A NEW PRICING FRAMEWORK FOR OPENREACH

AUGUST 2008

Cable&Wireless

EXECUTIVE SUMMARY

Ofcom's previous policy has been successful

The Telecoms Strategic Review set forth Ofcom's policy of promoting sustainable competition at the deepest level possible. The 2005 LLU pricing work plays a significant part in the implementation of this policy. The UK is now seeing the fruits of this strategy and there is potential for much more to come. We now have 4.7 million unbundled lines. We have moved up the worldwide broadband rankings. Consumers are seeing the benefits of competition with retail prices falling (yet increasing bandwidth provided at decreasing prices). The benefits of competition extend beyond just broadband. Bundled service packages result in the entire range of communication (and entertainment) services becoming far more competitively provided. Ofcom needs to make sure any action it takes does not jeopardise the continuation of these benefits.

We urge Ofcom to:

- Continue to promote competition to the deepest level where it can be effective and sustainable – the local exchange;
- Provide future stability and certainty by establishing a four year RPI-X charge control.

BT's assumptions lack credibility

It is difficult for us to give BT's figures credibility. Essentially we regard all BT cost saving targets to be weak. They would be entirely unsustainable if Openreach operated in a competitive market. BT's forecasting in contrast appears aggressive. Our experience in other product markets (particularly BCMR) has diminished our confidence in the validity of any BT numbers, be they business case assumptions or BT Regulated Accounts. We note the delay to the publication of BT's Regulatory Accounts for 2007/08 owing to a last minute concern from BT about issues on its reporting of internal volumes and revenues, despite the use of the same methodology for years.

We urge Ofcom to:

- Carefully scrutinise BT's base cost and profitability data to ensure that all relevant revenues (e.g. BT Retail's use of features and capabilities) are included and no irrelevant costs are included;
- Temper BT's substitution forecast and ensure that the outcome of price control models is not sensitive to BT's own internal decision as to which input products to use;
- Take a competitive view on what operating costs and efficiency targets should be. As a base this should be 4.6% as proposed by BT Group but given Openreach's incumbency we expect this to be higher;
- Take a hard line view on the acceptability of costs that can be recouped by Openreach products - Group overheads, Regulatory compliance (EMP, USO);
- Understand properly the increases in BT's cost estimates as we note that underlying unit costs appear to be rising at roughly twice the rate of inflation less modelled efficiency gains;
- Recommend that decisions from the Pricing Review must be adopted by BT for its Regulatory Accounts.

Ofcom must look in detail at all of Openreach's activities

In evaluating what the appropriate charges for WLR and LLU products are Ofcom needs to consider the full range of services that CPs buy. Ofcom cannot ignore the other services that Openreach supplies as clearly these are relevant to the distribution / recovery of common costs. Additionally Ofcom needs to bear in mind at all stages the fact that Openreach is part of the wider BT Group. Price rises in Openreach services could have a distortionary effect if they adversely impact external CPs while BT is able to offset / recoup elsewhere within its Group.

We urge Ofcom to:

- Understand the cost models for all Openreach services to the same extent in order to identify scope for cost recovery and revenue generation
- Understand the additional services a CP needs to purchase in order to make the basic rental product work - care, time related charges, features

In conclusion

It would seem to Cable&Wireless that when evaluating the wider picture:

1. there is potential for Openreach to become far more efficient in the provision of its services;
2. there are material additional revenues (and consequential potential to share more widely generic common costs) from services associated charge controlled services and other regulated services;
3. the increases in unit cost proposed by Openreach are far greater than those justified by the high level assumptions used;
4. the forecasts for the shift from WLR to MPF are too aggressive and in any case driven more by BT's own internal use than by that of Openreach's external customers;

And therefore Openreach will be able to remain profitable for the next four years without any increase to the current price ceilings. This, combined with the potential detriment to competition in the event that prices increase, means that there is no compelling case for increases to prices.

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INTRODUCTION

Ofcom's previous policy has been successful

This review follows up upon Ofcom's most successful policy making to date – the regulation of local loop unbundling (LLU). Up until Ofcom's LLU pricing review in November 2005 alternative investment in broadband services was low. As the majority of services were based on BT's IPStream and Datastream inputs the retail market was essentially full of "me too products". Since the November 2005 decision, the UK market has seen major investment in broadband networks and services.

- In November 2005 only 163,000 lines had been unbundled compared to 4.7 Million by June 2008
- Ofcom now predicts that LLU rollout could reach up to 2000 exchanges. Cable&Wireless itself has invested in the rollout of LLU to 802 local exchanges.
- Ofcom has been able to take the step of de-regulating the downstream WBA market for 70% of the population.
- The latest OECD study (Dec 2007[1]) has ranked the UK 4th by broadband subscriber take up and 11th (June 2007) when measuring users against population.

The results of this substantial investment by alternative providers has led to the availability of innovative service packages, increased broadband bandwidth availability (at generally the same price or lower prices than before) and the wider availability of bundled communications and entertainment packages. Consumer expectation is that they will receive greater bandwidths for the prices they paid for far lower bandwidths in previous years.

- Ofcom's Communications Market Data August 2007 shows that the average cost of a residential broadband connection fell by around 9% during 2006, despite a doubling of the average blended headline speed to 3.6Mbit/s (rising to 4.6Mbit/s by June 2007).

[1] http://www.oecd.org/dataoecd/22/15/39574806.xls
http://www.oecd.org/document/60/0,3343,en_2649_34225_39574076_1_1_1_1,00.html

- The cost of fixed access charges and calls at 2006 volumes fell by 2% per residential line. Ofcom attributes the rising take-up of bundled communications services as the main contributor to the falling costs of all services.[2]

The UK has taken a huge step in rollout and availability but we continue to have scope for far greater take up. Ofcom needs to continue to support the policy that has delivered and can continue to deliver real competitive benefit for consumers. In setting charges for these services in the past Ofcom has embedded its goals for competition to be viable as far upstream as possible. Cable&Wireless would hope, and encourage Ofcom to maintain this policy objective. By this we mean that Ofcom has sought to promote LLU access by ensuring that BT is directed appropriately in the allocation of Openreach common costs within the LLU portfolio of services.

It does not appear that MPF pricing has been a big issue to date as Openreach has only just taken the action to raise MPF charges to the maximum permitted. Cable&Wireless questions whether the increase in price (scheduled for August) is truly down to a requirement to find more revenue or as a strategic reaction in response to Ofcom undertaking this review.

It is important that the conclusions of this review provide a period of certainty and stability. We believe that a RPI-X charge control system will provide an essential framework for the future. In line with previous and existing charge controls and in order to provide sufficient certainty and stability we advocate a four year control period.

BT's assumptions lack credibility

Ofcom asks that we review the key assumptions that Openreach makes. We have little confidence that Openreach will have projected a view that Ofcom should adopt. It is entirely possible that costs from the Group are apportioned inappropriately into Openreach (for example Group corporate overheads). At the same time it is possible, within a wider group accounting structure (and a changing group structure) to allocate revenues / profits into other / selected areas of the business.

BT's wholesale divisions are very profitable, it is their profitability that underpins BT Group's performance. In the regulatory accounts we suspect they bear a disproportionate amount of group overheads.

[2] http://www.ofcom.org.uk/research/cm/cmr07/telecoms/

We have recently come to realise that some areas of the regulatory accounts are inaccurate, in particular in private circuits significant elements of BT's internal revenue are omitted. Clearly this has dented our confidence in the BT Regulatory Accounts overall. We therefore propose that Ofcom takes the opportunity of this exercise to fully review the treatment of costs and revenues for LLU and WLR (along with all relevant related services), as the charges that will result from this review hinge on the accuracy of BT's revenue and volume figures. We need to have total confidence that BT will not in the future suggest further accounting failings.

Ofcom has had to ask Openreach to make a number of adjustments to the accounts to take account of previous policy decisions and other unjustified costs, for example the RAV adjustment and LUS costs. How can we be sure there aren't more such issues?

There are a number of areas we believe warrant further explanation / investigation:

1. The £139M additional EBITDA that relates to regulated return on line cards which is shown in a BT presentation of 23rd January 2008 following BT's most recent departmental restructuring;
2. The increases in BT's cost estimates that result in underlying unit costs to appear to rise at roughly twice the rate of inflation less modelled efficiency gains;
3. The make up and validity of Group corporate overhead apportionment to Openreach;
4. The additional revenues that Openreach will make following the planned introduction of "demarcation" in Spring 2009;
5. The additional revenue that Openreach will make as a result of the "Common Services" portfolio;
6. Accuracy/ occurrence of BT/GS internal transfer charging for network services (WLR features).

We urge Ofcom to take a hard line on the acceptability of the cost that can be recouped by Openreach SMP products and that a rigorous reanalysis of BT's Regulatory Accounts for Openreach is conducted.

Even without vigorous analysis of the figures and simply employing some desk research into other published BT documentation it is obvious that the "base case" model and even the "aggressive case" model proposed by Openreach are overly cautious regarding costs and out of line with assumptions used by the rest of BT.

We note:

- Efficiency improvements are way too low, BT Group itself target 4.6%;
- Forecasts of product substitution are too high and driven largely by internal BT decisions;
- Actual unit costs climb much higher than forecast assumptions would suggest. We know the RAV adjustment does unwind but there is no explanation as to what all the other factors are that are driving cost increases by more than the inflation less efficiency assumptions.

Ofcom must look in detail at all of Openreach activities

It is really important that Ofcom casts its net widely when conducting this review. Presently Cable&Wireless firmly believes that there is considerable risk that Ofcom will fail to consider the full range of relevant services that we regard as essential to the provision of the core rental services. Openreach has developed a separate portfolio of services under the banner of "common services". These services cannot be purchased without a relevant LLU or WLR rental product. In order for the rental product to be appropriately installed etc it is necessary to purchase the related common service. Cable&Wireless believes that these "common services" need to be fully incorporated into Ofcom's review of Openreach profitability for LLU and WLR services. We have included an Annex to illustrate how we purchase these services.

The base WLR rental product is generally purchased with a range of network services (call barring, caller display, caller redirect etc). CPs are unable to self supply these features when purchasing WLR. As a consequence these network services are supplied hand in hand with the base rental product. Openreach cannot supply WLR network services without first supplying WLR rental. We believe that as a proportion spend on network services equates to significant percentage uplift to the standard rental service. We have supplied an Annex to identify to Ofcom our use of these services.

Examination of returns on core rental services alone does not provide a picture of the profitability of the LLU or WLR portfolio overall. Our rough calculations show that total revenues for Openreach Common Services relating to MPF/SMPF today equate to £11M which could represent a 4% increase in revenue for LLU in 2007/08 overall. We believe this percentage will rise in the future. Whilst for WLR additional revenues relating to Common Services could be in the region of £15M per annum and again this is likely to rise. In addition Openreach's plans to separate our demarcation and charge incrementally for this service could conservatively net a further £80M of revenue. Between these three items we have identified a relevant £100M of revenue. The important thing to note about Common Services and Demarcation is that historically these product components have been incorporated into the regulated rental service but now Openreach has extracted these components and is charging incrementally for them, earning excess revenues at unregulated rates of returns. Openreach seems able to strip down a product and charge incrementally for something that was previously included in the rental charge.

Ofcom itself notes that Openreach's other services have the potential to raise circa £100M of excess common cost recovery. Regardless we fail to see how it is possible to ignore the detail of these services (how much common cost is attributed, their rates of return) given this context.

In conclusion

Cable&Wireless simply does not accept that Openreach's profitability is at risk. We believe that taking a narrow perspective of services might lead to falsely coming to such a conclusion but if the totality of the service is accounted for the opposite is true. When the total range of inputs that a CP must purchase in order to offer service is considered, together with the correct inclusion of costs and revenues Ofcom will identify that Openreach is operating highly profitably.

We note that BT has announced a need to revisit the methodology used to calculate volumes and revenues for the past years Regulatory Accounts. It is more than plausible that BT's problems will span a wider range of services and consequently Ofcom should take formal action to ensure that BT is accounting appropriately for the entire product set relevant to this review (LLU rental, Common Services and Network Services).

Cable&Wireless

We fully support Ofcom in its decision to deploy a two stage consultation for this project. The topic area is particularly detailed and it is crucial data is adequately considered in order to deliver the correct conclusion.

In the remainder of this response we provide answers to Ofcom's questions in confidential annex 1 and some supplementary information in confidential annex 2.