



28 August 2008

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Competition Policy
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Dear Markham

TELEFÓNICA O2 UK LIMITED – RESPONSE TO OFCOM CONSULTATION: A NEW PRICING FRAMEWORK FOR OPENREACH

Introduction

Further to my email of 8 August 2008, I am pleased to enclose Telefónica O2 UK Limited's (O2) initial response to Ofcom's Consultation "A New Pricing Framework for Openreach" (the Consultation).

Ofcom's approach to the review

1. O2 is generally supportive of Ofcom's approach to the review as outlined in the Consultation summary (§§1.12 – 1.15) and Ofcom's overall intent to ensure that the regulatory framework:

"...continues to promote the competition and innovation that has been fostered over the past two or three years, and to ensure that it provides a sustainable basis for the continued evolution of this important segment of the communications market."

Context of the review

2. Ofcom's 2004 Statement on Broadband Regulation¹ made clear Ofcom's position in respect of LLU:

"Ofcom believes that Local Loop Unbundling (LLU) - in which a provider takes either partial or full control of the customer's connection - is the most effective means of delivering more innovation, greater choice and lower prices in broadband."

3. Furthermore, in the same Statement Ofcom recognised that LLU price reductions had (together with other developments) led to the significant increase in the market's interest in LLU.

¹ <http://www.ofcom.org.uk/consult/condocs/rwlam/bbr/bbr.pdf>

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4. We believe, therefore, that Ofcom is right to be “...cautious in considering making changes to the current regime ...” given “...the considerable benefits that have been delivered by the industry as a whole under the prevailing regulatory framework (including the associated charge controls)...” (§3.12).

The importance of a holistic perspective

5. In the Wholesale Broadband Access (WBA) review², the competitive dynamic arising from LLU is such that that BT is no longer determined to have SMP in the market in certain areas (Market 3). We believe that the impact of any changes to LLU price ceilings also needs to be considered against the WBA backdrop (which reiterates Ofcom’s view as to the crucial role played by LLU³ in the development of the broadband market). Ofcom must take a holistic view in relation to the competitive landscape. LLU operators have a legitimate expectation under Ofcom’s Broadband Regulation Statement (see above) in relation to LLU margins vis a vis wholesale broadband access products:

“Some LLU operators have suggested that Ofcom should intervene to protect the margin available to them, possibly through formal regulation such as an ex-ante margin rule. Given the commitments made by BT, Ofcom believes that such an intervention would be unnecessary and inappropriate. However, should formal regulation be necessary in the future to support the margin available for LLU operators then Ofcom will intervene swiftly and decisively.” [Emphasis added].

6. At §8.8 of the Consultation, Ofcom notes that the relationship between volumes and the charge control is complicated by the fact that, volumes are influenced by largely exogenous factors, including, in the longer term, from Next Generation Access (NGA). Equally, Ofcom’s consultation on its potential regulatory approach to NGA⁴, explains that anchor regulation may be an attractive option and that “...LLU could act as the static anchor...” (§A7.3). Accordingly, Ofcom must not consider its approach to the pricing framework for Openreach in isolation to its approach to NGA regulation. Again, Ofcom must take a holistic approach and consider the associated dynamics engendered.

Review of the evidence

7. It is helpful for Ofcom to summarise the case that BT makes in relation to its costs – and for Ofcom to outline its initial views on BT’s cost assessments. It will be essential over the course of the review (including Ofcom’s second, more detailed consultation on the range of price controls) for there to be robust and transparent scrutiny of underlying data, assumptions and supporting evidence.

² “Review of the wholesale broadband access markets,” Ofcom, 21 May 2008
<http://www.ofcom.org.uk/consult/condocs/wbamr07/statement/statement.pdf>

³ “Competition in the provision of retail broadband services depends on service providers having access to wholesale broadband services or local loop unbundling (LLU) to build their own services. Ofcom has identified that competition between networks based on LLU, rather than competition based on wholesale broadband products, is crucial to maintaining the UK’s broadband progress. Promoting competition based on LLU continues to be central to Ofcom’s approach in making sure that consumers can access the services they demand.” §1.2 of
<http://www.ofcom.org.uk/consult/condocs/wbamr07/summary/>

⁴ “Future broadband: Policy approach to next generation access”, Ofcom, 26 September 2008
http://www.ofcom.org.uk/consult/condocs/nga/future_broadband_nga.pdf



Key (Openreach) assumptions

8. At §6.28 Ofcom sets out that:

“Our current view is that Openreach has adopted a set of assumptions that are likely to overstate the magnitude of costs increases”.

9. Examples supporting such a view appear to abound. For example, in relation to the potential for efficiency savings (Ofcom identifies a top end of achievable gains at 4% rather than the 1% suggested by BT - see §A8.27).

10. Furthermore, we note that whilst BT forecasts assume that *...“future efficiency gains will offset some of the upward pressure on costs but will not do so completely...”* (as summarized by Ofcom at §6.15), elsewhere, BT comments in its Q1 2008 announcements regarding Openreach⁵:

“Operating costs decreased by £24 million to £815 million in the quarter. Our investment in service has led to continued improvements in lead times, which reduced by one quarter, and the number of access faults decreasing by 16 per cent compared with the prior year. The benefits from this investment and the associated costs in the prior year have more than offset the effects of inflation, resulting in an overall 3 per cent reduction in operating costs.”
[Emphasis added].

11. Overall, we believe that greater transparency and scrutiny is needed in relation to BT's forecasts, including:

- the increase in capital employed (figures 6.4 and 6.5);
- depreciation;
- the shift in financing structure (such as the structuring of liabilities - figure 4.1 shows assets less liabilities increasing, depreciation reducing and stable capital expenditure – suggesting a shift in financing structure) which may drive up BT's evaluations of WACC, and
- cost allocation between regulated and unregulated products.

Concluding comments

12. Overall, we believe the Consultation's approach is a constructive one. However, as Ofcom recognises, it is essential for there to be robust and transparent scrutiny of the cost assumptions, their allocation and supporting evidence for any change to the current charge control ceilings. We welcome the opportunity to participate in the review.

Yours sincerely

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Telefónica O2 UK Limited

⁵ <http://www.btplc.com/News/ResultsPDF/q108release.pdf>