A New Pricing Framework for Openreach

Openreach Response to Ofcom Consultation (dated 30 May 2008)

8 August 2008

Openreach welcomes comments on the content of this document, which is available electronically at http://www.btplc.com/responses

Comments should be addressed to:

Duncan O'Neill, Openreach Regulatory Affairs, British Telecommunications plc; Floor 3 Kelvin House, 123 Judd St, London WC1H 9NP email [duncan.oneill@openreach.co.uk]

TABLE OF CONTENTS

Separately attached Annexes

Executive Summary

Openreach welcomes this urgent and essential review by Ofcom of the pricing framework for Openreach's regulated copper access products. In this review, Ofcom has the opportunity to ensure the sustainable supply of Openreach's regulated services and in turn lay the appropriate foundations to support competition in access services going forward.

The current pricing framework is based on a number of Ofcom determinations, the earliest of which was published in 2004. Given developments in the market and the changing economic conditions the pricing framework that is in place today is out of step with the underlying costs of providing services. This review is therefore crucial to provide a new pricing regime that can deliver the right long term economic framework and appropriate investment incentives to Openreach and the industry more broadly.

A number of important market developments have occurred since the current charge ceilings were set. These include:

- the establishment of Openreach in January 2006;
- significant growth in the number of Local Loop Unbundling ("LLU") lines - from 300,000 in February 2006 to over 4.87 million today[1]; and
- substantial and consistent improvements in quality and service delivery by Openreach.[2]

The current regime has led to substantial under recovery of costs across a wide range of Openreach's critical copper-based product set. This is an issue which must be addressed now. This is particularly extreme in the case of MPF. This under recovery has in turn resulted in price differentials between Openreach's key products which have produced a distorting arbitrage between MPF and WLR+SMPF which is unsustainable.

If uncorrected, this will inevitably result in accelerating market movement towards MPF, which will result in Openreach failing to deliver an adequate return on investment – an unsustainable economic model. The consequences of this will be zero incentive to invest in either current or new service and products and a significant degradation of customer service affecting not only Openreach's customers, but consumers and businesses across the UK.

The current charge ceilings are fixed in nominal terms and without Ofcom's immediate and timely intervention to correct the position there could result a drastic reduction of Openreach's Return on Capital Employed ("ROCE"). This will remove not only the incentive, but also the ability, to invest, and could well

---

1. LLU Installed Base. Source: Office of Telecommunications Adjudicator (OTA), Key Performance Indicators, accessed on 8 August 2008.

2. Refer Office of the Telecommunications Adjudicator, Key Performance Indicators, <http://www.offta.org.uk/charts.htm>.

undermine the substantial consumer benefits that have been achieved to date.

Openreach believes that the following objectives, which Openreach considers are closely aligned to Ofcom's own objectives as set out in the "A new pricing framework for Openreach" dated 30 May 2008 ("the Consultation"), should apply to Ofcom's review of the charge control ceilings. Ofcom's aim should be:

- (1) to ensure the regulatory framework enables and incentivises Openreach to respond to market demand and to invest and innovate in new and existing products and services;

- (2) to provide confidence to CPs that prices are not excessive and that Openreach is complying with its other existing SMP regulatory obligations;

- (3) to use the new pricing framework for key copper access services to establish a transparent and stable regulatory framework; and

- (4) to allow Openreach to fully recover its costs, including a return on capital employed in line with the cost of capital, across its regulated copper access portfolio throughout the charge control period.

Appropriate regulation is essential to setting the right framework under these objectives. Openreach would suggest that it needs to be constructed as follows:

- an immediate increase in the price of MPF rentals of at least £16 per annum, such that MPF earns an appropriate regulated return, with a subsequent RPI + X regime thereafter:

    - an immediate correction is appropriate and proportionate due to the drastic effect of the projected shift towards MPF on Openreach profitability, while still retaining a significant and justified price differential between MPF and WLR+SMPF;

    - to delay the increase (no immediate step change) would mean prolonging the current damaging under recovery of costs and would remove our willingness and ability to invest;

    - the immediate rectification is critical to ensure short and long term sustainability of the regulatory regime in the UK through the viability of Openreach;

- there should be separate price control baskets for MPF, WLR, SMPF and Co-mingling product sets that allow Openreach an appropriate return, including its regulated cost of capital;

- other products not currently subject to price controls do not require further regulatory intervention;

- a price control regime set for a minimum of four years in order to underpin stability in the market;

- a recognition of the significant migration from WLR+SMPF to MPF forecast by the market, thereby increasing the proportion of fixed and common costs that need to be recovered from MPF;

- an efficiency target that is appropriately sized in relation to the true potential of Openreach to reduce its cost base, and to ensure the maintenance and improvement of service levels, as demanded by the market;

- all relevant costs to be included in the regulated cost base and recovered in Openreach's product prices under the new pricing framework, in particular Openreach believes that there are a number of cost items not included in Ofcom's analysis, including the costs of setting up Openreach, contributions to the pension deficit and leaver payments; and

- unforeseen and exogenous cost increases which are not captured in the Retail Price Index ("RPI") (i.e. cumulo rates) should be permitted to flow through immediately into prices.

A central part of appropriate regulation is the setting of the right weighted average cost of capital ("WACC") which can be recovered by Openreach (and indeed certain other BT investments). Currently, Openreach's WACC is set too low. Moreover, consideration of current and foreseen unstable conditions in the financial markets suggest a need to be cautious in setting the WACC to enable any ongoing investment in the regulated asset base.

Accordingly, Openreach's cost of capital should be set towards the upper end of this range, at 12.1% or more.

Cost allocation across the Openreach portfolio has an important part to play in the success of the future framework. We therefore look to Ofcom to ensure clarity around these principles to ensure two outcomes:

- Short Term: the ability to meet market demand through innovation and to create, price, sell and support supplementary services that may utilise a proportion of the common cost base; and

- Longer Term: once the market for these non-regulated products has been built, the opportunity exists at the next pricing review to share the common costs across a larger installed base.

Openreach looks forward to further discussions with Ofcom and with our customers in order to progress this review to a satisfactory and workable conclusion. In this way, Openreach can continue to underpin the UK communications industry in a financially sustainable manner, taking into account the ongoing costs of meeting the obligations of the Undertakings, for the benefit of Openreach, our customers and the industry as a whole.

1 Introduction

Openreach welcomes Ofcom's review entitled "A new pricing framework for Openreach" dated 30 May 2008 ("the Consultation") and this opportunity to respond to it.

From an economic and regulatory policy perspective, Openreach and the wider industry are now at a critical point. Regulation must enable Openreach to recover an appropriate return on its (regulated) investments, and the issues identified in Ofcom's review must be addressed in a transparent, time bounded and unambiguous manner.

Effective resolution of these issues is required to ensure that the UK communications industry has confidence to develop, supported by the right long term economic framework, and appropriate investment incentives. In the absence of an enduring and financially robust solution to the issues raised in Ofcom's review, there is considerable risk to the sustainability of the supply of regulated access services, the long term competitive process and continued positive consumer outcomes.

The background against which the wholesale access market has developed to date includes both the concept of equivalence and price caps on particular services. The policy background includes Ofcom's Telecoms Strategic Review ("TSR") and Ofcom's policy of encouraging competition by means of addressing enduring economic "bottlenecks".[3] This is primarily achieved by requiring Openreach to provide access services on equivalent terms. In addition as part of the wider regulatory regime, price ceilings were set for certain key Significant Market Power ("SMP") copper access products, Metallic Path Facility ("MPF"), Shared MPF ("SMPF") and Wholesale Line Rental ("WLR")[4] to encourage competitive investment (in access and networks).

Ofcom's objectives for this new pricing framework illustrate that its over-arching regulatory policy has not changed. Broadly, the policy emphasises facilitation of competition as deep in the network as is likely to be effective and sustainable. Openreach has already both enabled and made significant progress in this regard. In addition to creating Openreach, an effective, functionally separate entity within BT, Openreach has successfully underpinned the development of LLU and other access based competition.

Given the critical point that has now been reached, it is timely that Ofcom has commenced a review (and revision) of the economic and regulatory policy that applies to Openreach. This review is required to address issues created by

---

[3] Ofcom, Final statements on the Strategic Review of Telecommunications, and undertakings in lieu of a reference under the Enterprise Act 2002 dated 22 September 2005 at [1.5].

[4] For the purposes of this document, WLR refers to only Openreach's Wholesale Analogue Line Rental product.

the current charging regime, namely, that the current pricing levels and structures are expected to threaten Openreach's financial sustainability, and therefore jeopardise sustainable and effective competition over the long term.

In this Response to the Consultation, Openreach clearly illustrates the economic distortions created by the current charge ceilings and their likely future effects, particularly those created as a result of the present MPF rental price ceiling. Openreach's modelling and analysis shows that Openreach's ROCE for "Core Rental Services" (as defined in the Consultation) could potentially fall to around 1% in 2011/12 without intervention.[5] Such returns will be negative in real terms, and also fall well below the current risk free rate. Moreover such outcomes would clearly be unacceptable to investors considering an investment in an entity with Openreach's risk profile. This severely jeopardises Openreach's ability to invest in the maintenance and improvement of its network to the detriment of our customers, and will also lead to inefficient investment decisions by our customers which will undermine service development and performance. As such, current pricing levels are clearly unsustainable.

If the regulatory policy framework going forward effectively prevents Openreach from earning an appropriate return on existing assets, this will eliminate any incentives relating to future investments. Openreach considers that any potential shift in the nature of investment in underlying access technologies will be mainly determined by the revised economic model governing the existing access technology and pricing. In order for Openreach to develop an executable strategic plan, and to have the confidence to continue to invest in its people, networks, systems and service quality, the issues identified in this review must be addressed and resolved now.

Openreach is not in a position to resolve the issues identified in the review itself — the current pricing structures are predominantly derived (and determined) by Ofcom charge ceilings. Ofcom and industry engagement is a pre-requisite to a workable and economically sustainable outcome.

The structure of Openreach's response to the Consultation is set out as follows:

- Section 2 builds on the analysis in the Consultation and sets out why Openreach believes a financial review is necessary;
- Section 3 provides Openreach's views on a set of guiding principles required to put the industry on a sustainable footing going forward;
- Section 4 provides detailed answers to each of the questions raised in the Consultation;
- Annex A provides further information on international price benchmarking;

---

[5] Ofcom, *A new pricing framework for Openreach*, Consultation, 30 May 2008. ("Consultation") at [6.14]

- Annex B provides BT’s views on its cost of capital;
- Annex C reviews the impact of the ongoing financial turmoil in financial markets on BT’s cost of capital, as prepared by Oxera; and
- Annex D summarises interviews with city financial institutions held by Mr Philip Carse of Teleq Consulting, to assess capital market participants’ views on BT’s cost of capital.

Upon request by Ofcom, Openreach continues to provide updated information relating to its most recent estimates of future costs and demands. As new information becomes available, the Openreach forecasts may have modified projections of the costs for the key copper access products in the future.

To the best of BTs knowledge all information provided in this Response is accurate. However, certain information provided is indicative, and although all reasonable care has been taken to validate its accuracy at the date of this Response, BT reserves the right to amend such information. The information in this Response should not be relied upon by Ofcom or any third party, aside from the purpose for which it is expressly provided.

This Response is provided by Openreach, a line of business within British Telecommunications plc.

2 Why a review is needed now

This Section sets out that a price review is needed now to address the fact that:

- prices for MPF rentals are currently significantly below cost;
- prices for WLR residential rentals are also below cost;
- there are a number of factors which have contributed to the rising costs including inflation, changing product mix, and demand changes; and
- Ofcom's current estimate of cost is understated as its analysis excludes relevant costs, such as contributions to the pension deficit and leaver payments.

2.1 Introduction

Since its inception, Openreach has made significant progress in creating a business dedicated to serving the local access and backhaul needs of all Communications Providers ("CPs"). This is exemplified by Openreach underpinning the development of LLU in the UK. Going forward, Openreach has an ambitious agenda to meet its equivalence commitments and improve both service and efficiency, through a range of transformation initiatives, to deliver benefits to Openreach customers and the industry as a whole.

However, as the market for communications services continues to evolve, Openreach is increasingly faced with the need to balance competing pressures on its finite resources – its physical assets, systems, products and people. Given the importance of Openreach to the business models of all CPs, and its position as a supplier of essential inputs to those business models, the strategic imperative is for Openreach to find a path through the pressures while making a full regulatory return on its underlying assets and maintaining an economically sustainable business over the medium to longer term.

2.2 Insufficient recovery of costs

The current charge ceilings set by Ofcom do not allow Openreach to recover its relevant costs. For example, the Consultation in Annex 7 shows that:

- For MPF rentals, the Common Cost Allocation ("CCA") Fully Allocated Cost ("FAC") is estimated during 2008/09 to be £94, which far exceeds the current price ceiling of £81.69.
- For WLR residential rentals, the CCA FAC is estimated during 2008/09 to be £106, which is above the current price ceiling of £100.68.

Therefore, it is essential that the current charge ceilings are reviewed now and urgent corrective action taken which addresses these issues. Openreach also considers that a one-off step change is immediately required to rectify the price-cost disparity for MPF rentals. Openreach's latest analysis, based on the currently available data, and on the currently applicable WACC of 10% (which is also under review), suggests that an immediate increase of at least £16 per annum in the MPF rental price is in fact required. It is noted that upon setting the charge ceilings, Ofcom committed to undertake to review them within a reasonable period (i.e. within the first few years of operation). At the time, Ofcom noted that an appropriate reason for such a review would be if BT believed that it was no longer able to materially recover its relevant costs and charge below the ceiling, or additionally in light of significant changes in BT's costs. Clearly, Openreach considers that now is the appropriate time to review the charge ceilings so that it can recover its costs and inflationary cost increases.

This Section 2 sets out the factors which have contributed to the current situation whereby prices are below relevant costs.

2.3 Price controls have been fixed in nominal terms

In regulated industries, reviews of price ceilings are appropriate at regular intervals. While no review of charge ceilings for Openreach products has been carried out yet, and in light of the fact that some of the charge ceilings applied to Openreach products have not been updated or amended since 2004, it is now essential for this review to be conducted quickly. The current charge ceilings and the dates when they were last reviewed are shown in Table 1 below.

Table 1 Current nominal price controls imposed on Openreach

Core Rentals	**Price Ceiling**	**Fixed Since**	**Regulation**
WLR Residential	100.68	Jan-06	Jan '06 Ofcom WLR Statement
WLR Business	110.00	Jan-06	Jan '06 Ofcom WLR Statement
SMPF	15.60	Dec-04	Dec 04 Ofcom LLU Statement
MPF	81.69	Nov-05	Nov '05 Ofcom LLU Statement
Ancillary Services			
Co Location, Tie Cables	Various	Dec-04	Dec 04 Ofcom LLU Statement
WLR Connections, Transfers	Various	Jan-06	Jan '06 Ofcom WLR Statement
SMPF Connections, Migrations	Various	Dec-04	Dec 04 Ofcom LLU Statement
MPF Connections, Migrations	Various	Dec-04	Dec 04 Ofcom LLU Statement

For example, Table 1 shows that the charge ceiling for MPF, a crucial product in the Openreach portfolio, has not increased for nearly 3 years. During that time, the Retail Price Index ("RPI") has increased by 12%[6]. However, Openreach is restricted from having the ability to raise the MPF price to an appropriate level commensurate with this increase in costs.

All of the price determinations in Table 1 take the form of a price ceiling of unlimited duration. No allowance is made for the impact of inflation and therefore this imposes an annual devaluation of Openreach revenue streams in real terms.

Inflationary pressures are being felt right across industry, with the Confederation of British Industry recently stating that "Manufacturers have continued to raise the prices of their goods, in the face of the fiercest cost increases since 1980".[7] Specific inflation risks are further discussed in our response to Question 4.1. We have summarised the key points below:

- Openreach is a labour intensive business with relatively low flexibility (labour costs are increasing at or above RPI);
- Openreach's business relies on the mobility of its engineering workforce (fuel costs are rising above RPI);
- Openreach's business is susceptible to movements in energy prices (light, heat and power costs are projected to rise above RPI);
- Openreach's business is susceptible to commodity market price movements (the physical copper price is rising above RPI); and
- Openreach must make allowance for statutory increases in business rates (cumulo rates) and the effect of other government legislation/regulation (e.g. more stringent environmental standards).

2.4 Changing product mix

The changing composition of demand for the key Openreach copper access products towards MPF is impacting the recovery of costs. The price of MPF is below cost to a greater extent than that for WLR. However, according to current and projected customer purchasing activity from Openreach, MPF is fast becoming the main Openreach access product, (as shown in Figure 1 below) and the current artificial price differential between MPF and WLR+SMPF will accelerate this trend if it is not addressed.

---

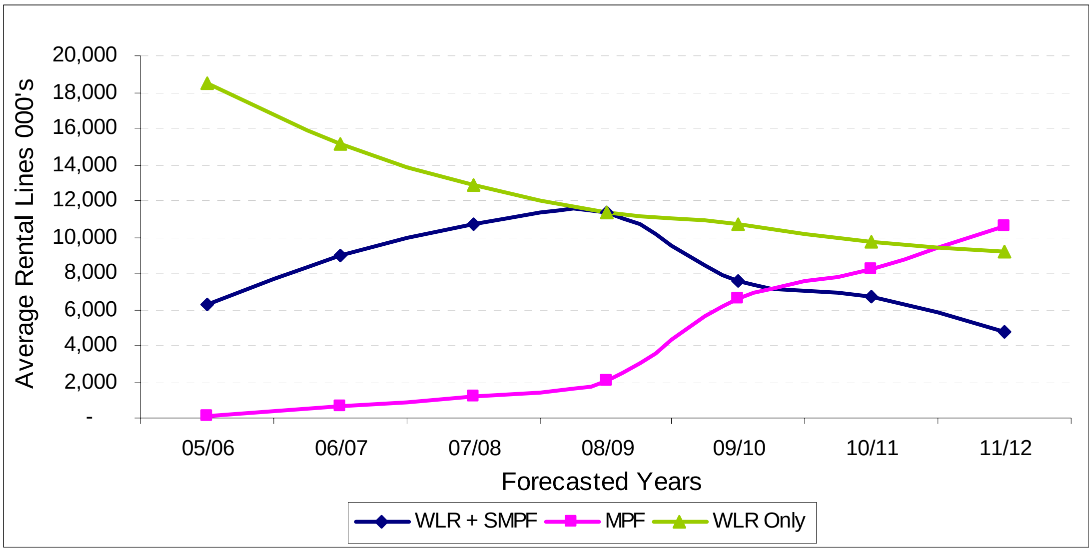
6 Table RP02, Retail Prices Index (RPI) all items, Issued by the Office of National Statistics, available from: http://www.statistics.gov.uk/CCI/nugget.asp?ID=21.

7 Confederation of British Industries, Manufacturers in pessimistic mood as record costs continue to force up prices – CBI, news release, 23 July 2008 <http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/56c04c73e998ee6b8025748a00561ef2?OpenDocument>.

Figure 1 shows that MPF lines are forecast to multiply ten-fold from approximately 1 million lines in 2007/08 to approximately 11 million lines in 2011/12. This presents two challenges for Openreach:

- first, the MPF price ceiling is set well below the level required to allow Openreach to fully recover its permissible regulated costs including a return on capital. As volumes increase this issue is exacerbated; and
- secondly, with each migration to MPF, Openreach generally loses approximately £35 in revenue per annum with minimal reduction in costs. That is calculated on the basis of the price of residential WLR plus SMPF (£100.68 + £15.60) to MPF (£81.70) again driving a major gap in recovering common costs.

Figure 1 Openreach actual and forecast demand for core copper services[8]



Although the major CP investment programmes to roll out LLU are largely complete, Openreach's demand forecasts indicate that certain major CPs are likely to increase their LLU presence up to approximately 2,000 exchanges, depending on the CP's scope and desire for capital expenditure. In addition, it is likely that CPs will move to full LLU (MPF) once critical mass is achieved in each individual exchange. The attraction for CPs of moving to LLU, using MPF, is the price advantage that MPF currently represents in comparison with WLR+SMPF based products, as well as the additional scope for product differentiation, functionality and flexibility. Openreach does not benefit from any economies of scale as a result of the migration to MPF, as the relationship between volumes of MPF and cost is broadly linear, although in the short term migration to MPF drives additional cost because of the additional jumpering work required.

---

8 Figures for 2005/06 and 2006/07 are actuals. Values for other years are estimates as Openreach is relying on the same data provided to Ofcom in Q2 2007/08; being the same data used by Ofcom in preparing its consultation document.

Openreach notes that in Annex 9 of the Consultation, Ofcom suggests that it has received data from industry suggesting that Openreach may actually be understating demand for MPF by approximately 2 million lines[9].

The largest CP which Openreach supplies is the rest of BT, whose consumption patterns are also set to change. Openreach currently sells SMPF to BT Wholesale, as input to its IPStream product range, and sells WLR to BT Retail. Under plans for BT's 21C network, the rest of BT will be able to emulate the network architecture of the other CPs and be able to consume MPF. For example, BT Wholesale will acquire MPF as the input into its Wholesale Broadband Converged Connection product. This will be a further shift towards MPF, again adding to the financial pressures on Openreach.

2.5 Other factors

In November 2005, Ofcom said that it was setting price ceilings in nominal terms on the basis that the current take-up of LLU services was too limited to allow an accurate enough assessment of LLU costs to set a sufficiently robust charge cap; and that the [then] possible implementation of "equivalence of inputs" meant that costs were uncertain.[10] Clearly, the number of LLU lines has increased massively since 2005 and there is now robust information about implementation costs and Openreach set up costs. In addition, as we have described in our answer to Question 4.1, many of Openreach's input costs have increased significantly in the interim period. Just on the basis of RPI increases alone, the MPF rental charge ceiling should now be nearly £91.50 per year.

In addition to under recovery of costs, inflation and the changing product mix, there are other factors that indicate that the current nominal price controls are no longer appropriate and need to be reviewed.

Volumes and aggregate future demand are declining

The aggregate number of regulated copper access lines is declining as consumers and small-to-medium enterprises substitute second lines and ISDN2 services for broadband solutions, and with the effect of increased competition from wireless and cable operators as access markets converge. This leaves Openreach with fewer lines from which to recover the fixed costs of operating and maintaining the network (including previous network investment in the form of depreciation).

In addition, Openreach is experiencing a decrease in demand for migration and connection products as the migration to LLU products slows.

---

9 Consultation, at [A9.5].

10 Ofcom, Local loop unbundling: setting the fully unbundled rental charge ceiling and minor amendment to SMP conditions FA6 and FB6, Statement ("LLU Statement 2005");, November 2005 at [3.17].

Unwinding of previous regulatory accounting adjustments

As discussed our response to Question 4.1, Openreach notes that some of the price ceilings were also set on the back of regulatory adjustments that will unwind over time as pre-1997 copper assets become a lower proportion of the asset base.

In determining the current charge ceilings for MPF and WLR line rentals in 2005 and 2006, Ofcom applied a number of regulatory accounting adjustments that had the impact of deferring the recovery of costs to a later date. These adjustments have the effect of requiring Openreach to recover these deferred costs in addition to costs incurred in the future.

Efficiency

Openreach strives to reduce costs and improve efficiency in all areas, but as well as operating in the inflationary environment described above, Openreach must also maintain network reliability against the backdrop of an ageing copper network and ensure that customer demands for quality service provision are consistently delivered. This requires significant ongoing investment in resources, limiting the scope for overall unit cost savings (see our answer to Question 6.2).

Impact of the Undertakings

The introduction of functional separation and equivalence also has a bearing, in that the option to recover any costs/losses over a wider (BT Group) portfolio of products is precluded; and the delivery of the legal obligations in the Undertakings, with associated equivalence systems (Equivalence Management Platform ("EMP") and re-engineered processes) has introduced costs not considered at the time of the Ofcom charge control determinations which set the current charge ceilings.

Openreach believes that while benefits have been delivered as a result of the package of measures introduced by the TSR (including the current charging framework), the TSR will only mark a genuine successful turning point for the industry if prices are now set at a sustainable level. Any regime which is not constructed on a firm basis is certain to stall and fail at some point – with lower investment levels, old and deteriorating infrastructure, a lack of new products and services, and significantly lower levels of customer service. This is why the unjustifiable transfer of value from Openreach through to downstream markets creates an unsustainable regulatory construct, and one that needs remedying before these effects irreversibly undermine the existing market structure.

Additional costs

Openreach notes that not all relevant costs have yet been included by Ofcom in their analysis of the Openreach cost stacks. Therefore, the extent to which relevant costs exceed prices is greater than Ofcom's initial analysis would suggest. These costs include setting up Openreach, contributions to the pension deficit and leaver payments. These are discussed in more detail in our response to Question 6.6 of the Consultation.

2.6 Conclusion

An immediate review of the price ceilings currently imposed by Ofcom on Openreach's key copper access products is necessary to address the disparity between prices and costs. The disparity is influenced by a range of factors including inflationary pressures, the changing product mix, changing future demand and the impacts of previous accounting adjustments, efficiencies and the Undertakings commitments. The extent to which costs exceed prices may be understated in the Consultation as not all relevant costs have been included in the analysis.

3 Regulatory objectives and proposed new pricing framework

This Section 3 outlines Openreach's comments on the objectives set out by Ofcom in the Consultation and also explains how Openreach's objectives differ.

- Openreach broadly supports with Ofcom's objectives, however, Openreach suggests the following changes:
  - (1) to ensure the regulatory framework enables and incentivises Openreach to respond to market demand and to invest and innovate in new and existing products and services;
  - (2) to provide confidence to CPs that prices are not excessive and that Openreach is complying with its other existing SMP regulatory obligations;
  - (3) to use the new pricing framework for key copper access services to establish a transparent and stable regulatory framework; and
  - (4) to allow Openreach to fully recover its costs, including a return on capital employed in line with the cost of capital, across its regulated copper access portfolio throughout the charge control period.
- The scope of the new pricing regime should be limited to those products where price regulation currently applies, i.e. MPF, SMPF and WLR.

3.1 Introduction

The review of the pricing framework for Openreach's key copper access products is a significant milestone in Ofcom's programme on regulatory policy. It is not merely a review of prices charged for particular products. Rather, the review creates an opportunity for Ofcom to build on the competitive foundation provided by the Undertakings, including the creation of Openreach, and to promote effective and sustainable competition across the value chain.

A new pricing regime can help deliver the appropriate incentives and economic framework to allow competition itself to determine the future shape of the market. Based on appropriately designed price controls which are of reasonable duration and allow for full cost recovery, the new pricing framework can provide the required regulatory certainty and set the right economic incentives and signals to the entire market. When clearly delineated, this will allow the market to develop, taking into account the appropriate underlying economics. The changing nature of the market dynamic and its underlying economics means that the current price regulation needs to be revised.

Openreach welcomes Ofcom's principles-based approach to the review and supports its objectives. Openreach generally agrees with the basic analytic framework proposed by Ofcom and the governing “principles”.[11] Openreach also believes that Ofcom’s proposed objectives for a new pricing framework are consistent with the delivery of financially sustainable and economically efficient outcomes that are to the benefit of all participants in the market.

3.2 Openreach’s objectives for the new framework

Openreach’s own objectives for the new proposed pricing framework are broadly consistent with Ofcom’s own objectives. In Table 2 below, the key responses from Openreach to each of Ofcom’s objectives[12] are set out and show the high degree of alignment between the Openreach position and Ofcom’s stated objectives.

[11] Consultation, at [1.12].

[12] Consultation, at [2.14].

Table 2 Ofcom's and Openreach's objectives for the review

Ofcom's objectives	Openreach's objectives	Comments
Promote efficient, sustainable competition in the delivery of both broadband and traditional voice services	Ensure the regulatory framework incentivises and enables Openreach to respond to market demand and to invest and innovate in new and existing services.	Openreach considers efficient and sustainable competition to be one of the outcomes of providing the appropriate economic incentives – effective competition cannot be sustained absent the correct underlying price regulation across the Openreach SMP copper access portfolio. Openreach should be free to respond to market demand and have incentives to innovate and invest in new and existing services.
Prevent excessive charging and abuse of SMP by Openreach	To provide confidence to CPs that prices are not excessive and that Openreach is complying with its other existing SMP regulatory obligations.	Openreach agrees that the application of appropriate and proportionate regulatory remedies to the services under review (e.g. in the form of future-looking charge controls for SMP copper access and the other associated ancillary services) will help to underpin CP confidence. In addition, other non-price SMP regulatory remedies already in existence prohibit BT from partaking in other forms of abusive conduct.
Provide regulatory certainty for both Openreach and its customers.	Provide transparency and regulatory certainty to establish a stable, long term regulatory framework for Openreach and our customers.	Regulatory certainty - including about what is to be regulated, and what is not to be regulated - is a pre-requisite not only for financial stability but also for investment and innovation, including by Openreach in services outside the set of core regulated services and for which market demand exists.
Ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred), including the cost of capital	Allow Openreach to immediately, and continuously throughout the charge control period, to fully recover its costs, including a return on capital employed in line with the cost of capital, across its regulated copper access portfolio throughout the charge control period.	Full cost recovery is vital if the copper access network is to be maintained and improved and so that Openreach can respond to market demand for new products and services.

We now set out below further detail on the specific objectives proposed by Openreach.

3.2.1 Ensuring appropriate incentives which allow Openreach to respond to market demand, to innovate and to invest in new and existing services

It is important to ensure that any framework is sufficiently dynamic. In short, the objective must also be to promote competition such that both the short and long term economic incentives, for Openreach and all CPs, are appropriate and properly aligned. Moreover, the development of effective competition, and the resulting benefits to consumers, can only be achieved if Openreach is able to efficiently supply services on an economically sustainable basis.

Regulatory obligations ought not to exist in a commercial vacuum. While the services under consideration in this review will be the main component of any new framework, the framework must be designed to ensure there is no “spillover” of regulation into new areas, and that regulation neither inhibits market developments nor Openreach’s ability to respond to market demand. Ofcom must ensure that its regulatory response is proportionate to the objectives which it sets out to achieve.

In particular, Ofcom should take into account the significant regulatory changes which have occurred since some of the previous price ceilings were set. We also request that Ofcom be mindful that regulation should be neither unduly burdensome nor duplicative in its approach. The extent and scope of regulation should not therefore be extended unless it can be fully justified. This would include, absent an SMP finding, not seeking to extend regulation to new, innovative products which Openreach develops in response to changing market conditions or extending price controls to services not currently subject to such measures.

Given a measured and proportionate regulatory response, we consider that Openreach can continue to provide the foundation for effective wholesale access and backhaul competition in the UK. Such regulation, when combined with the Undertakings, would represent a robust and enduring framework towards the promotion of sustainable competition. Openreach submits that its proposed objectives are consistent with Ofcom’s own policy objectives to the extent of ensuring that Openreach and the wider industry have the right economic incentives and, above all, confidence in the sustainability of the new regulatory framework.

Our first proposed objective is therefore (**Objective 1**):

- ***To ensure the regulatory framework enables and incentivises Openreach to respond to market demand and to invest and innovate in new and existing products and services.***

3.2.2 Provide confidence for CPs that Openreach is not excessively pricing and is not breaching any of its other existing SMP obligations

This pricing review can set fair charges for access services and, by the use of price caps, set cost orientated rates which can apply for a number of years. We have suggested that the optimum form of price cap is for there to be separate caps for MPF, WLR, SMPF and Co-mingling services but that within each of these service sets Openreach should have the ability to set individual prices in such a way that the overall basket of services is priced in line with an overall price control. In these circumstances CPs could be assured that Openreach was never permitted to charge excessively.

Openreach's conduct is further restricted given that it will also continue to have a large number of other "non price" SMP conditions imposed upon it, across a range of products/services, which prohibit Openreach from partaking in other forms of abusive conduct.

Openreach's second proposed objective for the new pricing framework is therefore (**Objective 2**):

- ***To provide confidence to CPs that prices are not excessive and that Openreach is complying with its other existing SMP regulatory obligations.***

3.2.3 Providing transparency and regulatory certainty

The design of any new pricing framework must provide transparency and clarity of policy and allow Openreach to earn a rate of return that includes its regulated cost of capital. For example, price controls need to be clearly delineated in terms of scope (see further our response to Question 6.3 below) while the duration and structure should provide a stable basis on which informed long term business decisions can be made. Therefore, it is critical that the framework provides for regulatory certainty and, where relevant, financial stability.

Openreach's third proposed objective is therefore (**Objective 3**):

- ***To use the new pricing framework for key copper access services to establish a transparent and stable regulatory framework.***

3.2.4 Allowing Openreach to fully recover its allowable costs

Full cost recovery is vital if the copper access network is to be maintained and continue to provide the improved customer service levels. Going forward, Openreach also needs to be incentivised to invest in new products and services and the ability to create new products to respond to customer demand.

Our fourth objective is therefore (**Objective 4**):

- ***To allow Openreach to fully recover its costs, including a return on capital employed in line with the cost of capital, across its regulated copper access portfolio throughout the charge control period.***

This objective is of fundamental importance to Openreach and the BT Group.

3.3 Setting the right regulatory framework

Setting the appropriate regulatory framework under these principles, especially for Openreach's key access copper products of MPF, WLR and SMPF is essential if the benefits of market developments to date are to be maintained and to enable future developments to allow for effective and sustainable investment, competition and innovation. Openreach's views on the appropriate regulation are summarised below, with more details set out in our responses to the specific questions asked by Ofcom in the Consultation set out in Section 4 of this Response.

3.3.1 Scope

Openreach believes that the primary focus for this review should be to ensure that appropriate price controls are in place for the rental prices of Openreach's MPF, SMPF and WLR SMP products. In addition it is appropriate to clarify the position of other SMP products and services that CPs need to purchase from Openreach in conjunction with MPF, SMPF and WLR rental products. This includes connections and ancillary services, most of which are already subject to price controls.

For other products and services within Openreach's regulated copper portfolio, Openreach does not believe there is a case to extend price controls where none currently exist. Principally this applies to ISDN2 and ISDN30 where we believe that supply side competition continues to provide an effective pricing constraint and that the imposition of regulatory price controls has the potential to adversely distort behaviours in the market to the detriment of consumers.

We further agree with Ofcom that unregulated products and services do not form part of this review, except to the extent that Ofcom wishes to satisfy itself that the allocation of common costs across Openreach's products is appropriate. Also, services subject to review in the Business Connectivity Market Review ("BCMR") are beyond the scope of this pricing framework review.

3.3.2 Price control type and duration

We believe that price controls in the form of an RPI+X adjustment provide the appropriate basis for setting charges for our key copper access products of MPF, WLR and SMPF. As discussed in Question 8.1, such controls would provide certainty for all players in the market and the incentive effects of price caps are well known[13].

Openreach also believes that it is preferable that price controls cover a *basket* of related services rather than individual services, because a basket approach will give Openreach greater flexibility to accommodate variations in customer demand within the overall regulated framework.

We therefore propose three separate baskets covering MPF, SMPF and WLR respectively with each basket including rentals and connections plus other SMP products that CPs must purchase from Openreach in conjunction with MPF, SMPF and WLR rental products. A fourth basket would cover Co-mingling.

Using a basket approach would give Openreach an appropriate degree of commercial flexibility to adjust prices within the basket to respond to customer demands and preferences, and for the pricing framework to remain relevant and sustainable.

It is important that any price control regime is set for a reasonable period of time to ensure stability in the market. Historically, price caps applied to BT services have generally had a four-year duration. Such a duration has usually worked well to provide a balance between providing certainty and keeping prices reasonably aligned with costs. We believe the modelling approach taken by Openreach and Ofcom has been sufficiently detailed and robust to allow four year controls (at a minimum) to be set with confidence.

Where prices are broadly aligned with costs, we consider it appropriate for any required charge control adjustments to be spread across the term of the control. This applies to WLR, SMPF and Co-mingling.

However, as outlined elsewhere in our Response, the price of MPF rentals is significantly adrift of the cost of supply. We therefore believe an immediate step adjustment increase of at least £16 per annum in the price of MPF annual rental is required to ensure that Openreach is able to earn an appropriate return including its regulated cost of capital (much of which is reinvested to maintain and improve the network) and so that customers have sufficient certainty of the future MPF pricing structure to make efficient investment decisions. An immediate correction rather than a glide is appropriate and proportionate due to the drastic effect of the projected shift towards MPF on Openreach profitability; while still retaining a significant price differential between MPF and WLR+SMPF. To delay would mean knowingly prolonging the cross subsidy between substitutional business models.

13 LLU Statement 2005at [3.16], 7 September 2005. Full quotation cited in response to Question 8.1.

3.3.3 Cost of Capital

The cost of capital is a crucial part of the regulatory framework, not just because a return is allowed for in the regulatory pricing decisions, but because it influences the climate for investment for BT, Openreach and existing or potential competition. Ofcom's stance on WACC will have both direct and indirect effects on incentives to invest by BT and other companies in the sector.

BT attaches high importance both to the methodology used, and to the value that is set for the WACC. Since 2005, Ofcom has produced a disaggregated WACC which identifies individual rates for each of Openreach's copper access network business, BT Group, and the rest of BT. The consultation therefore affects not just Openreach, but BT Group in general. The views expressed in relation to the WACC are therefore those of BT, including Openreach. BT has some material differences to Ofcom in its view of how to apply the Capital Asset Pricing Model ("CAPM"), and the parameter values that should go into a decision on a target rate of return. BT's views on how WACC should be set are contained in our response to Question 6.8 of the Consultation, and in Annex B.

3.3.4 Cost allocation

The cost structure of network service industries often display a large element of common costs which are shared across a number of services. For Openreach, the common costs are spread across both SMP and non-SMP products and services. Openreach has demonstrated its cost allocation methodology to Ofcom[14] and it is consistent with the approach used in BT's regulatory accounts. We believe that our approach is fair and reasonable and that price regulated services attract an appropriate share of such costs, but no more.

Openreach believes that the principles governing cost allocation across its portfolio have an important part to play in the success of the future regulatory framework. Accordingly, it is important that Ofcom provides clarity around these principles to enable two outcomes:

a. Short Term: the ability to meet market demand through innovation and to create, price, sell and support supplementary services that may utilise a proportion of the common cost base; and

b. Longer Term: once the market for these non-regulated products has been built, the opportunity exists at the next pricing review to share the common costs across a larger installed base.

---

[14] Ofcom notes that Openreach's approach to its cost calculations appear to be logically sound. Refer Consultation, [A7.1]

3.4 Conclusion

There is a large degree of alignment in the objectives of both Ofcom and Openreach. Openreach's customers need both certainty and to know that the supplier of a key input to their business can sustain and develop the services which it offers. Openreach also needs certainty that it can obtain fair recompense for its maintenance and development of the copper access network. By recognising the legitimate expectations of both Openreach and its customers, the outcome of this review can provide a stable platform for a competitive UK industry in which investments can be made with confidence, and innovation can flourish.

4 Answers to Ofcom Questions

This Section sets out Openreach's detailed responses to the Questions asked by Ofcom in its Consultation.

QUESTION 2.1: WHAT DO YOU CONSIDER TO BE THE APPROPRIATE GOALS FOR A NEW PRICING FRAMEWORK?

Openreach considers that the appropriate goals for a new pricing framework are as follows:

- to ensure the regulatory framework enables and incentivises Openreach to respond to market demand and to invest and innovate in new and existing products and services;
- to provide confidence to CPs that prices are not excessive and that Openreach is complying with its other existing SMP regulatory obligations;
- to use the new pricing framework for key copper access services to establish a transparent and stable regulatory framework; and
- to allow Openreach to fully recover its costs, including a return on capital employed in line with the cost of capital, across its regulated copper access portfolio throughout the charge control period.

For further details of these objectives, please refer to Section 3 of this Response.

Openreach also considers that these objectives are in general alignment with Ofcom's objectives, which are to[15]:

- promote efficient, sustainable competition in the delivery of both broadband and traditional voice services;
- prevent excessive charging and the abuse of SMP by Openreach;
- provide regulatory certainty for both Openreach and its customers; and
- ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred), including the cost of capital.

The new framework should ensure that there is a level playing field; that no individual CP is provided with an unfair competitive advantage over others.

---

[15] Consultation, at [2.14].

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?

Ofcom's analysis in Section 3 of the Consultation illustrates how the current pricing framework has contributed towards the development of the market over the last 2-3 years. To a large extent, the existing framework has been instrumental in delivering the outcomes observed in Ofcom's analysis. However, it is difficult to ascertain the counter factual, and it might therefore be reasonable to assume that some or all of the observed outcomes may have been achieved absent one or other of the components of the existing framework, e.g. without the current price controls.

While Openreach considers the existing framework has contributed to the development of the competition process, helped Openreach towards making considerable strides in service improvement and stability, and encouraged the significant – and continued – take up of LLU and WLR services, it is undeniable that now is an appropriate time to adjust the current pricing framework.

The Consultation sets out how prices for the key copper access products will either remain below costs (MPF and Residential WLR) or will fall below cost (Business WLR and SMPF) if the current charge ceilings are not reviewed. Further we have set out how for MPF rentals, the CCA FAC exceeds the current price ceiling of £81.69 (see Section 2.1).

Failing to adjust the framework now would risk undermining the beneficial outcomes already achieved in the market by denying Openreach sufficient funds to maintain and enhance service levels on the current copper network.

As shown in Section 2 of this Response, the current pricing framework is no longer appropriate given the changing nature of the market dynamic and its underlying economics, and each of the proposed objectives by Ofcom and Openreach would not be met by the continued application of the current regulatory pricing framework. This is further explained below.

1) Transparency and regulatory certainty

The regulatory pricing framework is a key determinant in investment decisions. The current charge ceilings are effectively "static" nominal (RPI-RPI) charge controls, based largely on historic factors that are outdated in terms of their relevance to the current market dynamic. Openreach considers the forthcoming framework —ideally in the form of a four year price control regime (at a minimum) — will help provide for increased regulatory certainty, and the opportunity for financial stability.

2) Provides the appropriate incentives for investment and innovation

Absent the ability to fully recover relevant costs (including an appropriate ROCE), Openreach has little or no incentive to innovate or invest in existing or future product sets. While the incentive to invest in future access technologies would almost certainly be removed, more immediate concerns exist in respect of the incentives to invest in existing services and service improvement(s). The existing framework does not promote a favourable environment for effective and timely investment, including that which might encourage continued improvements in service quality and innovation or, indeed, migration to fibre based services.

3) Ensure the framework enables Openreach to respond to market demand

While the current regulatory framework does not prevent Openreach developing innovative service and product options, there is considerable ambiguity as to exactly what might be captured by regulation and what might be considered free of regulatory constraint. This review presents an opportunity for Ofcom to increase clarity and incentivise Openreach to meet market demand outside the scope of any SMP obligation. This may deliver long term benefits if it allows the more efficient use of, and sharing of, common costs across a larger regulated and unregulated product base.

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?

The creation of Openreach, its functional separation from the rest of BT Group and the provision of services on an Equivalence of Inputs (“EoI”) basis have given customers greater confidence to make investments in the different access and line rental products. The main benefits that customers have experienced have been through service improvements, the streamlining of processes and the added confidence that heightened transparency gives to CPs in doing business with Openreach.

At the same time, prices for MPF, SMPF and WLR were subject to charge ceilings that were fixed in nominal terms. As outlined elsewhere in this Response, this has meant that prices have become increasingly misaligned with costs over time.

Taken together, the heightened confidence and attractive price levels have resulted in extensive market entry and competition, together with innovation at the retail and wholesale levels of the market. This has led to broadband penetration levels for the UK that are among the highest in the EU.[16]

Current market developments include:

- LLU rollout is approaching its economic limit of approximately 2,000 exchanges;

[16] Consultation, paragraph 3.4 referring to European Commission Progress Report on the Single European Electronic Communications Market 2007(13th Report), 19 March 2008.

- a shifting product mix (discussed in more detail in our response to Question 6.7) as CPs migrate to MPF-based business models;
- development of new innovative business models which result in market behaviours which previously could be interpreted as irrational as CPs compete to gain market share;
- increasing levels of horizontal integration; and
- industry consolidation as a result of a number of CP mergers and acquisitions.

These developments are in part driven by unsustainable access and line rental pricing, and in particular a price for MPF rentals that is currently below its regulated cost. It is important that the price control regime is reviewed, so that prices are realigned with costs such that the benefits of recent market developments are maintained, and so that Openreach and its customers have the ability and incentive to invest and innovate going forward.

In addition, there has been growing competition from alternative access providers. For example, mobile broadband services are increasing in popularity and it is estimated that approximately 12% of households do not now have a fixed line service, instead they opt to be completely served by "wireless" solutions.[17] Also, the cable industry has consolidated and has shifted its focus onto marketing its broadband rather than pay TV capabilities, leading to increased competition in the provision of broadband and telephony services.

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?

Our answer covers the first part of this question. We consider the second part of how sensitive future developments will be to changes in the pricing of LLU and WLR+SMPF in our answer to Questions 6.10 and 6.11 (which consider the impact on the wholesale and retail markets respectively).

In Section 3 of the Consultation, Ofcom sets out a number of market developments. We believe that the current pricing structure for LLU and WLR+SMPF has been an important, but not the only, contributory factor to market developments since the implementation of the TSR and the Undertakings.

---

[17] Ofcom, Nations & Regions Report, May 08.

Clearly, the price of LLU and WLR+SMPF is one of the inputs into the business models and investment decisions of Openreach's customers. The package of products sold by Openreach is broader than this though, and the pricing structure of other key Openreach inputs such as co-mingling, other exchange based products and backhaul also needs to be taken into account.

There are also a range of factors beyond the scope of Openreach that impact CPs business models and investment decisions and hence market developments. These include:

- the cost of inputs from other suppliers (such as content);
- the growing competition from wireless and cable solutions; and
- the extent and nature of downstream competition.

Also important is the relative price of LLU and WLR+SMPF. MPF is a clear substitute for WLR plus SMPF and as outlined elsewhere in our Response, our customers are increasingly migrating to MPF based solutions. It is important that the rental prices of the key copper access products are immediately set to correctly align with costs, such that efficient investment decisions can be made going forward.

There are a range of non-pricing factors that we consider equally important contributors to market developments. These include, in particular, the creation of Openreach and the provision of access services on an EoI basis. As explained in our answer to Question 3.1 we believe this has increased transparency and given our customers greater confidence to invest and innovate, underpinning the positive market developments Ofcom refers to in Section 3 of the Consultation.

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?

The evidence presented by Openreach clearly demonstrates the requirement for a revision of the current charge ceilings, including a step change for MPF of at least £16 per annum in the MPF rental price.

Furthermore, in light of the broader industry trends, not least the increase in input costs, we believe any suggestion that there is no case for a review of the current charge ceilings to be without foundation.

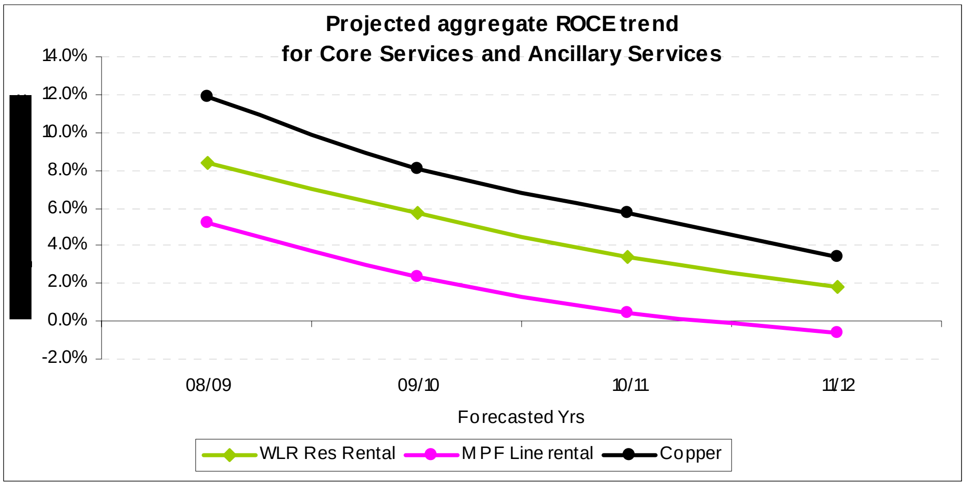
It is clear that the cumulative effect of a number of factors provide sufficient evidence for a review the charge ceilings. Indeed, some of these issues are also addressed in the Consultation[18] and Ofcom's preliminary conclusions

[18] See section 6.15 and supporting information in Annexes 7 and 9 of the Consultation.

based on evidence received from Openreach is that there is "*likely to be a case for some increases in the charges for regulated services*".[19]

It is inevitable that with fixed nominal price ceilings, Openreach's overall returns will decline significantly in a short period of time. Figure 2 below shows Openreach's estimates of how returns are projected to decline if the current price ceilings remain unchanged.

Figure 2 Projected ROCE for key copper access products with no price change



The key drivers behind the need for a review of the charge ceilings are:

- overall volumes of copper access lines are set to decline but much of Openreach's cost base is fixed in nature;
- the "product mix" is rapidly changing so that customer's who were buying WLR+SMPF are moving to MPF, resulting in material loss of revenue without a corresponding reduction in costs;
- there is considerable inflationary pressure on inputs to the Openreach business and the effect of other government legislation/regulation (e.g. more stringent environmental standards); and
- previous regulatory cost and asset adjustments are now unwinding (and adding to the input cost inflation).

Each of these factors is discussed in more detail below.

1) Volumes and aggregate future demand

The aggregate number of regulated copper access lines is declining as consumers and small to medium enterprises substitute second lines and ISDN2 services for broadband solutions, and with the effect of increased competition from wireless and cable operators as access markets converge.

---

19 Consultation, at [1.19].

In broad terms, this results in Openreach operating and servicing fewer lines, with a proportionate decrease in revenues, but nonetheless having to recover the fixed costs of operating and maintaining the network (and previous network investment in the form of depreciation). In addition, Openreach forecasts a reduction in chargeable engineer activity, as the general migration to broadband and LLU products begins to slow and taper out, which means that fixed and common costs previously absorbed by connection and migration products will need to be recovered from line rental products.

2) Product mix effects

MPF is increasingly being substituted for WLR+SMPF, with the volume of MPF consumption largely being driven by the current low price ceiling. This migration to MPF is forecast to accelerate, as shown in Figure 1.

This presents two challenges for Openreach. The first is that the MPF price ceiling is set well below the level required to allow Openreach to fully recover its permissible regulated costs including a return on capital. Therefore, as each line migrates to MPF this issue is exacerbated. This can only be fixed by a correction to the price ceiling for MPF.

The second is that with each migration to MPF, the product(s) it effectively replaces is both a WLR service and an SMPF service. Again, this reduces the overall product base over which common and fixed costs can then be recovered.

3) Input cost trends

The rise in input costs is of increasing concern right across the economy. Overall industry indications suggest that increasing cost pressures will lead to continued price increases. The CBI has recently said "Manufacturers have continued to raise the prices of their goods, in the face of the fiercest cost increases since 1980".[20] To expect that nominal prices can remain flat in such circumstances is wholly unrealistic.

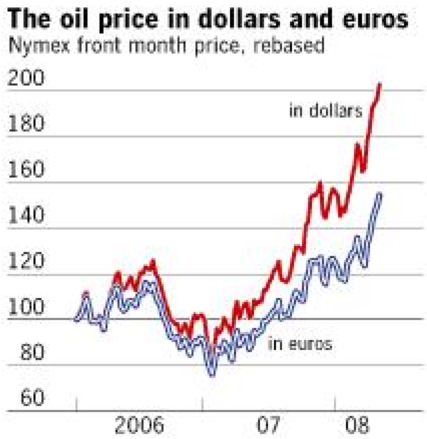
Openreach's copper access business is particularly susceptible to inflation on the key input costs for the following reasons:

- ***Openreach is a labour intensive business (labour costs)*** – inflation associated with labour costs is rising at a higher rate than RPI as employees and supplier contractors seek to obtain pay rises in real terms. The expectation is for labour costs to continue to be higher than RPI over the likely period of the likely price control.

- ***Openreach's business relies on the mobility of its engineering work-force (fuel costs)*** – oil costs are increasing at a rate well in excess of RPI as shown in Figure 3 below. The rising price of fuel increases the costs of keeping engineers and contractors "on the road".

[20] Confederation of British Industries, op cit, footnote 7.

Figure 3 The rising cost of fuel[21]



- **Openreach's business is susceptible to movements in energy prices** — the prices associated with energy which is needed to power the network as well as to light, heat and power offices and exchange buildings are expected to rise at a rate greater than RPI.

- ***Openreach's business is susceptible to commodity market movements (copper)*** – the raw material cost of copper is also rising at a rate above RPI. Again, this trend is expected to continue for the duration of any proposed charge control due, in part, to increasing demand in the emerging international markets. These cost increases impact the cost of essential maintenance on Openreach's copper network and the addition of new lines. Figure 4 below shows the significant increases in the cost of copper since the start of 2005.

---

[21] Source: Martin Wolf, the market sets high oil prices to tell us what to do, *The Financial Times*, 13 May 2008, <http://www.ft.com/cms/s/0/219fcbde-2108-11dd-a0e6-000077b07658.html?nclick_check=1>.

Figure 4 Increasing price of copper 2005–2008[22]

- ***Openreach must make allowances for statutory increases in business rates (cumulo rates) –*** these are the non domestic rates that BT pays on its rateable network assets, which include all Openreach's street assets, duct, fibre and copper as well as assets owned by other BT divisions. Openreach believes that any changes to these rates—whether increases or decreases —should be immediately passed through into prices of the key copper access products.

  As for any ratepayer, the liability is the product of a rateable value and a rate in the pound. Rateable values are reassessed every 5 years. Between revaluations rate poundages increase by inflation as prescribed by legislation.

  Ofcom's previous MPF and WLR ceilings were based on 2004/05 costs, which were based on 2000 list rateable values. The revaluation undertaken by the rating authorities for the 2005 rating list (which applied from 1 April 2005) increased BT's cumulo rates liability significantly but Ofcom did not allow this increase to be reflected in the resulting cost ceilings.[23] Since then BT's rates bill has increased by inflation causing the recovery gap to widen.

  Work on the reassessment of BT's cumulo rateable value for the 2010 list is just beginning. There is considerable uncertainty over what BT's rates bill will be post 2010/11 but there is a real possibility that it will rise by more than RPI. BT notes that Ofcom recently made a commitment to the

---

22 Source: London Metal Exchange, Grade A Copper, cash buyer, http://www.lme.co.uk/copper_graphs.asp.

23 See for example Ofcom' s LLU Statement 2005at [4.9].

Scottish Parliament that BT would be able to recover its rates bill in full.[24] Openreach believes that any increases should be reflected in the permissible charge for all its UK access services.

- ***Miscellaneous cost pressures -*** there are other sources of cost increase which we have not so far mentioned, including meeting more stringent end-user requirements (including safety issues), higher environmental standards, compliance with the new Traffic Management Act 2004 legislation and changes to agency staff contracting terms.

General inflation is currently running at more than 3% per annum and is increasing. Therefore the current nominal charge ceilings translate into a revenue decline of more than 3% per annum in real terms. There are clear *extra* pressures on Openreach, including the effect of several years where prices have remained static, which is why permitted increases in the form of an RPI+X control are justified.

4) The "unwinding" of previous regulatory adjustments

Openreach recovers efficiently incurred cash costs in one of two ways: either immediately in the form of operating costs or by being capitalised and added to the Regulated Asset Value ("RAV") when the costs are recovered over the life time of the asset in the form of depreciation and regulatory cost of capital (based on an Ofcom determined value of WACC). Openreach's annual investment is added to the RAV each year and then depreciation charges are deducted.

Currently Openreach invests c £1bn annually, but the total depreciation charge allowable under the CCA principles is less than £0.7bn, meaning that £300m of efficiently incurred costs are not being recovered and are being added to the RAV. The reasons for this are discussed below. Additionally, the application of accepted CCA principles to Openreach's networks means that the RAV can be expected to increase in line with, or above, RPI. The capital element of the copper access charges therefore needs to increase annually.

2005 Adjustments

In determining the current charge ceilings for MPF and WLR line rentals in 2005 and 2006, Ofcom applied a number of regulatory accounting adjustments. These are now in the process of "unwinding" and this has implications for the regulatory cost base. While Ofcom's approach may have provided for lower MPF and WLR prices at that time, one of the long term effects of this approach was to increase the rate of recovery of certain efficiently incurred costs over time. The reasons for this are explained in more detail below.

---

[24] Scottish Parliament, Local Government and Communities Committee Official Report 23 April 2003, <http://www.scottish.parliament.uk/s3/committees/lgc/or-08/lg08-1202.htm#Col773>

- **Duct life** — Ofcom changed the asset lives from 15 to 18 years for copper and from a rolling 25 years to a fixed 40 years for duct. At the time, Ofcom considered that the new asset lives would align "*more closely to international benchmarks and typical service lives*".[25] This had the impact of reducing the amount of recoverable depreciation in the year of the adjustment. However, the arithmetic is such that in subsequent years the annual value of recoverable depreciation gradually returns to its original level and the book value of the asset increases.

- **Assets revaluation** - Ofcom's 2005 RAV methodology only values assets registered since 1997 using CCA principles, with the pre-97 assets being valued at their historical purchase price at 2005, and then indexed using inflation. As pre-1997 assets become fully depreciated, and new assets are installed, this means that a larger proportion of assets will be valued using CCA principles, until eventually all assets are valued on a CCA basis.

- **Dropwires** – Openreach's preferred treatment of these assets is discussed in more detail elsewhere in this Response (see our response to Question 6.6). Briefly, however, Ofcom's approach in 2005 was to disallow investment on residential dropwires as it was considered that the investment (costs) had already been recovered, by BT Group, via the line connection charges raised in the downstream consumer market. Openreach's investment in this area of the network continues to be substantial, and these costs are not currently included in the Ofcom determined charge ceilings for either connection charges or rentals.

All these factors have an impact on the size of the RAV and hence the annual efficiently-incurred costs of the copper access network business. We have illustrated the issue in Figure 5 below.

[25] Ofcom, *Valuing copper access, Final statement*, 18 August 2005

Figure 5 Illustrative example of accounting adjustments unwinding over time

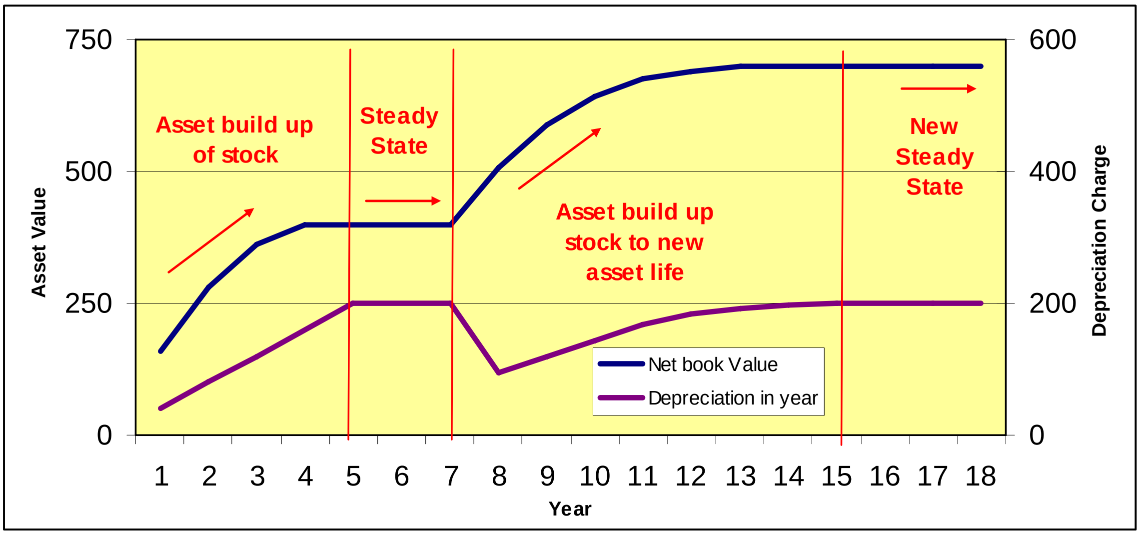


Figure 5 shows a simple example of the effect of making changes in Year 8 which lower costs in that year, in a step change manner, but which then means that costs will increase annually until a new "steady state" is achieved. In terms of the illustration, Openreach is currently around Year 10 of the chart, with costs on an upward path due to the unwinding of the accounting adjustments.

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?

Ofcom presents MPF benchmarking data in Figures 6.6 and 6.7 of the Consultation which it says "suggests that other regulators (and operators) have agreed tariffs for LLU services that may be significantly below the costs indicated in the Openreach forecasts." Ofcom also states that this data "somewhat contradicts the cost evidence set out by BT."

It is by no means clear that prices across the European countries shown in the Consultation have been set by clear reference to costs. It is therefore misleading to imply that price comparisons will always reflect cost comparisons.

For the reasons set in Annex A, we do not believe the European Commission data used in the Consultation presents an accurate picture of relative price levels. For instance, Figure 6.7 of the Consultation suggests that UK prices for fully unbundled loops are the fifth highest of 27 countries analysed. Our data – which takes account of charges for space and power and focuses on comparisons against eight key European countries – suggests that UK prices are in fact amongst the lowest in Europe.

We acknowledge that benchmarking per line prices in this way requires assumptions to be made on the volume of connections a CP can provide from each exchange. Openreach has used a price comparison model which allows such assumptions to be flexed and would welcome the opportunity to discuss this further with Ofcom. We nevertheless firmly believe that UK CPs now pay less for fully unbundled loops on a per line basis than in France, Germany, Italy and Spain.

Whilst it is clearly important to ensure that any benchmarking analysis is based on complete and accurate data, it is also worth stressing that caution needs to be shown in using such analysis to assess Openreach's views on unit cost trends and Openreach's efficiency in service provision. This is because there are a number of reasons why costs will differ across jurisdictions. For instance, differences exist in network design and topology and population demographics. In addition, Ofcom should have regard to the context in which prices elsewhere have been set. Overall, Ofcom should not attach significant weight to international benchmarking of prices compared to its analysis of UK-specific costs.

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.

Summary views

- Ofcom's preliminary conclusion is that annual efficiency gains on operational unit costs in the range of 1% to 4% could be achievable.

- We do not believe that there is any evidence to suggest that Openreach is "inefficient" and we are extremely concerned that the higher end of Ofcom's range overstates the scope for cost reductions over the period of the controls.

- Any proposed efficiency assumptions feeding into the charge controls must be assessed against a forward-looking analysis of where the implied unit cost reductions could realistically be delivered and what the impact of such reductions would be on the Openreach business. In particular, Ofcom's analysis must take account of the following:

  — the step change in service improvement already delivered by Openreach and the resource requirements, customer-focussed business transformation programmes and related investments which continue to underpin this;

  — the significant upwards – and in many cases, exogenous – cost pressures Openreach faces in meeting the demands of customers and delivering its regulatory requirements through the provision of service on an ageing and naturally degrading copper network;

- the fact that, in this context, headline “efficiency” assumptions applied across <u>all</u> operational costs – such as Ofcom’s proposed 1% to 4% range – effectively understate the savings that would need to be made on any potentially “compressible” costs; and

- the significant implications any overall efficiency assumptions would have on future reductions in Openreach’s workforce costs. With 84% of the Openreach workforce employed as engineers focussed on service delivery, any significant reductions would severely challenge Openreach’s ability to sustain current service and deliver ongoing service improvements.

- Openreach firmly believes that Ofcom’s cost modelling should assume an efficiency target closer to the lower end of Ofcom’s range (i.e. 1%) and apply this only to identified “compressible” Openreach operating costs. Reductions of this magnitude would be comparable with the annualised efficiency savings of US Local Exchange Carriers (“LECs”).

Any proposed efficiency assumptions feeding into the charge controls should be assessed against a forward-looking analysis of where the implied unit cost reductions could realistically be delivered and what the impact of such reductions would be on the Openreach business

Improvements in service delivery

Openreach has made significant improvements in service performance since it was established in 2006. For instance, the proportion of repairs delivered in line with customer commitments for voice and LLU have increased from 65% in August 2006 to almost 90% in July 2008.

It is important to understand the steps taken to support these improvements in the context of assessing the scope for future efficiency savings:

- With the creation of Openreach in January 2006, the different parts of BT that were responsible for the access and backhaul networks and the associated service were brought together into one unit. The previous units had different objectives and priorities, rather than the structured programme of service improvement introduced under Openreach. This combination of these business units on the creation of Openreach generated one-off synergy savings which are not capable of being repeated. Demand for resource is highly variable from day-to-day. As service level targets increase, that resource has to be more precisely matched to demand on a day-to-day and even hour-by-hour basis. In a normal operational geographic area (there are about 100 of these in the UK) day to day fault volumes can fluctuate significantly, in some cases by more than 100%.

- Rather than compromise service delivery in an environment where we have had little opportunity to introduce demand flow control mechanisms – e.g. via a forecasting process for provisioning which provides incentives for

CPs to provide more accurate forecasts – we need additional resource to cover volatility. To this end, 1,738 additional Openreach field engineers were recruited across the UK to underpin performance improvements in the key areas of field provision and repair.

- This more focussed approach to deploying the Openreach workforce has allowed Openreach the scope to reduce certain operating costs such as overtime payments and to improve flexibility by introducing third party labour.

- These steps, taken together, have effectively delivered a more sustainable “base line” of costs from which to move forward. The workforce is now deployed to efficiently and effectively meet what is variable and often volatile demand. As expanded upon below, the scope for further cost savings without threatening the improved service levels is limited.

- The improvements in service levels have also been driven by a broader range of business transformation programmes which have required significant investments in systems, testing and diagnostic capabilities, etc. Therefore whilst certain of these transformation measures to date have reduced Openreach’s overall operating costs – e.g. by reducing the fault incidence and/or the ability to diagnose and fix problems remotely – this has often been as a result of increases in capital expenditure.

Limitations on future cost savings

Table 3 shows a breakdown of the 2007/08 operational costs shown in tables A7.5 to A7.9 of the Consultation – i.e. total costs across the core rental and ancillary products considered within the broad scope of this review.

Table 3 Breakdown of Openreach operating costs, 2007/08 (shown in the Consultation)

	2007/08 opex (£m)	**Share of total**	**ratio of cost item considered "compressible"**	**Share of "compressible" only**
Pay	797	31%	100%	39%
Line cards and TAMs	518	20%	40%	10%
Accomodation	303	12%	41%	6%
Stores, contractors	234	9%	100%	11%
Corporate overheads	169	7%	100%	8%
IT	235	9%	100%	11%
Fleet	125	5%	100%	6%
Other	157	6%	100%	8%
Total operating costs	2,538			
Total compressible	2,048	81%		
Total non-compressible	490	19%		

From our own assessment of the scope for cost reductions moving forward, we would highlight the following:

- Almost 20% of Openreach's operating costs are unambiguously "non-compressible" operational costs and no efficiency assumptions can realistically be applied to the following items:

  - **Accommodation:** 59% of these costs are considered non-compressible as they relate to cumulo rates (which are levied by the Government) and the rental of floor space (where BT is committed to a long term outsourcing contract with Telereal) which increases rental charges year-on-year and where the scope for Openreach to reduce its operational requirements for frame space, etc is extremely limited; and

  - **Line Cards and Test Access Matrix ("TAMs"):** the Openreach operating costs consist of transfer payments made to BT Operate ("BTO") for the use of their network equipment - predominantly made up of WLR and ISDN line cards. Of these costs 60% are non-compressible as they relate to depreciation costs and the cost of capital on the underlying assets – i.e. to non-operating costs within BTO – and therefore opex efficiency assumptions cannot apply.

- Openreach's ability to control even costs broadly defined as "compressible" is limited in a number of areas:

  - Openreach's ageing copper network is degrading. This drives a potential increase in the fault rate of approximately 12% each year. Investment in the region of £56m each year is required to avoid the estimated 260,000 faults that would otherwise arise;

  - the need for Openreach to deliver high quality service levels and meet the ever evolving needs of our customers – e.g. to support provision of ever-faster broadband over a network designed to carry voice – which again drives investments to support efficient provision of such service moving forward;

  - the "Right First Time" programme aims to increase service performance by 7.5% by 31 March 2009 and requires incremental investment in systems, process and people of £22.1m in 2008/09, largely driven by upgrades to the test and diagnostics technology. To sustain these levels of service requires an expected additional ongoing operating cost of £10.6m per year. The changes in the Service Level Guarantee ("SLG") regime and the move to automated payments for failure to meet performance targets will mean that these significant improvements in Openreach service levels are required just to keep costs steady, rather than the cost increases that would otherwise occur;

  - Openreach must continue to meet its obligations to comply with universal service requirements, the obligations set out in the Undertakings and relevant regulatory SMP obligations;

— as detailed in response to Question 4.1 above, Openreach is facing additional, above-inflation increases in relation to fuel costs, pension costs, as well as needing to meet more stringent end-user requirements (including safety issues), higher environmental standards, compliance with the new Traffic Management Act 2004 legislation and changes to agency staff contracting terms; and

- given the above, and with around 40% of potentially "compressible" operating costs relating to pay, any overall assumptions around cuts in operational costs imply reductions in Openreach workforce costs.

Challenges in reducing Openreach workforce costs

If Openreach were to be targeted with a 4% year-on-year efficiency target this would imply that 5% year-on-year reductions would be required on "compressible" costs – i.e. 25% higher than that implied by the "headline" efficiency target. Given the upward cost pressure in a number of areas, this could imply even higher percentage reductions in the Openreach workforce.

About 84% (or 28,000) of Openreach's total workforce in 2007/08 were employed as engineers in service delivery. Even a 5% headcount reduction each year from current levels until 2013 would imply an engineer headcount reduction of over 6,000 Full Time Equivalent ("FTE") by 2013, or over 20% of FTEs employed as engineers today.

Clearly, maintaining service levels in the face of such cuts would be extremely difficult.

- As set out above, Openreach has taken steps to ensure that its workforce is deployed in a way that can most efficiently and effectively meet variable and volatile demand. This has involved the removal of certain costs associated with overtime and the use of agency staff and the scope for further reductions in these areas is limited.

- Reducing headcount will reduce Openreach's ability to react to the peaks in demand and meet the service levels required in terms of fault repairs and provisioning.

- As noted, demand is volatile, therefore headcount reductions may need to be reversed. However, the investment required in the workforce to train engineers and equip them can take around nine months and would drive further costs, including recruitment costs.

- Openreach needs to ensure its workforce is suitably skilled and resourced to address all future technological requirements including issues that may arise through the roll-out of next generation access services.

- Activities to improve the overall reliability of the network and generally deal with faults more efficiently will all require investments. As such, higher reductions in opex will require additional capex.

- The variability of demand for provisioning is linked to the absence of effective incentives for CPs to provide accurate forecasting. We would note that this contrasts with the fact that regulation heavily penalises service failure via the new SLG regime.

Notwithstanding these points, it is also difficult for Openreach to actually realise significant cost reductions in this area given inherent difficulties in unpicking legacy structures. In particular, natural turnover rates within the workforce are low. Redundancy payments therefore need to be factored in to any assessment of the scope for cost reductions. It currently takes on average over two years before cost savings accrue for engineers leaving on voluntary redundancy terms, meaning limited savings would accrue during the period of the proposed charge control.

Openreach firmly believes that Ofcom's cost modelling should assume an efficiency target closer to the lower end of Ofcom's range (i.e. 1%) and apply this only to identified "compressible" Openreach operating costs

In the context of this analysis, it is unreasonable to expect that Openreach can deliver efficiency savings across all operational costs of as much as 4% for each year of the price control.. To do so would result in severe negative impacts on Openreach's ability to meet the needs of its customers.

The base case and "aggressive" scenarios presented by Openreach to Ofcom last year and referred to at paragraphs A8.3 to A8.9 of the Consultation, assumed the stated efficiency savings would only apply to "compressible" costs. For the avoidance of doubt, no efficiencies are possible for "non-compressible" costs.

To be clear, Openreach believes that – in the context of the issues set out above – an assumption of a 1% reduction on the broad "compressible" costs would be a very challenging target. Anything above this level would be unreasonable. As noted, headline "efficiency" assumptions across a range of costs effectively understate the savings that would need to be made on certain "compressible" costs and therefore mask true efficiencies which will need to be delivered in those areas. For instance, with pay costs accounting for almost 40% of total "compressible" costs, a 1% reduction in overall "compressible" costs would, all other things being equal, require a 2.5% real terms cut in pay costs if all other costs rose with inflation. With the above-inflation pressures on certain cost items, this figure rises.

We do not believe that there is any evidence to suggest that Openreach is in "inefficient" and we are extremely concerned that the higher end of Ofcom's proposed range significantly overstates the scope for cost reductions over the period of the controls

Statistical analysis

Ofcom refers to the Stochastic Frontier Analysis ("SFA") carried out to assess the potential for future efficiency gains against "frontier shift" and "catch-up" efficiencies. However, as referenced by Ofcom, the studies were unable to make a satisfactory comparison between Openreach and US LECs.

However, separate SFA studies have been undertaken to support the BCMR charge controls proposed for partial private circuits and wholesale Ethernet access and backhaul services. These studies have concluded that BT's network as a whole is ranked within the top decile of US LECs . There is no evidence to indicate that Openreach is any less efficient than the rest of BT. As such, it would not seem reasonable to conclude that there is any scope for Openreach to make "catch up" efficiency improvements. Furthermore, a study conducted for BT by Deloitte for the BCMR[26] indicated that annual productivity increases across the LECs were only between 0.5% and 1.1% per annum. This suggests that any "frontier shift" assumptions around efficiency should be limited to this range.

Historic trend analysis

Ofcom has assessed the costs contained within the regulatory accounts for PSTN residential access between 2001/02 and 2006/07 as a proxy for the trends in costs for Openreach's range of rental products. Ofcom concludes that BT's annual efficiency during this period was just below 5%.

As noted at paragraph A8.21 of the Consultation, Openreach's own analysis of suitably comparable costs suggests that real efficiency gains during the period were around 2% to 3% per annum.

Actual Openreach cost data is only available from 2006/07. As has been noted, reductions in operational costs have been delivered via the transformation programmes targeted at improving the effectiveness and efficiency of service provision and further reductions are planned for 2008/09. However, these reductions are linked to, among other things, significant capital expenditure to improve systems and testing/diagnostic capabilities and on reducing costs such as overtime payments. These steps taken together have effectively got Openreach to a more sustainable "base line" of costs from which to move forward. As we have explained, the scope for further cost savings without threatening the improved service levels is limited.

Overall, we do not believe that any measure of historic efficiency savings provides a reasonable basis for setting future efficiency targets from April 2009.

---

26 Deloitte, The Efficiency of BT's Network Operations, March 2008

Cost reviews

Ofcom states that work by KPMG suggests that efficiency savings of between 1% and 3% during the review period would seem reasonable. This is based on identification by KPMG of a reported £300m of potential efficiency savings based on available benchmark and comparator data.

Openreach has not had visibility of KPMG's work in this area and it is therefore difficult to comment on its initial conclusions. Ofcom notes that further work is required to form a robust view in this area and Openreach would expect to have full sight of any such work to understand the potential cost savings which have been identified. As the further analysis below suggests, Openreach does not believe that costs could be removed from the business to the extent suggested by KPMG's work to date. Furthermore, our experience of reviewing benchmarking reviews has been that the detail required to draw sound conclusions is either not available or highlights significant inconsistencies which prevent effective comparisons being made.

In this context, we note that Ofcom refers to the external research on comparative efficiency provided by BT. Ofcom has made reference this research and suggested that it supports efficiency savings "towards the upper end" of the range set out in Ofcom's preliminary conclusions. We disagree, and in this respect Ofcom's conclusions are unsubstantiated. We were very clear that although the research provided a useful "sense check" of the overall level and direction of our costs, it also had a number of acknowledged limitations that invalidated its use in measuring efficiency or setting regulated prices for Openreach. In particular:

- only a small subset of the metrics considered are relevant and specific to Openreach;
- a number of significant Openreach cost areas are not treated explicitly or are only addressed at a very high level;
- there is inadequate assurance on the reliability or accuracy of input or output data;
- a large proportion of the expenditure metrics are calculated on a "per revenue" basis rather than in relation to the outputs generated by the expenditure;
- the definition and make-up of the peer group affects a participant's results; and
- results reflect national externalities as well as internal factors.

Ofcom's preliminary conclusions

Ofcom notes the potential limitations of all the approaches it has considered to inform its assessment of potential efficiency gains. Nevertheless, the outputs from each approach are used to support Ofcom's preliminary views of an achievable range of efficiency gains. It does not appear that any specific weighting has been attached to one particular approach over another in defining its range.

Although no explicit reference is made by Ofcom to the distinction between “compressible” and “non-compressible” costs, it would appear that Ofcom’s range of possible efficiency gains are assumed to apply to all Openreach operating costs and not just “compressible” costs. This effectively means that – based on this analysis of 2007/08 operating costs – Ofcom would actually be expecting Openreach/BT to achieve reductions in “compressible” costs 25-50% higher than headline reductions quoted.

For the reasons set out previously, Openreach believes that the higher end of Ofcom’s range significantly overstates the scope to deliver efficiencies during the period of the controls. Furthermore, given our comments on Ofcom’s analysis, we do not believe that evidence exists to suggest that assumed efficiency gains above 1% are reasonable.

QUESTION 6.3: IN ANNEX 7 WE DISCUSS THE OPTIONS WITH RESPECT TO THE SCOPE OF SERVICES TO BE INCLUDED WITHIN THIS REVIEW. PLEASE PROVIDE YOUR VIEWS ON THE APPROPRIATE SCOPE FOR CONSIDERATION WITHIN THIS REVIEW AND THE APPROPRIATE TREATMENT OF NON CORE SERVICES.

This is a two-part question. One part focuses on the scope of regulatory price controls and the latter on the allocation of costs for “non-core services”. We address each of these below.

Openreach believes that the primary focus of Ofcom’s review should be to ensure that appropriate price controls are in place for the SMP key copper access products of MPF, SMPF and WLR. Based on information provided by Openreach to Ofcom, these services account for around 70% of Openreach's total revenues from its regulated copper products.

Price ceilings for these were fixed in nominal terms in 2004 (for SMPF), 2005 (for MPF) and 2006 (for WLR), Since that time, for reasons set out elsewhere in this Response, there have been significant changes in the dynamics of the market as well as cost inflation. It is important therefore that price controls are revised so as to ensure that prices are realigned with costs and allow Openreach to earn its regulated cost of capital. Revising price controls in this way will ensure appropriate incentives for investment are maintained and that Openreach's investors and customers have the certainty they need over future price changes and returns.

It is also appropriate for Ofcom’s review to examine the cost controls for other SMP products and services that CPs need to buy from Openreach in conjunction with MPF, SMPF and WLR. This includes MPF connection prices as well as products and services CPs need to buy to enter the market, such as co-mingling. The majority of these services are already subject to price controls.

Openreach believes it is preferable that price controls cover a basket of related services for a particular product rather than individual products/services - for example all the products and services (where SMP has been found) that a CP needs to buy from Openreach to offer, say, WLR. By including these in a single basket, Openreach has a degree of flexibility to adjust relative prices to respond to competitive pressures and market changes and to ensure that its customers are able to gain and retain business over time. We have expanded on this in our response to Question 8.2.

In general, we believe that Ofcom's aim should be to minimise the regulatory burden over time. To extend price controls beyond the services currently covered by price controls would require Ofcom to justify why any extension was an appropriate and proportionate response to any market failure identified which required such a remedy. In markets where competition has started to develop and charges are increasingly driven by market forces, charge controls are less appropriate because of the potential for them to adversely distort behaviours in the market to the detriment of consumers.

Therefore, we do not believe that there is a case to change the regulatory treatment of the remainder of Openreach's regulated copper portfolio.

In the case of ISDN2 for example, the current SMP conditions were set as part of Ofcom's Wholesale Narrowband Market Review (2004). In that review, Ofcom imposed cost orientation obligations on Wholesale Business ISDN2 exchange line services. Since that review, ISDN2 has been subject to strong supply side competition, especially from broadband services that are increasingly seen as a substitutable product. This is evidenced by the continued decline in ISDN2 volumes (with a decline of approx. 4% in the 07/08 financial year)[27]. We believe therefore that price controls are not required for this product and that the existing cost orientation obligation is sufficient.

Similarly for ISDN30, existing SMP remedies were set as part of the Wholesale Narrowband Market Review (2004). Ofcom found ISDN30 was subject to strong supply side competition from Ethernet services and especially 2Mb circuits. It also noted the potential substitution with ISDN2 and in particular the possibility that multiple ISDN2 lines could substitute for a low-utilisation ISDN30 line. Therefore, we again believe there is no case to change the existing regulatory treatment for this product.

Turning to "Non-Regulated Services", we further agree with Ofcom that these products/services do not form part of the scope of this review, except to the

---

[27] BT, *Current Cost financial Statements for 2007 including Openreach Undertakings*, Annex 11 of the Consultation

extent to which Ofcom wishes to ensure that the allocation of common costs across Openreach is appropriate.

Openreach also agrees that services covered by the BCMR are beyond the scope of Ofcom's review.

QUESTION 6.4: SHOULD WE CONSIDER GREATER OR LESSER USE OF PRICE CONTROLS FOR SMP NON-CORE SERVICES? HOW SHOULD PRICE CONTROLS DEAL WITH THIS IN TERMS OF CHARGE CONTROLS AND RECOVERY OF COMMON COSTS?

In our response to Question 6.3 we set out views on which services should be covered by price controls (including those for SMP Non-Core Services).

It is a feature of network services that there may be large elements of common costs, that is, costs which are shared across a number of services. These costs are often common across services where Openreach has SMP and where it does not. Openreach has shared its cost allocation methodology with Ofcom and it is consistent with the approach used in BT's regulatory accounts. We believe our approach to be fair and reasonable and that price regulated services attract an appropriate share of such costs, but no more.

Common costs therefore form part of the cost stack for products subject to price control and are accordingly part of the calculation of the "X" in the RPI+X regime. This is discussed in further detail in our response to Question 8.1.

QUESTION 6.5: TO WHAT EXTENT SHOULD WE INCORPORATE THE REVENUES AND CONTRIBUTIONS TO COSTS FROM NON–SMP SERVICES IN THE REVIEW?

Revenues and contributions from non-SMP services should not be included in the assumptions or models used for the purposes of determining charge controls for SMP services.

While the majority of Openreach's revenue is derived from regulated copper access products (mainly WLR and LLU and associated services) Openreach's product portfolio also includes backhaul, Ethernet point-to-point services (fibre based SMP products) and a number of non-SMP services (which amount to approximately £1bn of total revenue). It is understood that regulation of any form must be preceded by a determination of SMP (in the relevant economic market), followed by a consideration of appropriate remedies, if SMP is found.

The costs associated with the provision of copper SMP services should be recovered only from the revenues derived from those copper SMP services. For example, if Openreach earns revenue from non-SMP services, then those revenues are not relevant to the pricing of SMP services, any more than if that revenue were accrued in BT's downstream divisions, or those within Openreach's other customers.

It may be that SMP and non-SMP services share some fixed or common costs within Openreach. This is a matter of cost allocation rather than regulation of revenues or contributions, and we believe that appropriate cost allocation is relevant to the review. Openreach has started from a position where total Openreach costs are allocated to all Openreach products, whether SMP or not. We have shared a functioning copy of the cost allocation model with Ofcom. In that model Openreach allocates costs to products consistent with the methods used in BT's regulatory accounts. Openreach is confident that its allocation of costs to non-SMP products is both fair and reasonable and logically sound [28].

QUESTION 6.6: PLEASE REVIEW THE OTHER COST ASSUMPTIONS SET OUT IN ANNEX 7. WHAT ARE YOUR VIEWS ON THE ASSUMPTIONS MADE AND ADJUSTMENTS PROPOSED?

To ensure that any new pricing framework is sustainable and enduring, and that charge controls provide the right incentives and demand signals, Openreach recognises that a thorough review of relevant costs and underlying allocation methodologies is required. To that end, and as is illustrated in the Consultation, Openreach has already supplied Ofcom with detailed information relating to all of Openreach's costs, and will continue to provide all the information reasonably necessary for the derivation of a sustainable and economically rational future pricing framework.

The information supplied to Ofcom is now some eight months out-of–date. Ofcom have requested a new data set with latest assumptions on 2007/08 financial outturn and 2008/09 budget build. Openreach will provide this updated data, which will include new financials /new volumes/new short term efficiency targets plus some additional costs previously not submitted:

- **Openreach set-up costs** — although not especially relevant in determining the cost stacks for the end of the price control, the inclusion of these costs is helpful for putting into the context the 13% ROCE which Ofcom have derived [29] and say that Openreach achieved in 2006/07. Obviously, the 13% ROCE figure would be significantly reduced had these costs been included.

- **Pension deficit contributions** — BT Group has agreed with the BT Pension Trustees to make substantial contributions toward the pension deficit. Openreach notes that a number of recent regulatory price

[28] Consultation, at [A7.2]

[29] Consultation, at [4.18]

determinations[30] have included pension deficit contributions and request that Openreach's share of the BT contributions be included in this price control.

- **Leaver payments** — these are a necessary consequence of Openreach's requirement to reduce costs in the long term and need to be included in this price control. Should Ofcom be minded to set an unreasonable efficiency target, leaver payments would become a much greater expense to Openreach, and this increase would also need to be reflected in the regulated cost base.

- **The allocation of cumulo costs** — the amount that Openreach is allowed to recover for cumulo within MPF prices is currently understated not only for the reasons outlined in our answer to Question 4.1 but also because MPF loops are, under the rating hypothesis, more valuable for unbundlers than other loops. The value of individual loops to the unbundler varies considerably. MPF loops have a much greater propensity to be used to provide broadband and other value added services than non MPF loops. Under the rating hypothesis, a hypothetical tenant would therefore be prepared to pay more to rent MPF loops than other loops. The amount that BT should be allowed to recover for rates should be higher for MPF loops than for other loops to reflect the additional value to the unbundler. In contrast, Ofcom set the amount to be recovered for rates within the current MPF cost ceiling to be less than the average recovered on other loops though its reduction of "D Side" access costs. This needs to be rectified in the next set of price controls.

- A number of Openreach "inputs" have seen recent prices rises in excess of inflation, including electricity and fuel.

Openreach have prepared the financial models and associated cost information in good faith, provided a great deal of transparency and invested considerable time and resource in ensuring that Ofcom are aware of, and understand, all the detailed cost inputs to the model and the manner in which product specific cost stacks have been constructed. We ask that Ofcom will be equally transparent in their analysis.

Furthermore, in deriving the total and product specific costs, Openreach has of course adopted a considered and financially robust approach. The costs presented are based on methods consistent with, and reconcilable to, the regulatory accounting statements and Openreach's management accounts,

---

[30] See OFWAT, Future water and sewerage charges 2005-10 Final determinations (Periodic review 2004, published December 2004); Postal Services Commission, Royal Mail's Price and Service Quality Review 2006-2010 Licence Modifications Proposals March 2006, dated 1 March 2006; OFGEM, Electricity Distribution Price Control Review, Final Proposals 265/04, dated November 2004. See also OFGEM, Developing network monopoly price controls Update document February 2003 05/03; OFGEM, DRAFT Gas/Electricity Transmission Price Control Review Price Control Review Reporting Rules: Instructions and Guidance dated February 2006; OFGEM Developing network monopoly price controls Initial conclusions 54/03 dated June 2003.

and also use cost accounting approaches consistent with those used by Ofcom in determining the current charge ceilings (CCA FAC).

We note Ofcom's review in Annex 7. We have serious concerns with the proposed adjustments in Annex 7 and their likely impact on the estimated cost stacks, (and Openreach's ability to recover all relevant costs). The risk of constant adjustments will undermine confidence in the regime. Openreach needs to understand the rationale for Ofcom's proposed approach in more detail. Set out below is a brief summary of Openreach's position on some of Ofcom's proposed adjustments. Further detail on each of these items is contained elsewhere in this Response, e.g. in particular, in our response to Questions 4.1 and 7.1.

Light User Scheme ("LUS")

Ofcom proposes to remove the cost of supporting the Light User Scheme ("LUS") — the product used to help underpin the Universal Service Obligation ("USO") — from the Openreach cost stack; the costs for this service are currently recovered across the WLR portfolio. Ofcom bases its proposals on what Openreach considers to be an incorrect assumption - that the net cost of the USO is relatively small. Openreach understands that Ofcom intends to review the USO in the near future and we would ask that Ofcom confirm that the conclusion of any such review be reflected in the regulation of Openreach. In particular, Openreach does not consider that it should simply absorb the cost of the LUS going forward, and that this should be shared across UK CPs.

SLG payments

This issue is addressed in our response to Question 7.1 below.

Line cards

Openreach looks forward to working with Ofcom on the development of the most appropriate allocation methodology for combi-cards. However, we believe the methodology we have proposed for recovering these costs is both workable and well-founded in economic terms. Next Generation Network ("NGN") investment is a commercial reality (including for Openreach's competitors), and the costs associated with new line cards will be incurred; it is clear that Openreach should be able to recover the full costs through the relevant products. Any apparent increase in costs in comparison to legacy PSTN line cards is entirely misleading. The existing equipment is nearing the end of its natural asset life and therefore the costs currently allocated to line card costs are artificially lower than the true LRIC+ cost of providing the functionality.

Openreach believes this approach to be consistent with the approach to LRIC+ taken by Ofcom in its Review Of the Wholesale Local Access Market.[31]

Line lengths

In constructing the costs associated with line length, Openreach has applied the same methodology as that which is currently used in compiling the regulatory accounts. This methodology determines an average line length reduction for MPF of 6% when compared to a WLR residential line.

Ofcom's approach in November 2005 was to adjust the average MPF line length by 16%, arguing that MPF lines were shorter because of technological constraints on the delivery of broadband. However since that decision advances in ADSL technology mean that broadband can be delivered on longer copper lines as should be evident from the take-up of LLU, in particular MPF. Openreach considers that as more lines move to MPF (<1% in 2005/06, moving to 40% in 2011/12) there is less, or no, justification at all for any adjustment to line length. Moreover, any costs that are not recoverable via MPF, i.e. those excluded as a result of such an adjustment, must then be recovered by other products within the regulated copper access portfolio i.e. WLR.

Openreach therefore believes there is no justification for the line length adjustment applying to MPF and that should therefore be removed.

Dropwire costs

Openreach confirms that the financial model provided to Ofcom does not adjust the dropwire asset base to take account of the Ofcom 2005/06 determinations on LLU MPF and WLR.

Ofcom's original decision was that some of the dropwire costs had already been recovered by BT Group by the line connection charges raised in the downstream consumer market. Since then BT has established Openreach as a functionally separate division with the clear ownership of the dropwire asset. In consequence of this change Openreach requests Ofcom to review the original decision and provide further clarity of how this policy should be implemented going forward. In particular Ofcom should note:

- that Openreach continues to invest circa £180m per annum in this part of the network and that under the current pricing structure Openreach is unable to recover a large proportion of this investment in either new connections or line rentals;

---

31 *Ofcom, Review of the Wholesale Local Access Market, Consultation,* 26 August 2004, paragraph 6.61 "LRIC+ based charges also encourage efficient entry at the network level because they reflect replacement costs, which are the costs that would be faced by a new entrant."

- that the recovery of all Openreach investments should be facilitated by the pricing of products in the wholesale market and not in the retail market. It seems unlikely that the intention of this regulatory method was to ask BT Retail to pay for a WLR connection on an equivalent basis to another CP but to then add in cost recovery for a part of Openreach's network that is effectively being used for free. To rectify this anomaly, Ofcom is asked as a minimum to allow full recognition of all assets registered since the creation of Openreach on 11 January 2006. However, Ofcom should consider the full recognition of all assets since the creation of wholesale access products. We note that Ofcom's main justification for this adjustment was that BT had already recovered these costs through BT Retail. [The Retail Price Control ended on 31 July 2006.] There can be no justification for deletion of Openreach costs beyond this date;

- that the allocation of remaining drop wire assets should be recovered equally across all wholesale access products rather than the current method of allowing dropwires for business lines and disallowing for consumer lines. Openreach is a wholesale provider of access lines and therefore the nature of the end-users should be of concern to CPs only; and

- capital costs associated with the dropwire have not been included in the current modelling however it will be included in the updated model that Openreach will provide to Ofcom. The updated model will also include other costs such as leaver payments and increased pension contribution costs due to reassessment of that liability and costs incurred in the creation of Openreach.

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?

Openreach provided Ofcom with the volume scenario set out in Annex 9 of the Consultation. The future growth and product mix of our copper access portfolio will be heavily influenced by the continued migration to MPF because of:

- the current price advantage MPF has over WLR+SMPF; and

- the greater product functionality and flexibility MPF allows.

As a result of these factors the growth in MPF volumes is expected to accelerate significantly.

Product Mix

The future projections of product volumes will be fundamentally impacted by the outcome of this review.

From an MPF perspective, the key customers driving growth are those CPs who are migrating their broadband and WLR based customers from their acquired or organic customer bases to their LLU MPF infrastructure. Furthermore, we anticipate that CPs with their own LLU infrastructure will continue to migrate their customers from IPStream and DataStream to SMPF or MPF. As Ofcom notes in Annex 9 the move to 21CN based services will increase growth of MPF and is clearly contingent on the rollout plans of Openreach's customers.

Any shift in the underlying product mix reinforces the need to ensure that the respective charges for Openreach services are aligned with their underlying costs and promote the appropriate choices for CPs and their end users.

Despite the shift to MPF, WLR+SMPF will continue to be important products for a large segment of our customer base. Pricing certainty across the portfolio is therefore critical to sustaining a competitive downstream market.

Total Volumes

There are a number of factors that are impacting Openreach’s overall volumes. These include:

- the increasing number of households that have dispensed with any fixed line service, whether for voice or broadband, and are instead relying solely on wireless applications for their telephony and broadband needs. This market is currently running at 12% of UK households.[32] The contributing factors include the rental housing market, and the removal of the requirement to purchase a fixed line for broadband with the marketing of mobile broadband products;

- the shifting focus of cable company marketing to broadband rather than pay TV capabilities;

- the slowing of the UK housing market that is reducing the number of new fixed line voice and broadband connections. According to the Council of Mortgage Lenders and the Royal Institute of Chartered Surveyors mortgage completions and residential property surveys are at near record lows;[33] and

- the ongoing reduction of second lines for residential customers, whether for home working or fax lines, and the reduction of multiple business lines

---

[32] Ofcom Nations & Regions Report, May 08

[33] Communities & Local Government, June 08; Council of Mortgage Lenders, June 08

with the use of broadband by small businesses and the removal of fax lines.

Additionally we are seeing a reduction in churn, driven by a number of factors, including the effect of 18 month minimum term contracts with end users and the emphasis on triple play service packages. This has reduced the demand for migration products.

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?

Question 6.8 of the Consultation comprises a series of questions in relation to the cost of capital. Here we set out our brief responses.

Accompanying detail and empirical support is provided in:

- Annex B — BT Group's comments on the cost of capital[34]);
- Annex C — a report by Oxera commissioned by Openreach on the impact of the recent financial turmoil on its cost of capital to date and the potential impact of the ongoing crisis in the future ; and
- Annex D — a survey of key financial institutions on BT's cost of capital conducted by an independent consultant.

Ofcom last reviewed the BT Group cost of capital (WACC) in 2005. Given the turbulence in current financial markets and enormous changes taking place in the telecommunications sector, it is extremely difficult to see why there should be any reduction in BT's WACC since 2005. For Openreach in particular, the perception of an "enduring bottleneck" across the copper network may be less obvious now than in 2005, given the change in perceptions of competing cable networks and wireless solutions. As Ofcom has noted, overall demand for copper loops is actually falling as more households are using only wireless solutions. BT acknowledges that Ofcom needs to take a view of the WACC before deciding on price controls.

---

[34] It is necessary to assess the WACC for BT Group as a whole prior to any consideration of the appropriate WACC for Openreach or a subset of its products, since the Openreach WACC cannot be estimated directly. The first step is to consider the appropriate value for BT Group's WACC, and the second is to consider the differential, if any, based on relative risk of different parts of BT. The views below, and those presented in Annex B are therefore those of BT Group.

BT's views on key parameters

Ofcom is undertaking a review of all the parameters which enter the prices of Openreach products including the WACC, using the established CAPM methodology. We have therefore undertaken considerable analysis of Ofcom's estimates of the WACC and validated our work by obtaining advice from external experts and financial market participants as noted above.

The first step is to consider the appropriate value for the BT Group WACC, and the second is to consider the differential, if any, based on relative risk of different parts of BT. The views below are therefore those of BT Group.

Annex B contains BT's current analysis of the parameters underpinning Ofcom's assessment of BT's WACC and a critique of Ofcom's preliminary conclusion that both BT Group's and Openreach's WACC has actually declined since 2005. In our analysis, we show that, to the contrary, key parameters such as the risk free rate and the beta factor are already either at or even above the *upper bounds* which Ofcom and its advisors have proposed.

It is a feature of the current volatile markets that Ofcom's estimates have become outdated very quickly.[35] BT has constructed a forward-looking range for *future* WACC which is more attuned to current views of market participants, given current and likely future market conditions.

BT has commissioned a study by an independent consultant to review opinion in a range of City financial institutions to consider how today's market conditions influences the cost of capital, and the climate for telecoms investment (see Annex D). This study corroborates BT's estimates of the WACC. For example, one of the conclusions is that the financial institutions interviewed find it "*inconceivable that BT's WACC could have fallen since 2005, given subsequent increases in equity risk premiums and interest rates. Some also argue that BT's beta has increased over the period"*. The majority of institutions interviewed believe that BT's WACC is actually above Ofcom's upper bound.

BT has also given considerable attention to the recent determination on airports[36] and the contemporaneous review of the water sector.[37] These all point to a much wider range for WACC than Ofcom suggests and, as discussed below, this is critical for setting the determined WACC given the issues of:

---

35 As Oxera notes at pp 4 of its report (Annex C): *"The spreads and yields for corporates with credit quality similar to that of BT have increased substantially, since the start of the turmoil and since the publication of Ofcom's proposals."*

36 Full references of the relevant reports are provided in Annex B and are not included here for the sake of brevity.

37 NERA, Cost of Capital for PR09 – Final report for Water UK, June 2008

- incentives to invest;
- the need for ”headroom”;
- sentiment in financial institutions on BT’s cost of capital;
- the ability of BT to finance investment.

Current uncertainties in corporate and global financial markets

The accompanying report by Oxera (in Annex C) demonstrates that tight financial conditions will prevail for a considerable period of time and certainly over the likely period of the Openreach financial review.

BT therefore attributes considerable weight to this, in conjunction with the sentiment of City financial institutions identified in Annex D. The institutions interviewed represent a wide cross section of the groups that BT and others would actually have to raise financing from or through in the future. This makes their views critical, even though the study is qualitative not quantitative, and is not claimed to be an econometric study into the parameters to be used in a WACC calculation.

The implications on incentives to invest

Ofcom’s stance on the WACC will have both direct and indirect effects on incentives to invest by BT and other companies in the sector. Traditionally, both Oftel and Ofcom have tended to err on the side of “caution” in setting the WACC above the central estimate, at least partially to reflect the welfare asymmetries of setting a WACC too low because investment will not be undertaken, or unduly delayed, as a consequence.

This stance was recently supported by the Competition Commission in its report on airports where a WACC toward the upper end of the likely forward-looking distribution was recommended. BT endorses this approach. There is also some evidence that other regulators in EU countries have awarded a WACC to the incumbent rather higher than the central estimate which Ofcom is proposing – and these operators are undisputedly in much stronger market positions than BT with consequential greater ability to raise finance[38].

BT and other operators are investing significantly with the potential for the UK to have broadband access at considerably higher speeds than at present. Openreach itself additionally has to invest in the copper network and Ofcom’s stance on WACC will have a major bearing on these plans. Ofcom’s Consultation was written prior to BT’s announcement that it intended to invest in super-fast broadband (NGA) subject to a satisfactory regulatory regime. Throughout its responses on cost of capital, BT is referring to the WACC that is appropriate for existing services, and not future ones.

---

[38] For further details see paragraph B.1.3 in Annex B.

BT proposes that Ofcom sets a WACC which is some way above a central estimate constructed using up-to-date estimates of the parameters in the CAPM model and which, as noted, would be in line with the estimates of key financial institutions of BT's (central estimate) of the WACC.

In summary, BT's central estimates are that the BT Group and Openreach WACC are set too low. Arguments put forward to suggest that regulators should set a WACC cautiously to avoid the welfare losses from setting a WACC which is too low could increase these estimates significantly. Accordingly, Openreach's cost of capital should be set towards the upper limit of this range, at 12.1% or more[39].

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?

Ofcom suggests that regulation typically involves trade-offs between allocative, productive and dynamic efficiency. That is, in the language used in paragraph 6.34 of the Consultation, there are trade-offs between setting prices close to cost (for allocative efficiency); to encourage cost minimisation (for productive efficiency) and to provide the right incentives to invest (for dynamic efficiency).

Price caps have, for over 20 years, been used on the basis that they provide powerful incentives for *productive* efficiency. This is because exceeding the efficiency targets in a price cap is a primary way by which the regulated firm can earn more than its cost of capital and which ultimately feeds back to the market at future price reviews. The success of this type of incentive structure in improving cost efficiencies (but not investment levels) has been confirmed on numerous occasions and there is no obvious trade-off with either of the other two types of efficiency described by Ofcom.

Dynamic efficiency

The use of price caps to provide incentives for productive efficiency does not inform the <u>level</u> of charges which should feature in a price control. Ofcom appear to be indicating there is a conflict between allocative efficiency and dynamic efficiency – in other words, that prices in line with costs might not create the right incentives for firms to invest and innovate. Put another way, charges which create the right incentives for other firms to invest and innovate might not reflect the resources used to provide the service.

39 See also Summary and Section B.5 (Incentivisation of Investment) of Annex B to this Response.

This is a difficult supposition to address at anything more than a theoretical level. The idea appears to be that, using the terminology from the Consultation, lower input charges will "*drive more efficient behaviours*" than otherwise.[40] The first issue is why this might be assumed to be the case – one would not expect lower aviation fuel charges to drive more efficient behaviours in airlines, for example.

Ofcom presumably has in mind a correlation between the level of MPF charges and the take-up of MPF; and that a greater number of MPF lines will spur efficiency and innovation in the provision of services over copper access lines. While the level of charge will partly determine the level of demand, and may even initially help toward the development of a competitive structure for the downstream provision of related services, it cannot simply be argued that encouraging further take-up – through low charges – results unambiguously in an increased level of efficiency and innovative supply of these downstream services.

Furthermore, it is plainly incorrect to consider Openreach's access network as if it were a complete monopoly. There is a large cable platform in the UK and a number of wireless platforms. There is also the prospect of even greater competition between existing and emerging fibre networks in the medium term. The discussion in the Consultation does not recognise that the lower the charge for the copper network, the more difficult it may become to make a commercial return from other competing networks because there will be network competition between access platforms.

This applies particularly to networks which have not been built and for which all the costs are still avoidable. Thus, were Ofcom to focus on only one target – to maximise dynamic efficiency gains over Openreach's copper network by maximising competition over this platform – it might find it inadvertently reduces gains from another form of dynamic efficiency, this being the future investment and innovation in copper and non-copper access platforms. There is, in effect, a trade-off involved with the objective of dynamic efficiency itself, this concerning the promotion of dynamic efficiency over the copper network at the possible expense of other networks as yet not installed. In particular, low wholesale access charges for copper-based services are not consistent with a policy which seeks innovation and new services, whether over copper or fibre.

Allocative efficiency

Even if it were correct to assume that lower wholesale access charges for copper-based services promote dynamic efficiency, there is a conflict with another requirement on regulated charges – that they should promote allocative efficiency, i.e., reflect the resource costs of the services in question. Prices lower than cost will encourage over-consumption, because customers will be purchasing the service up to the point where their private value equals

---

[40] Consultation, at [6.35]

price, and this is below the cost of provision. At the margin, the resource costs of providing the service will be greater than the value of the service. This would (unless there were clear externalities) be inefficient.

A relevant consideration is the level of costs which reflects the resource costs of supply. A familiar claim is that sunk costs should be disregarded on the basis that these are not relevant going forward. However, the clear consequence of such a policy is that it provides very poor forward-looking incentive properties – knowing that a "hold-up" of this kind is a possibility, and that assets cannot be withdrawn should an event to occur, a rational investor will not commit funds to an investment in the first place. For sustained investment, some protection of the investor's (i.e. shareholders' and debtors') interests is therefore necessary in any regulatory regime which has long term efficiencies in mind.

Thus, Article 13(1) of the Access Directive states that, "National regulatory authorities shall take into account the investment made by the operator and allow him a reasonable rate of return on adequate capital employed, taking into account the risks involved"[41]. This is reflected in Section 88.2 of the Communications Act 2003, which states that Ofcom must take into account the extent of the investment in setting prices of network access services.

Charges set on the basis of long run cost largely provide this because sunk costs are included, the long run being defined as the period over which all assets (and costs) are variable. This also accords with regulation which provides that all efficiently-incurred costs can be recovered in regulated charges.

The remaining issue is what mark-up ought to be applied to long run costs, there being a need for a mark-up to cover the difference between the totality of service long run incremental costs and the total costs of supplying the set of services in question (the difference in costs usually being referred to as "fixed and common costs", where fixed in this context means fixed with respect to volumes). Here economic theory suggests that the services with the least elastic demand ought to provide, proportionally, the highest contribution. Such services are likely to include access services of the kind supplied by Openreach, which are necessary for downstream services to be provided at all.

Openreach is not, however, suggesting that its services are subject to higher than average mark-ups (i.e. that Ramsey pricing principles are applied), simply that all access services contribute the same level of contribution to fixed and common costs as other services. This is the basis of an equal proportion mark-up regime, known as Long Run Incremental Cost ("LRIC") plus Equi- Proportional Mark-Up ("EPMU"), which Ofcom has widely used in the past.

---

[41] Directive 2002/19/EC Of The European Parliament And Of The Council of 7 March 2002

In 2004/5 Ofcom noted that, in terms of regulated network charge controls:

> "the total costs of inland conveyance on a LRIC+EPMU basis were not significantly different from CCA FAC. However, the decision [to use LRIC+EPMU] was not based on any claimed intrinsic superiority of LRIC+EPMU over CCA FAC, which was regarded as likely to be little different, although both these were regarded as superior to historic cost ("HCA") FAC which did not provide appropriate entry or investment signals."[42]

In other words, both LRIC and an equal mark-up, and CCA FAC, are cost systems which tend to show the same level of costs. CCA FAC is, in other words, a good proxy for long run costs which include a fair (equal) contribution to fixed and common costs.

Openreach certainly believes that access services should contribute towards fixed and common costs. To suggest otherwise would, in effect, mean that Openreach would need to be supported by other activities in BT Group, which in turn would need to earn higher margins in order to cover the margins foregone on access services. Not only is this inconsistent with functional separation and the underlying rationale of the Undertakings, which is to make downstream services competitive, it would be against Ramsey pricing principles if, as can presumed to be the case, Openreach's access services are less price elastic than downstream services.

Nor does Openreach suggest that mark-ups for fixed and common costs should be varied across its core services on the basis that the underlying elasticities of demand vary between products. Such evidence is not available, and there is no reason in principle to expect that there should be any significant variation of demand elasticity between services which all have the characteristic that they are essential for the provision of downstream services (i.e. they are "economic bottlenecks"). We note too that Ofcom has, without exception, rejected Ramsey pricing on numerous occasions in the past. A regime which treats all services equally, and hence all CPs equally, will allow the market to decide which CPs prosper. Openreach believes that this is far preferable to a regime which, by subjectively reallocating fixed and common costs between services, treats some CPs more favourably than others.

On the basis of this explanation, Openreach therefore believes that charges based on CCA FAC are the right way to balance the various types of efficiency which Ofcom is considering. This would be in line with well-established regulatory precedent.

42 Ofcom, Explanatory Statement and Notification of decisions on BT's SMP status and charge controls in narrowband wholesale markets, dated August 2005

QUESTION 6.10: HOW WOULD PRICE INCREASES FOR MPF, SMPF 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?

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?

We have answered these two questions together as they are related, one asking for possible impacts at the wholesale level, the other looking at possible impacts at the downstream retail level.

As explained throughout this Response, it is necessary for Openreach to increase its prices for MPF, SMPF and WLR to correct current under recovery of relevant costs incurred. This correction is necessary to provide for a financially sustainable Openreach and to safeguard a viable and competitive access market going forward.

How any such rises will impact CPs at the **wholesale level** depends on a number of factors.

It is important to set the scale of the required price increases in context. Our required immediate step increase for MPF rentals, such that it earns its regulated return, is equivalent to around £1.30 per month. Other annual increases will be even smaller. These should be compared relative to other CP input costs.

It is our view therefore that the impact of the required price increases, even for MPF, is unlikely to have a material effect on CPs profitability and will therefore not impact substantially on their business models. To support this argument, Openreach has modelled the likely costs faced by an LLU CP in providing voice and broadband services to retail end-users. This is shown in Figure 6 below.

Figure 6 Openreach estimated average wholesale and retail costs to a LLU CP

Average Cost per Customer per Month £	MPF	SMPF+WLR
Connection	0.71	1.39
Line Rental	6.78	9.84
Network Opex	3.32	3.17
Network Capex	4.19	3.53
Calls	6.03	5.65
Customer acquisition costs	3.07	3.07
Total Cost	24.10	26.66
Openreach Line Rental as % of total	28%	37%

The current price of MPF rental can be seen to constitute approximately 28% of the total costs to a generic LLU CP to provide a service to a retail end-user. Similarly, for SMPF and WLR, the rental is still less than half of the total costs.

For the sake of illustration, if the price of Openreach rentals were increased by 20% *ceteris paribus*, the share of total costs of MPF rental only increases to 32% of total costs to the LLU operator. Therefore Openreach does not consider that any price rise will have a material impact on CPs in the market.

Importantly, many of the other input costs incurred by CPs for their “bundled” offerings are falling. For example, Openreach has itself announced significant reductions in the costs of backhaul (which we provide to many CPs) through direct pricing action and through product developments such as Ethernet Backhaul Direct.

One of the major factors affecting LLU rollout and take-up is the fact that the price difference between MPF and WLR+SMPF does not represent the true economic cost differences in the supply of these respective offerings. While this may have stimulated earlier investment, this model is not sustainable on an ongoing basis for Openreach or industry. If prices were to increase, the absolute price advantage of MPF versus WLR+SMPF will decrease to the level justified by the true underlying economics, but will not be eroded completely. This continuing profit differential, along with the other advantages mentioned above, will mean that the future roll out of LLU will not be affected. Price increases that are reflective of real costs will also allow CPs to make business decisions on a sound economic basis going forward.

Indeed, the current market distortion that is occurring because of the artificially low input prices charged by Openreach has led to market behaviour which cannot, in our view, be sustained in the long term. Business models for all operators need to be realigned to better reflect true costs.

At the **retail level** as explained above, CPs will have a choice as to whether or not to pass any increase in input costs onto their respective end users.

As noted above, wholesale price levels are small relative to other input costs. Moreover our customers increasingly offer “bundles” of communications services to their retail customers at a single price point. Openreach’s input prices are only one cost amongst many incurred in setting up such bundles and the CP can choose to pass on or absorb the price increases in any of their inputs.

We believe that because of CP ability to absorb the relatively small increases in costs requested by Openreach that the impact on retail prices charged to consumers will be minimal. The retail broadband market is highly competitive and it is unlikely that costs charged to end users will rise to any material extent, if at all.

Indeed, many bundled offerings now offer broadband for “free” where consumers take it as part of a bundle of communications services. Bundling is increasingly significant at the retail level, with broadband featuring prominently.

Competition in the downstream market is fierce at the present time, and we do not believe that any price increases imposed by Openreach will have a detrimental impact on that competition. The market is characterised by strong competition not only amongst CPs, but also amongst and between wireless and cable operators.

QUESTION 6.12: WHAT ARE THE IMPLICATIONS OF A NEW PRICING FRAMEWORK FOR INCENTIVES TO NEW INFRASTRUCTURE INVESTMENT BY BT AND OTHER CPS?

The new pricing framework may have a number of implications on the investment incentives of BT and other CPs. As Ofcom notes in the Consultation, the primary drivers for new investment decisions by a business should be commercial, such as responding to changes in demand or competition. Hence it is important to consider factors which affect the ability of a business to react appropriately to such pressures. In this respect, Ofcom acknowledges that the objectives and structure of the regulatory framework should influence commercial decisions:

> *“The new framework should continue to encourage efficient, sustainable competition in access services. It should also provide appropriate incentives for future improvements in the quality, innovation and investment in existing and next generation services….”*

Openreach agrees that the regulatory framework will not only affect the day to day commercial decisions that a business makes, but will also set the scene and provide signals to the market regarding investment and innovation. In this way, the framework highlights the importance that the regulator places on future investment and innovation.

The outcome of this review will inevitably send important signals to the market about the way that future investment will be treated by the regulator, the likely returns that can be expected, and the importance attributed to infrastructure investment in the UK. The long term needs of infrastructure investors needs to be balanced with those of the providers whose services rely on such network investment. A settlement which does not look at the sustainability of all elements in the telecoms value chain will inevitably raise significant questions for the very substantial ongoing investment demanded to support the existing infrastructure as well as the financial viability of any future large scale projects such as the deployment of NGA networks. Institutional investors and analysts have also raised such concerns as reflected in recent comments by telecoms analysts at Nomura:

> *The question is will they [BT] have the security of a return, or at least the guarantee that they will not have the rewards undermined by regulators?*[43]

Statements like these lend weight to the view expressed by Ofcom that "building trust" in the regulatory framework is a critical aspect of achieving efficient and timely investment by Openreach, or indeed any other long term investor. Ofcom, and for that matter Openreach, need to be mindful that this trust can be undermined if numerous and regular adjustments are made to the regulatory pricing framework e.g. one-off cost adjustments or any reopening of the framework.

Inappropriate or out-dated regulation also has the potential to reduce the economic efficiency[44] of investments. Leaving aside any debate around specific price levels (subject to Ofcom continuing to assess Openreach's financial submissions) the picture which is emerging of regulated price ceilings for copper products becoming increasing misaligned to the cost base is not typical of the way in which an efficient and competitive market would operate.

Where prices are not set to reflect costs, or indeed demand, there is likely to be a distortion in the investment incentives of CPs at both the infrastructure and service layers. For example, if prices are set below costs then there is a significant risk that investment by firms in new services will be held back by competing products which are set at an artificially low price level. Infrastructure investors may not be able to develop business cases for investing in new technology and downstream firms may continue to utilise capital to invest in and sustain businesses which are built on legacy infrastructure. In this case the regulatory framework can act to chill appropriate and timely new investment.

43 Quote from Martin Mabbutt, Telecoms Analyst with Nomura in "Tough Act for Openreach's New Boss", The Observer, 13 April 2008

44 Ofcom cite three types of efficiency in the consultation; allocative, productive and dynamic, and state that the aim of telecoms regulation is to mimic a fully competitive market.

In light of the above, Openreach believes that moving to a new framework is likely to be widely beneficial and that correct alignment of price regulation to an acceptable regulatory cost base will help to alleviate many efficiency concerns.

The risk of the new regulatory framework impacting on investment incentives is particularly real and relevant to Openreach at this time as BT Group announces plans to make substantial investments to upgrade the UK access network (subject to the correct regulatory framework being in place). In order for such an investment to have a chance of commercial success, we need to ensure that both copper and fibre access products are properly priced to enable costs and an appropriate return on capital to be recovered. Under-pricing of existing copper access products will create a disincentive for CPs to move to fibre based products at the appropriate time and increase demands for regulatory protection on existing legacy business models. As the market evolves it is essential it does so on the basis of a sound underlying economic network.

Moreover, there is also the more immediate and pressing implication which arises from staying with the existing regulatory pricing framework. That is, the current framework fails to recognise the scale of the potential changes in copper costs going forward and this threatens the sustainability of the Openreach business model in the short to medium term and hence the businesses which rely upon its services.

Although the core of this response concentrates on the impact of the regulatory pricing framework on Openreach, it is also appropriate to consider the effect on other CPs. At face value, any increase of input costs to CPs that use copper based input services is likely to be viewed as unwelcome and likely to lead (in the short term at least) to either a reduction in margin or a retail price increase. However, it is not possible to fully prejudge the financial effect of such a change without knowing the relevant price elasticities, or whether the price change is viewed as a correction to achieve a sustainable pricing level for competition and trading, then the stability of the value chain and business model may be improved for the medium and long term. Furthermore, a new regulatory pricing framework that is correctly aligned to costs will provide better incentives for timely investment in new technologies by alternative CPs at both the infrastructure and service levels. It would be likely to stimulate management consideration of new business opportunities rather than a focus to sustain existing business models and investment strategies based on copper services. It could also increase demand for investment in new infrastructure from Openreach or alternative providers.

With respect to the operational and compliance aspects of the new framework Openreach requests Ofcom to consider approaches which allow for some flexibility and responsiveness. For example:

- any forthcoming price control could be configured so as to allow for a suitable level of management discretion. For example, assuming an RPI+X format, any proposed X parameter(s) must of course be reasonable and achievable, but if too stringent, will leave little or no resource for re-allocation to other economically efficient initiatives;

- detailed consideration could also be given to the cost of capital and particularly whether all potential risks are properly factored into the prevailing estimates; and

- an unnecessarily rigid and restrictive approach to Openreach cost stacks may be similarly inhibiting, such that Ofcom determined cost allocation(s) and/or methodologies by which costs may be recovered, could severely restrict management decision making. Some flexibility in the structure of the price control, i.e. baskets, would provide for greater discretion in the economic management of the business.

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 important to note that allowing for the recovery of SLG compensation payments should not be considered a reward for service failure. For various reasons, as set out below, it is appropriate that an allowance be made. Such payments are a legitimate business cost and it is a widely accepted commercial practice to recover a reasonable proportion of such costs within the price(s) of the service(s) supplied.

Openreach has come a long way in improving its service performance. These significant strides in service quality are illustrated in Figure 7 below.

Figure 7 Service improvements in 2008 – average offered lead times across products portfolio[45]

	March 2008 (working days)	March 2007 (working days)	Improvement
Business order provision	2.9	4.8	40%
Consumer order provision	3.9	8.4	54%
Business fault repair	0.6	1.3	54%
Consumer fault repair	0.9	1.6	44%

45 BT Group plc, Annual Report & Form 20-F at pp 21

Openreach is fully committed to continuing to implement measures to improve service quality. However, it would be wholly unreasonable to assume that Openreach should be required to consistently meet 100% service levels. As such, going forward, an allowance for the recovery of some SLG compensation payments should be made.

Aside from the obvious economic irrationality of such an approach (close to 100% delivery would entail very high costs) it is, in practice, unlikely to be operationally possible. There will be a tipping point where the incremental cost of increasing quality actually outweighs the potential benefit. This would be an outcome that would neither benefit Openreach nor its customers.

Instead, Openreach should be expected to meet target delivery levels which an efficient operator should be able to deliver. Estimating the level of service an efficient operator should deliver is difficult, so we suggest that an allowance for SLG compensation payments is based on an assessment of Openreach's actual data and projected outcomes. This would, in effect, set targets for Openreach, which if it exceeded would allow it to benefit, but that if it failed would impose adverse financial consequences.

We suggest that any such service targets should be based on a form of glide path, i.e. where Openreach is given an incentive to continue to improve service over the period of any charge control. In simple terms, this implies that the amount of SLG costs Openreach is able to recover would gradually reduce over time, until the amount of recoverable costs is at a level considered to be consistent with that of an "efficient operator". Such an approach is also consistent with many of the targeted service outcomes Openreach has presented and agreed with industry (largely through the Office of the Telecoms Adjudicator).

This area is one which may become administratively complex and Openreach is therefore keen to ensure that a manageable and transparent approach is developed. In addition, we suggest that the setting of specific quality of service targets, the recovery of an appropriate level of SLGs and the ongoing management thereof, cannot be met via occasional "regulatory planning". Any system will need sufficient flexibility to allow Openreach to respond to demand and the ability to (re)allocate resource to meet different service requirements if they develop.

Openreach therefore considers that Ofcom should seek an arrangement which is simple, bounded and flexible.

Outline of Openreach's proposed approach

We propose that Openreach will recover a reasonable amount of SLG compensation payments for all of the core services and products contained within the regulated copper access portfolio e.g. MPF/SMPF provision and repair, WLR provision and repair etc. However, the level of allowable recovery may vary across the product set, for example, while 5% provision failure (95% success rate and compensation cost based on provision failure of 5% being recoverable) might be the reasonable level for Product A, the different operational and technical processes used for Product B might suggest a higher (or lower) figure.

The “efficient operator” benchmark, and the extent of recoverable costs, should be determined by reference to current actual metrics and Openreach’s targeted service measures, many of which have already been presented to and agreed with industry. The proposed glide path would then be set relative to these measures. For example, if the current actual metric is 95% and the [efficient operator’s] target is 98%, the amount of SLG costs recoverable over time would decrease from 5% to 2% over the glide path period, thereby providing Openreach with a clear incentive to meet the targeted level of service. In the event that for certain services the actual metrics show that Openreach is already operating at the “efficient operator” benchmark, then that measure would continue to hold for the duration of the charge control.

The level of allowable recovery must take into account the fact that CPs purchasing products from Openreach suffer no effective contractual consequences for inaccurate forecasting or inaccurate provision of data.

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 THE CURRENT CHARGE CONTROLS ARE REQUIRED, SHOULD THOSE ADJUSTMENTS BE IMPLEMENTED IMMEDIATELY OR SPREAD OVER THE TERM OF THE CONTROL?

Openreach believes that price controls in the form of an indexed allowance, RPI+ X, for changes over a number of years are an appropriate basis for setting charges in the context of this review. Although there are some material issues concerning technological competition (e.g. Wi-Fi access for broadband and the continual erosion of fixed lines by mobile access), MPF, SMPF and WLR are a good fit to the criteria for an effective RPI+X regime. Volumes and costs are reasonably predictable, meaning that likely returns too are foreseeable given any the level of any price control. In addition, as Ofcom set out in 2005:[46]

> Charges that are re-determined regularly have a number of positive properties, but provide the dominant provider with limited incentives towards cost minimisation and provide little predictability for competing providers. To ensure that charges better mimic those that could be expected in a competitive market, it may be appropriate to introduce a charge control. In general, a charge control constrains the movement of regulated charges so that they reflect any cost savings derived from expected volume increases, expected reductions in asset and input

[46] Ofcom, LLU Statement 2005at [3.16].

prices and expected efficiency improvements (assessed through a benchmarking exercise). At the same time, a charge control allows the retention of all gains from unanticipated efficiency improvements for the period of the control, thus providing the dominant provider with incentives towards cost efficiency.

The main alternative to RPI±X type controls are cost plus prices, effectively the basis used by Ofcom to set the current controls. The advantage of this type of control is that cost recovery is effectively guaranteed if permitted charges are regularly updated (if they are not, then they are in effect a form of price cap, with ceilings set at “RPI minus RPI”). The regular update of cost-based charges is, however, administratively onerous. They also do not have the incentive properties of RPI±X controls in terms of improving efficiency.

RPI±X controls can also provide certainty for all players in the market. In view of this, Openreach considers that RPI±X controls have important advantages over the main alternative basis of price regulation, and are therefore appropriate for Openreach’s core copper portfolio of MPF, SMPF and WLR.

Ofcom phrases the question in terms of RPI *minus* X controls, that is controls which involve real term reduction in prices. This would be totally inappropriate for the Openreach portfolio where the regime will start after more than three years of fixed prices, against a background of sharply increasing costs to the business (including those due to the unwinding of previous regulatory accounting adjustments) and where the central MPF charge fails to cover its cost. Real term prices *increases* are fully justified and necessary for the sustainability of the copper access network in the medium term. This applies particularly to MPF prices.

Use of Glide Path

The objective of the price control is to align prices with costs. Where current prices are not significantly misaligned with costs, Openreach considers it reasonable for any required adjustments to be made over the period of the charge control itself. This applies to WLR, SMPF and Co-mingling as evidenced in the cost stack analysis presented in Section 6 of the Consultation.

In the case of MPF rental, however, the cost stack is already significantly above the price ceiling. Figure 6.2 in the Consultation shows the misalignment to be of the order of £12 in 2008/09. Openreach’s latest analysis, based on the currently available data, suggests that an immediate increase of at least £16 per annum is now required to bring the rental price in line with the CCA FAC cost stack[47].

---

[47] Ofcom/ Oftel have used step changes in the past. For example, a step change reduction was imposed on H3G in part on the grounds that prices were "well in excess of cost based levels” - see Ofcom, Mobile Call Termination Statement, March 2007, at [9.137]. A step change was also introduced on interconnect services by Oftel in 1997 – see Oftel, Network Charge from 1997, July 1997.

Openreach believes this misalignment justifies an immediate step increase in the price of MPF rentals, such that this service can begin to earn its regulated cost of capital. Such an increase would provide a clear signal to customers, and investors, of the future basis of prices (in which no single form of access service being preferred over others) and correct the immediate misalignment of margins across the access portfolio. Not to do so has the clear implication that structural issues are being left unaddressed and that fundamental problems are being stored up for the future – in effect, the UK would have an industry structure based on distorted input costs, and an increasingly underfunded access platform on which the communications industry will still be dependent. Openreach believes it should be clear that now is the time to put the industry on a sure long term footing and to regulate in such a way that allows the UK's main access network is to be maintained and improved.

Openreach therefore believes that:

- an immediate correction in relative prices is appropriate and proportionate due to the drastic effect on Openreach profitability of the projected shift towards MPF;
- the use of a glide path for the necessary correction to MPF prices would mean prolonging the distortion inherent in current charges and should not therefore be used;
- that the immediate rectification is critical to ensure short and long term sustainability of the regulatory regime in the UK through the viability of Openreach; and
- that following a immediate step-change increase in MPF rental prices, this service should be subject to an RPI+X regime thereafter to ensure that charges remain aligned to costs.

QUESTION 8.2: SHOULD CHARGE CONTROLS CONTINUE TO BE SET FOR EACH OF THE INDIVIDUAL SERVICES (WLR, MPF AND SMPF) OR WOULD IT BE MORE APPROPRIATE TO SET AN AGGREGATE CONTROL COVERING SOME OR ALL OF THESE SERVICES?

QUESTION 8.3: DO YOU HAVE ANY VIEWS ON THE APPROPRIATE STRUCTURE OF A CONTROL OVER ALL OR ANY INDIVIDUAL NON-CORE SERVICE?

We address these two questions together since they are clearly related.

The current price controls apply to individual access services. This provides a degree of certainty to CPs about future price movements. However, by setting prices for a number of years, a price control can be inflexible and raises the risk that individual prices might diverge from costs, whereas it is more likely that an overall basket will be less subject to such a divergence. It also prevents Openreach from responding to market demands and maintaining competitive prices across its portfolio to the benefit of its customers. An alternative approach is to group together related services into a basket to which a price control is then applied. This approach would give Openreach relative flexibility within each basket to adjust prices in response to market demands, subject to the overall price cap and cost orientation obligations.

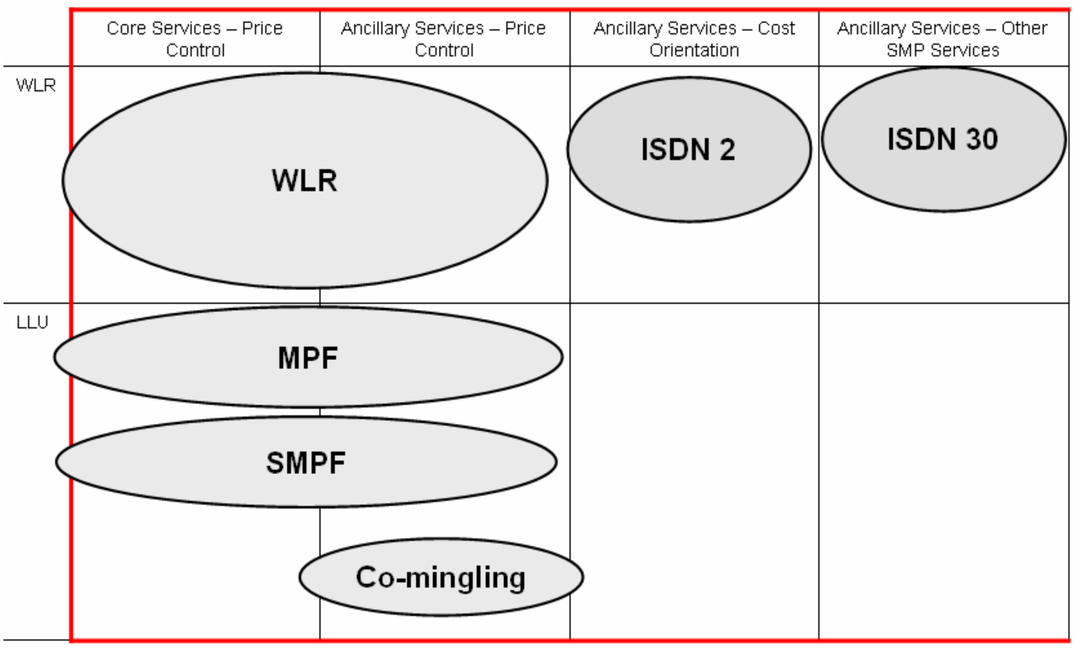
We believe that an appropriate balance is to group together into single baskets each of the core rental services, together with other SMP products that CPs need to purchase from Openreach in conjunction with those services.

Therefore, Openreach proposes separate baskets for MPF, SMPF and WLR, each comprising rentals and connections together with certain SMP ancillary services CPs need to buy from Openreach in conjunction with MPF, SMPF and WLR respectively.

In addition we propose a separate basket for co-mingling as these products and services are an essential pre-requisite to the supply of LLU services.

The proposed baskets are shown in Figure 8 below.

Figure 8 Openreach's proposed pricing baskets



As set out in our response to Question 6.3 we do not believe it is appropriate to apply price controls to SMP non-core services which are not ancillary to the provision of SMP Core Rental Services (MPF, SMPF or WLR).

Other products and services which sit outside the SMP Core Rental Services (i.e., not MPF, SMPF or WLR rental products or SMP ancillary services which need to be purchased by CPs in conjunction with MPF, SMPF or WLR), should continue to be regulated as they presently are or not at all (for example Non-Regulated Services).

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 AS REVIEW?

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?

The duration of a control needs to balance factors that justify a longer control (e.g. certainty, continuity, efficiency incentives) with factors that suggest a shorter duration (e.g. concerns over the ability to forecast with reasonable confidence, to ensure prices do not diverge too far from actual costs in the future).

Price caps applied to BT's services have generally had 4 year duration and this has normally worked well as a balance between providing certainty, and keeping prices reasonably aligned with costs. The modelling approach used by Openreach and Ofcom has been sufficiently detailed and robust to allow minimum four year controls to be set with confidence. In general, re-opening a price control (including with the use of triggers) is not desirable, as it weakens the incentive properties of a price cap and risks becoming hard to distinguish from rate of return regulation.

Start date for the new framework

In terms of the start date, it must be appreciated that the main Openreach services, especially WLR and MPF rentals, are subject to fixed price ceilings. This fails to take account of the profile of unit costs, particularly so for MPF, and of the effects of inflation since 2005. Openreach therefore urges a price control regime should commence as soon as possible and no later than 1April 2009.

QUESTION 8.6: HOW SHOULD THE PRICING FRAMEWORK RESPOND TO NEW SERVICE OFFERINGS FROM OPENREACH? WE WOULD WELCOME EXAMPLES OF NEW SERVICE OFFERINGS WHICH YOU WOULD CONSIDER SHOULD BE ENCOURAGED?

We believe the principles and general approach set out in Section 3, and also in our response to Question 6.3, provides the appropriate framework for consideration of how to regulate new products and services. Broadly, regulation must be both proportionate and appropriate, and these general “tests” are as applicable to new service offerings as they are to existing products and services found in markets with SMP.

In addition to the equivalence obligations in the Undertakings that govern the development and supply of new Openreach services, Openreach is required to comply with a series of related regulatory obligations, including cost orientation. It is widely understood that, in the context of economic bottlenecks, both equivalence and a number of SMP-determined obligations would (and should) continue to bind. However, if the new service or product is neither bundled (nor loosely bundled) with an SMP service, it would be inappropriate and disproportionate to apply <u>any</u> regulatory constraints and/or obligations.

In terms of the current review and the new pricing framework, the objective must also be to clearly delineate the services subject to charge control, and by definition, “ring-fence” the specific service(s) subject to regulation (and charge control). For example, MPF “*standard care”* should be defined as the regulated service subject to charge control, and the service against which any strict cost orientation obligation – for the purposes of accounting or charge control compliance – would apply. In contrast, premium service offerings such as the enhanced service packages on MPF should not be subject to the same level of pricing regulation and costs review as MPF “*standard care*”.

While the current regulatory framework(s) does not prevent Openreach developing innovative service and product options, there is ambiguity as to exactly what might be captured by regulation and what should be free of regulatory constraint. For example, if the SMP obligation on *wholesale local access* (LLU) requires cost orientation, it is not clear whether this obligation binds the full suite of service options on LLU. In addition, there is also a lack of clarity of understanding of the principle that it is inappropriate for the regulatory framework to apply where products or services are developed outside of an SMP obligation. It is essential these issues are addressed as part of the review and that the new pricing framework creates the right environment for innovation, and the ability for Openreach to more effectively meet customer demand.

Set out below is a suggested framework for the consideration of these points and the development of new service offerings. We begin with a clear delineation of the actual regulated service subject to charge control and/or strict cost orientation. As the product or new service moves away from having the characteristic of an economic bottleneck, the regulatory constraints and/or obligations should either fall away completely, or be subject to lighter-touch regulatory measures.

Defining a “standard” regulated product

- The starting point should be the definition of a “standard” regulated SMP product set. In short there should be a form of functional specification for each regulated product which clearly defines the product/service and the associated Service Level Agreement. For example, SMPF at standard care levels might be defined as the regulated product. Any costs associated with the related care level would therefore be included and recovered in the regulated charge for the SMPF product itself. This approach should apply across the portfolio of core services.

Value Add to regulated products (stage 1)

- While ring-fencing a standard regulated product creates clarity, certainty and potential for innovation it does not necessarily follow that all regulatory obligations fall away in relation to products and services outside this “ring-fence”. For example, an enhanced service wrap on an LLU product is, broadly, a *bundle* comprising an SMP regulated product (access) and a service directly related to that regulated product; neither the regulated product nor the bundle can be easily/economically replicated. However, strict cost orientation should only apply only to the SMP regulated product element of the “bundle”. The enhanced service wrap should be capable of being priced on a supply/demand commercial basis.

Value Add to regulated products (stage 2)

- As the product or service moves further away from the idea of *pure* regulated bundles, for example, wiring in end-user premises (beyond the proposed 3m rule), the regulatory constraints should start to loosen or fall away.

Commercial Propositions (stage 3)

- For propositions which have little or no direct link to the provision by Openreach any specific SMP product or service, there is no requirement for any regulatory constraints. An example might be the deployment of Openreach engineering field resource to support third party commercial entities with their own engineering activity.

The basis of this approach is the development of a standard regulated product set which is recognised as being directly subject to charge controls/cost orientation, Openreach should then be able to innovate across the product portfolio further up the value chain, free of regulatory constraint and according to customer demand.

QUESTION 8.7: HOW WOULD YOU SUGGEST OFCOM BE INVOLVED, IF AT ALL, IN AN ASSESSMENT OF THE CHARGES FOR THESE SERVICES? DO YOU AGREE THAT OFCOM SHOULD ONLY CONSIDER REGULATING THE PRICES OF THESE SERVICES WHERE ISSUES OF SMP ARISE OR DISTORTIONS MIGHT OCCUR IN RESPECT OF THE RECOVERY OF FIXED AND COMMON COSTS (BETWEEN SMP AND NON-SMP SERVICES)?

Further to the issues discussed in our response to Question 8.6 above, we firmly believe that regulatory oversight is only required where issues of SMP arise, that is, where Openreach (as a part of BT) has been found to have SMP and/or where common costs may be distributed across both SMP and non-SMP products.

The level of scrutiny and degree of intervention would of course need to vary according to the market or product under consideration. Price control regulation may be applicable to SMP products where cost orientation and accounting separation obligations are felt not to be sufficient. For non-SMP services, only a review of the apportionment of fixed and common costs may be required.

In terms of the allocation of common costs and the risk of distortion, we consider the current review as providing the most appropriate mechanism and opportunity to clearly delineate - and define - the regulated (SMP) products and services, and conduct a thorough review of the relevant costs (including any attribution of common costs). This should provide Ofcom and industry with a understanding of all the actual and projected costs associated with each SMP product, including the attribution of any common costs, and therefore, should give sufficient confidence in the future charge control framework governing these SMP products and services.

The definition of regulated products, and the identification of all relevant and associated costs at this stage, and the manner of allocation, will remove any means of re-allocating cost and should effectively eliminate the risk of distortion. It would also provide assurance to Ofcom and industry that fixed and common costs have been allocated in a fair and reasonable manner, and that SMP services are now bearing and will continue to bear an appropriate proportion of these costs.

Openreach will, of course, continue to be bound by the equivalence obligations in the Undertakings relating to the development and provision of new and existing services. To the extent that different allocations of fixed and common costs are possible under a new charge control framework, Openreach would continue to attribute costs on a fair and reasonable basis, in accordance with the methodology agreed with Ofcom during this current review. The effect of any change in the distribution of cost would be equivalent, minimising the risk of any competitive distortion downstream.

Further to our response to Question 8.6, Openreach must be given the incentive to invest and innovate across the entire portfolio, with an ability to respond more effectively to market demand. The development of new services will be largely customer driven, and outside the SMP products Openreach and customers must be in a position to agree innovative and differentiated services. Accordingly, non-SMP services should be priced according to demand and willingness to pay – not by regulation. In short, the new pricing framework must seek to clearly distinguish between the SMP and non-SMP products, where necessary identify and attribute fixed and common costs in a fair and reasonable manner, endure for the period of any charge control, and allow the market to flourish properly for the non-regulated services.