CWU and Connect Response to Ofcom Consultation Paper, 30 May 2008: *A New Pricing Framework for Openreach.*

This response has been jointly drafted by the Communication Workers Union and Connect who, between them, represent more than 90,000 members working at all levels across the UK telecommunications industry in more than thirty separate companies.

In relation to the Ofcom consultation on Openreach pricing, in our general approach we would stress the following points:

- **Openreach must be able to recover its costs: -** Ofcom should adjust the current regulatory pricing framework to enable **full cost recovery including appropriate ROCE on all key copper access products and services**, thereby ensuring an economically sustainable Openreach and a healthy and competitive UK communications market. Cost-oriented pricing is a key tenet of the UK regulatory regime: benchmarking cannot be used to replace this methodology.

- **Prices for the key copper products need to be realigned (with costs):-** We consider, in line with the view of Openreach, that the current economic model, notably the price ceilings on LLU and WLR services, is causing economic distortions in the market. A significant proportion of the market is underpinned by an economically unsustainable price. Again, cost orientation should prevail.

In relation to the above points, we believe that Ofcom needs to set the right investment incentives for copper and future access networks. If these issues are not properly addressed, and Ofcom does not enable Openreach to make an appropriate return on capital, the incentive to invest in future access networks (and technologies) will disappear and the recent BT Group announcement as to NGA investment may well come to nothing.

Immediate concerns also arise with respect to the incentives around existing services and Openreach's continuing service improvement(s). Openreach's customers and consumers deserve these improvements and they require ongoing investment.

To incentivise (or even justify) investment in today's network as well as to incentivise future investment, we believe that the return on capital needs to remain stable or increase, reflecting greater access competition, higher risk factors and the recent movements in the financial markets.

As the Broadband Stakeholder Group has argued from the commencement of its recently-concluded review of next generation deployment, there are situations where the public value of next-generation networks (broadband) for society and the economy as a whole is potentially high but the potential value to private investors relatively weak. This is because of a combination of the large scale of investments and the uncertainties surrounding the prospects for recouping the investment (Pipe Dreams? Prospects for next generation broadband deployment in the UK", Broadband Stakeholder Group, 16 April 2007). However, without the right incentives for Openreach to invest to improve service and the ability to recover appropriate costs, industry and consumers will suffer in the long-term.

Regarding the approach taken in the Ofcom consultation paper, and the analysis used, we would stress the following points:

- We question the use of certain comparisons to justify the analysis. For example, international comparisons are tenuous because of the differing policy frameworks and economic conditions in other countries. For example, and despite EU membership and the concomitant obligations under the EU telecoms framework, comparisons with Estonia and other former Soviet bloc countries are rather dubious given the very different historical and economic circumstances. Policy frameworks and levels and types of competition vary widely. Using examples closer to home, such as France and Ireland, is more useful. For example, whereas BT's regulated return is 10% on copper base, with Ofcom indicating a future rate of 9-10%, in Eircom and France Telecom it is 11.2% and 12.46% respectively.

- UK-based comparisons with regulatory frameworks in other utilities are also questionable given that they are often faced with rather different challenges – the distribution of non-variable energy resources for example – whereas the telecommunications sector requires a framework which can facilitate innovation and investment in order to meet the demand for new technologies (such as NGA, for example).

- We also question the perceived efficiencies that Ofcom project can be made within Openreach. Ofcom are proposing up to 4% p.a reductions. There is no concrete evidence for this. Historically the efficiencies have been around 1% p.a. Such targets could result in pressure for ever greater staffing reductions at a time when these are already severely stretched. We believe that greater awareness is required of the actual and potential risks to the effective and sustainable operation of the business. Careful consideration is required of sustainable efficiency targets, based on the clear evidence of the levels that have historically been achieved, that will continue to facilitate a thriving market in the UK and enable customers of Openreach (i.e. the various CPs) to make investment decisions based on a real understanding of their underlying costs.

Find below our responses to some of the specific questions asked in the consultation document:

Question 2.1: What do you consider to be the appropriate goals for a new Pricing Framework?

A new pricing framework needs to provide regulatory certainty for Openreach and its customers. This means giving Openreach the opportunity to cover all relevant costs, and at the same time encourage innovation and incentivise timely and efficient investment in new infrastructure deployments.

This would benefit consumers and citizens in the longer term, for example through increased investment to encourage development of super fast broadband services. This will be critical to UK competitiveness in a global economy and a key driver of economic growth and social cohesion.

Question 2.2: To what extent do you think that the existing framework has supported the achievement of these goals, and when has it worked against them?

In some areas the framework has been appropriate for the achievement of these goals. In other areas it has only allowed for enough resources to be invested in the necessary improvement to network infrastructure.

Question 3.1: What do you see as the key developments in the provision of access and line rental services since 2005 and how have these affected customers and consumers?

As stated in the Ofcom document, there has been a marked decline in the number of WLR lines/channels (declining from 28.2 million to 26.9 million between the end of 2005 and end of 2007). This has been driven partly by a shift to MPF (which has increased by over a million lines). There are now over 4 million LLU lines (also including nearly 3 million SMPF lines). Choice of network providers has increased, including carrier pre-select services. Average broadband speeds have increased while prices have fallen.

Question 3.2: Within the context of the overall package of changes instituted by the TSR, to what extent has the current pricing structure for LLU and WLR contributed to market developments and how sensitive do you believe future developments will be to changes in the pricing of those wholesale access services?

The current pricing structure has encouraged competition and driven down retail prices. Changes in the pricing of LLU and WLR will encourage further investment in infrastructure since there is no evidence that the current pricing regime has restricted the growth of competition; indeed, what evidence there is points in the other direction. As the Ofcom paper states, reductions in LLU and WLR charges in 2005 and 2006 clearly provided a major stimulus to competition. The separation of Openreach and the knowledge of a level playing field has also helped; as has the ability of retail-focussed organisations to bundle and create different business models while they focus on gaining market share.

It remains to be seen how sensitive future developments will be to pricing, but what is clear is that, if there are no changes to the pricing structure, the room to establish the investment required for next generation access networks will be much smaller.

Question 4.1: Do you accept that the evidence presented by BT on movement in costs provide a compelling case for a review of the price controls? Are the cost movements consistent with broader industry trends?

Yes, based on the evidence it is clear that, with the shift from WLR to MPF services, as well as rising costs and the declining returns shown by the historical cost accounting evidence, the time is right for a review of price controls. We would agree with the analysis that there is a general shift away from WLR towards MPF and this is likely to continue even with the adjustments needed.

Question 6.1: What weight would you give to international benchmarks in comparing LLU prices? What other factors should we take into account in considering the comparison of prices?

International benchmarks are useful to an extent in comparing LLU prices and understanding what is an appropriate level for the UK. However, the difference in operating conditions between countries is an important consideration and we should recognise that BT has USO responsibility with no support from Government or a USO fund. This differs from the situation in other countries.

However, not too much weight should be given to direct international comparisons, as there are too many other variables to be taken into account when looking at practice in other countries such as different policy frameworks, and historical and economic conditions.

Question 6.2: Our initial analysis on the potential for efficiency gains is set out in Annex 8. Please provide your views on the appropriate efficiency projections that should be assumed for Openreach over the period, given the evidence collected so far and your own experience in this sector. Please provide any additional evidence that may be relevant in assessing these projections.

There is no concrete evidence as to how greater efficiency gains can be achieved, especially as they have been 1% per annum so far. Neither do we believe that the comments of stakeholders outside Openreach are likely to be valid here, separated as they are from the reality of the situation in the company. Neither do we believe that internal company efficiency should be the subject of regulatory supervision. We believe that efficiency levels within Openreach may have increased recently but we do not believe the improvements derived as a result of the creation and early years of cost control focus of Openreach is repeatable year on year. Thus the 4% figure seems unrealistic.

Question 6.7: Please review the volume assumptions set out in Annex 9. What are your views on future MPF and WLR growth? What factors are likely to be most important in determining the future level balance of demand for wholesale access services?

We would agree with the analysis that the price advantage of MPF over WLR and SMPF, and the greater product functionality and flexibility allowed by MPF, will drive growth in MPF and decline in WLR and SMPF.

Question 6.8: Is it appropriate to update our assessment of Openreach's cost of capital? If so, what are your views on the key parameters that should inform that review and what account should be taken on the current uncertainties in corporate and global financial markets? To what extent should we take account of the implications of (and for) new infrastructure investment?

Yes, it is appropriate to update the assessment of Openreach's costs of capital. This is important due to changing financial conditions at the international and national level. For example, the international repercussions of the credit crunch have increased the cost of borrowing in the UK.

Global economic factors are important, as are agreements entered into at the international and EU level, such as the Lisbon strategy on economic competitiveness, aimed at creating a dynamic knowledge-based economy in the EU. In order to achieve this, more attention needs to be paid to creating the right framework for infrastructure investment in the knowledge economy in the UK, and specifically the communications infrastructure. The development of high speed broadband networks will be a key element of this.

As the Broadband Stakeholder Group noted, again from the outset of its work: 'Given the critical importance of broadband as the key enabling infrastructure of the knowledge economy, a failure of broadband supply to meet demand could stifle the pace of innovation in the UK economy compared to our global competitors. This risk should be recognised and addressed.' (BSG Report *Pipe Dreams* 2007, p.34).

Question 6.9: In the context of the current markets for WLR and LLU what do you consider to be the key challenges for ensuring allocative, productive and dynamic efficiency in the context of the revision of charges?

We believe that pricing needs to favour dynamic efficiency, promoting incentives to innovate and invest in infrastructure. We nevertheless recognise that this creates a tension with the desire of consumers for prices to be kept low. The challenge therefore is providing services that customers are willing to pay extra for – which is equally about differentiation at the service layer – and minimising costs where possible. There obviously needs to be a trade-off between allocative, productive and dynamic efficiency. One way of doing this might be to use sewer networks to run fibre optic cable, thereby reducing the cost of engineering work, which would otherwise account for a major proportion of overall costs. We are aware that Ofcom is currently looking at the feasibility of this solution.

Question 6.10: How would price increases for MPF, SMP and WLR affect Communications Providers and the roll-out of LLU? How would this vary if the relative balance of WLR, MPF and SMPF prices were to change?

They would be unlikely to affect or slow the roll-out of LLU in areas where LLU has already proved popular. Other CPs could be expected to extend coverage as they realise returns after recovering their initial start-up costs.

Question 6.11: How will price changes at the wholesale level impact on consumers, taking account of network roll out and the potential impact on retail prices?

Price changes at the wholesale level are likely to increase charges for consumers at the retail level. However, Communication Providers are likely to be able to absorb some of the costs which will moderate the impact on retail prices as they move from fully recovering their initial start-up costs.

Wholesale price increases may mean that CPs start charging consumers more for the types of services they use and the amount of data they send or receive, rather than the speed of their connection. It is probable that users of more advanced high speed services will be willing to pay more for the benefit of those services, so differentiating price in this way could be a logical solution to the issue of increased costs.

In the long term, the impact of price changes at the wholesale level is likely to benefit consumers through increased investment in infrastructure, with consequent innovation in services and content.

Question 6.12: What are the implications of a new pricing framework for incentives to new infrastructure investment by BT and other Communication Providers?

We recognise that investment in next generation access networks by BT is not solely predicated on a favourable settlement of the pricing framework. However, an unsatisfactory settlement that does not take into account prevailing efficiency levels and the backdrop of economic slowdown and uncertainty in financial markets will create a situation where BT and other CPs defer investment in NGA on the basis that there is simply no economic case for investment.

As BT chief executive Ian Livingston stated, following the announcement of its £1.5bn programme of fibre roll-out in July 2008: ‘A supportive and enduring regulatory environment is essential if this investment is to take place.’ This would involve ‘removing barriers to investment and making sure that anyone who chooses to invest in fibre can earn a fair rate of return for their shareholders.’

This view is shared by other communications providers including 02 and Virgin Media. Since BT announced its plans for fibre, 02 has also stated that it is considering offering broadband via fibre to the home, but that any commitment to investment would depend on clear and unambiguous regulation. Virgin Media has made clear that it supports BT’s call for a stable regulatory environment that rewards both current and future investment.

Question 7.1: Do you agree that it is appropriate to include an allowance for compensation payments in Openreach's cost base for the purposes of determining Openreach's service costs? If so, what level would you consider consistent with the level likely to be incurred by an efficient operator?

It is appropriate. We believe that this should be equivalent to the full costs likely to be incurred.

Question 8.1: Do price controls in the form of an RPI-X adjustment provide an appropriate basis for setting charges? If not, what alternative would you propose and why would this provide a more suitable basis? To the extent that adjustments in current charge controls are required, should those adjustments be implemented immediately or spread over the term of the control?

We have noted Ofcom's comments about whether a reference to other measures of inflation might be taken into consideration in terms of setting a structure under which price controls are adjusted to take account of movements in the cost of providing the underlying services: we would point out that RPI remains the most reliable and credible measure of price movements in the economy and that CPI – for instance – has less acceptability in this area.

Question 8.4: What are your views on the appropriate duration for a revised framework? Should Ofcom retain the flexibility to undertake a mid period review, and what do you consider should be the appropriate triggers for such a review?

The duration should be at least four years for provision of certainty.

Yes. Openreach should be able to trigger a review according to specific economic circumstances. That is, if a pre-agreed set of circumstances are met. If certain criteria are met – or certain circumstances arise – then Openreach should be able to request a review – which would be automatically agreed to.

Question 8.5: Do you consider that it would be appropriate to consider automatic mechanisms for modifying the charge controls in the event of substantial volume change? Do you have any specific views on the start date for the new charge control framework?

Certainty is needed from the charge controls put in place. Automatic triggers may work but considering the additional competition and risk in the market it would equally be appropriate to give Openreach the ability to manage volume shifts within the overall four year price cap set.

Question 8.6: How should the Pricing Framework respond to new service offerings from Openreach? We would welcome examples of new services offerings which your would consider should be encouraged?

A pricing framework should be structured in such a way that any other CP should be able to enter the market, but Openreach should be able to obtain a full return, in particular recognising the risk associated with innovation investment. This is the principle that should guide the introduction of new service offerings – and, indeed, the one which will act to encourage them. The general principle should be equality of access for all (encompassing BT Retail and all CPs) while Openreach should be guaranteed a fair and proportionate return for this.

Contact

For further information about any aspect of this submission, please contact:

Billy Hayes
General Secretary
Communication Workers Union
150 The Broadway
Wimbledon SW19 1RX

Tel: (020) 8971 7200
Fax: (020) 8971 7300

e-mail: info@cwu.org
http://www.cwu.org.uk

Adrian Askew
General Secretary
Connect
30 St. George's Road
Wimbledon SW19 4BD

Tel: (020) 8971 6000
Fax: (020) 8971 6002

e-mail: union@connectuk.org
http://www.connectuk.org/

7th August 2008