

Important recommendations Tiscali is making in this response are summarised as follows:

- Ofcom should clarify proposed basket structures by presenting products and controls by basket
- Ofcom should avoid starting charge adjustments as far as possible and minimise them if not possible
- Ofcom should seek a way to discuss final proposals with key stakeholders prior to statement publication
- Ofcom should define measures and trigger points relating to the financial model to allow ongoing review and adjustment, occurring at least annually
- Ofcom should continue Openreach efficiency reviews by means of individual projects focused on particular areas of operation
- Ofcom should give more transparency to the way in which economic uncertainty is dealt with in current phases of modelling and review assumptions for critical factors such as capital returns and wage inflation
- Ofcom must ensure that potential or proposed changes to BT's 21CN strategy are taken account of before final decisions on price controls are made
- Ofcom must ensure that the financial model is able to incorporate new products at any future point, alongside the provision for ongoing review and adjustment

Scope

Tiscali is in general agreement with the scope of the review as set out by Ofcom, but Annex 7 does not give an adequately clear view of the content and structure of baskets (although Ofcom intends that it should). The ancillary services to be included in the relevant baskets that are mentioned in section 7 of the consultation include provision and cease charges for both MPF and SMPF. Ofcom should clarify which products are included in proposed baskets by re-presenting Annex 7 information basket by basket.

It would also be useful for industry to have a clearer idea from Ofcom of what the forthcoming Wholesale Local Access market review will cover and the extent to which it will include a rationalisation review of SMP conditions and affected products and services.

Starting charges and baskets

In sections 6.53 to 6.56 Ofcom correctly concludes that immediate rebalancing of prices, which would mean imminent large price changes, would be inadvisable. The option of rebalancing over four years by means of a glidepath approach is taken. In section 8 of the consultation, Ofcom sets out pricing and control regime proposals that include an element of immediate rebalancing for MPF rental based on the apparent need to front load the movement towards fully allocated cost by 2012/13.

The unfortunate contradiction built into the conclusions and proposals means that the unwelcome impacts of significant price increases for MPF will be felt, even though Ofcom seeks to avoid them. The range proposed for the MPF rental charge in 2009/10 (a change that would have effect less than a month from the time of response to the consultation) is between £85 (a 4% increase) and £91 (an 11% increase). Any increase within this range that is implemented so soon will significantly affect LLU investment in the UK, the business plans of competitive providers already suffering the consequences of the recession and prices paid by consumers. There has already been evidence of Openreach expecting to price at the higher end of this scale, along with an argument that even that is less than the immediate change it would prefer to see.

Any such starting charge adjustments should be avoided. The need to adjust prices over time to reach the required levels by 2012/13 should be fulfilled by the effective design of the glidepath charge control model. CPs planning to invest further in MPF would not make inefficient decisions in the absence of immediate adjustments, because future changes necessary to Openreach pricing will be thoroughly anticipated as a result of Ofcom's review work and regulatory statements.

The structure of the baskets Ofcom proposes is sensible and sub-caps should help avoid gaming by Openreach to the disadvantage of non-BT customers. One point regarding the presentation of which products are in which baskets has been made above.

The ranges for price indexation from 2010/11 are too wide to help CPs understand potential effects on their business and this significantly reduces the ability of CPs to provide Ofcom with useful input at this stage. It is understood that many factors that Ofcom must take into account in deriving these are extremely volatile in the current economic climate, not least the inflation rate itself. Arguments on cost and efficiency regarding the data feeding into the financial model that have been made by Ofcom, its advising third parties and industry stakeholders indicate that final indexation percentages should be at the low end of the range. If Ofcom intends to fix the rate in a statement made in Spring 2009, it is not clear that this will not need further explanation and discussion to support a case, even if Ofcom feels the need to take positive action. It is recommended that Ofcom finds a way to discuss final proposals with relevant parties before publication, to ensure against undesirable challenges afterwards.

Review process

Not enough consideration has been given to the need for a review process, specifically to deal with the fact that price control proposals will inevitably affect the market factors that are used in the model that derives the proposals. Ofcom acknowledges this and proposes to review controls after two years, but more specific thinking needs to be done immediately and more review provisions need to be made.

A set of measures should be defined that reflects the sensitivity of the financial model to certain variable inputs, so they can be reviewed at any time to assess the effectiveness of the new regime. Important examples would include internal and external sales volumes, headline cost and return assumptions and consumer pricing. In addition to this, relevant triggers should be defined, based on the ability of certain aspects to undermine the model as a whole. Therefore, for instance, a floor and ceiling should be set for volume assumptions in the model, beyond which an automatic complete review should be necessitated.

In the context of the above provisions, Ofcom should plan to review the model and assess the level of price controls every year to ensure they are reflective of the market and industry and still taking prices to where they are intended to be by the end of the control period. Ofcom must be prepared to change the regulatory model, even if that is an onerous task. Adopting this pragmatic approach, even if it does have resource impacts, will improve confidence and enable Ofcom to monitor and enforce compliance directly. A system like this needs to be available for all regulatory pricing regimes in the future, to the benefit of a competitive market and UK consumers.

Efficiency

Tiscali commented on efficiency assumptions in the response to the last consultation and would refer to points made there. It is encouraging that Ofcom is setting efficiency gain targets that are more demanding than those Openreach has suggested in evidence, but concern remains that perhaps more could be done to review actual activities and changes (historical and planned). It is clear that a great deal of work has been done to analyse possible efficiency targets for Openreach, some published some not, but the potential remains for a more pragmatic view to be taken. Such a view should consider real experience of Openreach operations and support functions and take specific account of the systems and process plans that are in place, which should result in significant opportunities for efficiency improvement.

As suggested previously, Ofcom should be able to bring more focus to EMP system developments and the continuing industrialisation of LLU (including 21CN developments), along with some review of management structure efficiency and duplication with BT Group. The current economic environment is demanding such a focus of all organisations anyway, so it is appropriate that it occurs in this context. Of course, it would be resource-intensive and unwieldy for Ofcom to have to bring this level of attention to bear across all Openreach activities. It would be appropriate and more manageable for Ofcom to identify individual areas for attention (exchange-based engineering activity, for example) and then initiate projects to assess them for expected and achieved efficiency gains. This approach could be combined with the

review process described above to ensure that all synergies are found and findings fed back into the model.

Whatever Ofcom is able to do in this respect and whatever the outcomes, Tiscali expects modelled efficiency gains to be at the high end of ranges suggested so far. If Openreach efficiency and productivity was measured against that of its customers, the results would indicate relative luxury for Openreach at a target of 5% or less.

Cost factors

Ofcom has done a great deal of work on costs and much of the detail on Openreach costs is not available to third parties. The particular difficulty in deriving risk and return rates for cost of capital calculations is acknowledged and this must have increased hugely, even since publication of the current consultation.

It would be appropriate for Ofcom to give more transparency to the way in which these difficulties are being faced and the impact that volatility has on setting charge controls. With regard also to comments made above on review processes, Ofcom must build these factors into regular modelling review and any relevant trigger regime. At the extreme, it may be necessary for Ofcom to alter the timetable for implementation that currently exists to account for the challenges presented by the economic situation.

Another key factor significantly affected by the economic climate is inflation, which is now close to zero (by certain measures) with a real risk of deflation to come. This will affect the operation of the RPI+ model and the assessment of Openreach cost bases. In particular, assumptions on wage inflation should be reviewed, as companies are likely now to avoid wage increases and squeeze pay budgets as part of their strategy for dealing with recession.

Market impacts

Impacts on consumers and the state of the market were discussed in Tiscali's response to the first consultation. The competitive nature of the industry and the prevailing economic conditions mean that any change in wholesale pricing is likely to be passed on to consumers. Recent developments in retail pricing support this, as 'free' services and very low introductory pricing are withdrawn. This sensitivity makes immediate changes to prices, which have been proposed, an especially difficult proposition (see comments above).

Impacts on the competitive market, along with changing cost bases, would affect investment plans and volume forecasts and create the risk of circularities that could undermine proposals. These issues were discussed in the previous response and are covered below. It is acknowledged that reductions in Openreach BES prices will help to offset changes brought about by this review, but the potential impact on LLU investment would still be significant.

Margins that are already relatively low and the effects of changes on the market would add up to a serious threat to the viability of MPF, even as transition to it continues throughout the UK. This in turn would impact the ability of CPs to offer attractive bundling packages and compete with other platforms effectively. The result

could be a negative market impact that disadvantages consumers and renders the variables and projections that the model relies upon invalid.

Modelling

The risk of circularities affecting this review and other regulatory provisions has been mentioned here and in the previous response. Ofcom suggests that changes proposed are unlikely to be large enough to have such unwelcome consequences, but the extreme sensitivity of the market and financial conditions under which CPs are operating makes this point too important not to be subjected to proper analysis. The real risk is that the proposals implemented will change the market in a way that alters fundamentals upon which they, the wholesale broadband access market review and future local access market reviews are based. Add to this the fact that volume assumptions may easily be proved inaccurate and the argument for a robust system of triggers and review processes is made.

Other key issues with the financial modelling Ofcom is undertaking include BT's forecasts of internal versus external volumes (especially for MPF), the assumptions included derived from BT's 21CN plans and the impact forecast for mobile broadband and VoIP. It is very difficult for individual CPs to challenge many of the assumptions that must be made on variables, but caution must be exercised due to the highly sensitive nature of the modelling and the impacts on the market that have been discussed. Account must be taken of BT's current voice strategy review, which questions whether BT will proceed with plans for 21CN products that use MPF as an input (WVC and WBCC). If BT were to make this change in plan and use WLR3 for 21CN voice services, the forecast volumes for MPF would be significantly different from what is included in current modelling. Ofcom must acknowledge and respond to this issue now, before committing to a new price control regime.

Ofcom's financial model must be the foundation of this piece of policy and it must be maintained for the future on a continuing basis, even if that means extra resourcing and ongoing consultation. The ability to review the outputs from the model and modify the resulting regulatory provisions is essential. It will also be essential that Ofcom is able to incorporate new Openreach products and services into the model where relevant, such that changes to cost and activity are made and effects on charge controls measured. This must happen rapidly in all cases and there should always be adequate advance notice of need prior to the launch of any new Openreach product. Particular current developments that may lead to this requirement include active line access products based on fibre deployment (GEA etc) and future MPF derivatives that may arise from 21CN roll out (see above) and the regulatory implications of that (xMPF, virtual SMPF etc).

It will not be enough for Ofcom to complete the review now with a version of the financial model that will then be out of date for the next four years and beyond. If the regulatory regime created is allowed to become unfit for purpose in this way, the negative impacts on all industry parties and UK consumers could be very serious.