A New Pricing Framework for Openreach

Carphone Warehouse plc additional input

Price control baskets

Criteria for price control structure

CPW believes that Ofcom should base its decision on basket structure on two criteria:

- The basket structure should enable prices to be set at an efficient level by, for instance, allocating costs between products in a Ramsey fashion;
- The basket structure should limit the flexibility for Openreach to dis-proportionately recover common costs from those services purchased by competitors and so harm competition and consumers' interests.

In markets where a regulated operator is supplying wholesale services to competitors of its own downstream business, the operator is likely to have a strong incentive to use any freedom to set prices to provide an advantage to its own downstream business.

Application to Openreach

CPW expects that pricing decisions for Openreach will be taken in the context of forward looking profit maximisation for BT Group as a whole, as there is no difference in ownership. As a result, and even in the presence of functional separation, we expect BT to continue to have an incentive to recover disproportionately more of its fixed and common costs from its competitors, rather than from its own downstream business. Accounting and functional separation prevents direct price discrimination by Openreach between external and internal customers. However, the different mix of Openreach products purchased by external customers and by BT internally can allow BT to indirectly discriminate by seeking to recover relatively more costs from services that are predominantly used by external customers.

The different mix of services purchased by BT internally and from external customers is the result of a number of factors:

- BT's customer base contains a greater proportion of narrowband only customers compared to external customers;
- Currently BT generally uses WLR + SMPF to deliver broadband services while external customers use MPF extensively; and
- The different rate of customer acquisition and customer migration to MPF means the balance of connections and rentals will vary between BT and external customers going forward.
- BT does not purchase the co-mingling or BES products that competitors have to rely on

Whilst the mix of products purchased by BT and by external customers will shift over time, BT could use any flexibility within baskets to shift the cost recovery over time to its benefit. For example, BT could seek to set prices for MPF connections that make a relatively greater contribution to the recovery of fixed and common costs currently, as external customers such as CPW increase the proportion of customers using MPF, and then reverse this approach in the future, during its own migration to MPF in the move to NGN.

Openreach's past pricing behaviour in those services not directly price controlled supports this view. The regulated accounts show several example that those products predominantly used internally show much lower returns on a FAC basis than those products predominantly used externally - for example BES/WES circuits where the ratio of price to FAC for external sales was 2.06 and for internal 0.98 .

BT's suggested baskets

In BT's response to the consultation it suggested setting up 4 baskets:

- WLR and ancillary services;
- MPF and ancillary services;
- SMPF and ancillary services; and
- Co-mingling.

We agree with the proposal to separate the different core rental services into separate baskets as this removes the ability of BT to discriminate by recovering costs disproportionately from those core rental services purchased predominantly by external customers.

It is not clear why ancillary services, such as transfers and connections, should be included with the core rental services. The level of fixed and common costs between the core rental services and the ancillary services is limited as there is little overlap between the underlying activities and assets. As noted above, the revenue mix between the core rental services and the ancillary services is likely to differ between BT's internal purchases and external customers' purchases due to different rates of migration to broadband and to MPF. This raises the risk of BT shifting cost recovery over time in a way that discriminates against external customers.

CPW's proposed basket structure

We describe below the suggested basket structure. This draw on the principles that we have outlined in our previous submissions and above.

This structure is based on the following applying:

- There is some rules set as to the way in which fixed/common costs are allocated between these baskets in the initial price setting (e.g. use of Ramsey)
- Each basket has its own X reflecting the cost trends for that basket

- Each product within the basket much recover at least its incremental costs and should not be priced at more than the standalone cost
- The average price movement in a year (used to assess compliance with the RPI-X cap is based on previous year weightings or estimate of this year
- There are sufficient reporting requirements to be able to ensure that these rules are followed

Suggested basket structure

	Basket	**Product(s)**
A	MPF rental	Standard rental
B	MPF ancillary services	transfer, new provide, working line transfer (WLT), hard cease, soft cease, flexi-cease, bulk, managed, expedite
C	WLR (analogue) rental	Standard rental
D	WLR (analogue) ancillary services	transfer, new provide, working line transfer (WLT), hard cease, soft cease, flexi-cease, bulk, managed, expedite
E	SMPF rental	Standard rental
F	SMPF ancillary services	transfer, new provide, working line transfer (WLT), hard cease, soft cease, flexi-cease, bulk, managed, expedite
G	Miscellaneous	all MPF, WLR, SMPF TRCs e.g. RWT, NFF, customer own wiring, damaged NTE, NTE shift, SFI
H	Co-mingling	e.g. BBUS, MCU, UBASE, Access Locate, Access Locate plus, Cablelink, survey, escorted access, rental and set-up every single accommodation / space / power etc charge (<u>no</u> exclusions) Tie cables: 100, 500 pair rental and connection

Inclusion of tie cables within the co-mingling basket does present a possible threat of BT shifting common cost onto co-mingling from tie-cables. However, given the small relative value of tie-cables it may not warrant a separate basket. This might suggest the need for a sub-cap on co-mingling products.

Any new products such as higher care levels or expedited repairs, to the extent that BT is dominant in their provision, should be brought into a relevant basket as they are introduced (e.g. fast repair into rental basket or expedited connection in ancillary). This will give BT some flexibility in pricing when new products are introduced, as at this point they will have zero weight. Including new products in the basket after introduction should inhibit “gaming” of the price control which could result if new products were outside of the control. We recognise that this structure would not allow BT to make higher than the standard return on new / innovative products. However, we cannot see an easy solution to this.

Finally, in order to provide certainty for wholesale customers we consider that Ofcom should also consider general controls on the rate at which individual prices (within a basket) vary over time i.e. sub caps on individual prices.