

A New Pricing Framework for Openreach

Sky's response to Ofcom's consultation

Executive Summary

- Any changes to the current charge control regime need to be supported by evidence (to the relevant legal standard); Ofcom must therefore carefully interrogate arguments Openreach has advanced in favour of increases to its current charge controls, and minimise the potential for over-recovery;
- Ofcom should not, however, start from a position that Openreach's controls require increasing, but should query whether or not changes are required and, if so, what level can be justified (with charges being kept to the lowest level possible);
- The financial framework under which Openreach operates must continue to encourage competition, and provide the correct incentives on ISPs to continue to invest in their broadband businesses; any changes to current charge controls need to be assessed carefully in light of their potential impact on (downstream) competition; this includes any changes to the margin between WLR/SMPF and MPF charges;
- We have set out in this response a number of issues which challenge the quality of evidence (from Openreach) that Ofcom has reported in the consultation document and should specifically be interrogated further under this review.

1. Introduction

- 1.1 Ofcom reports (in paragraphs 1.17 and 6.1 of the consultation document) that BT has provided it with evidence that MPF and WLR prices are *"unbalanced"* with respect to its underlying costs, and that BT's projections suggest that *"the cost of these services will increase over the next few years, even after allowance is made for improvements in efficiency levels"*. Ofcom states (in paragraph 1.17) that *"the implications of these projections are that the charges for these services overall may need to rise and, potentially, that the price of MPF in particular may need to increase relative to the price of WLR"*.
- 1.2 Ofcom has indicated (in paragraph 2.14 of the consultation document) that the objectives for its review of this request and for the establishment of a new Pricing Framework for Openreach should be to:
- 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.
- 1.3 Ofcom also states that these objectives are designed, inter alia, *"to encourage competition at the deepest level of infrastructure where it can be achieved and sustained; ... and to incentivise timely and efficient investment in new infrastructure deployments by*

promoting certainty in the market through a stable and consistent regulatory framework" (paragraph 2.15).

- 1.4 It is important that Ofcom ensures that all of these objectives are taken into account in its review rather than, for example, primarily focus on the impact on Openreach of whether or not to amend the current charge controls. It is helpful that Ofcom acknowledges this approach in the consultation document, where it states that it is:

*"of the view that operators using the network should act on the basis of input prices **that are efficient and sustainable**. Thus, if the evidence provided by Openreach ... is robust, and the forecasts represent the efficient costs of delivering these services, there is then a case for considering increases to the current regulated charge ceilings"* (emphasis added) (paragraph 6.17),

and that it:

*"will also need to consider **the impact of any changes on competition and consumers**, particularly bearing in mind the benefits that the current regime has brought to consumers over the past two years in terms of new services, choice and reduced retail prices"* (emphasis added) (paragraph 1.18).

- 1.5 These objectives must shape Ofcom's approach, and notably be reflected in the standard of information that Ofcom uses as support for its decisions in this review – i.e. if the information provided by Openreach is not sufficiently robust evidence, or if Ofcom has concerns that changes to the current charge controls risks harming efficient, sustainable competition, then BT's request should not be acceded to.
- 1.6 In this regard, we note that Ofcom considers that *"Openreach may have adopted a conservative approach in projecting future costs"* (paragraph 1.17) and that *"we do not currently believe that the increases [in charges for regulated access services] need to be as significant as implied by the projections provided by BT"* (paragraph 1.19). In fact, Ofcom starting position should not be whether what increase is justifiable, but whether or not any increase (as opposed to maintenance or reduction) to Openreach's current charge controls is required.
- 1.7 Sky shares Ofcom's stated concerns that there are some areas of Openreach's cost projections that appear unduly pessimistic (with respect to expected returns) with little or no foundation. In fact, the (limited) relevant data that is at our disposal suggests that BT may be overstating the extent of the cost increases it faces. It is also worth questioning the need for charge increases given that, for example, until April 2008 Openreach wasn't even charging at the level of the regulated MPF ceiling.
- 1.8 We also have concerns over Openreach's aggressive MPF forecasts and very low predicted efficiency gains – **[REDACTED]**.
- 1.9 Nonetheless, Sky does accept that there is little for Communications Providers and their customers to gain from a charge control regime that does not allow Openreach appropriately to cover its costs and make a reasonable rate of return, which provide it with the necessary incentives to continue to invest in and maintain its local access network, from which many Communications Providers benefit, given their reliance on Openreach's services to deliver their retail services. Sky also recognises that costs to some parts of the Openreach business can be outside its control and that, in the case of regulated charges, periodic reviews of the basis of charges are therefore appropriate in order to account for any material changes to demand and cost profiles for these

services. As noted above, however, this does not mean that the current charge controls must be increased; any change must be justified.

- 1.10 Many Communications Providers' business models are significantly impacted by the inputs from Openreach; as a result, it is important that Ofcom's assessment of the historic and forecast returns that Openreach makes from the provision of WLR and LLU services is undertaken thoroughly, such that Ofcom's conclusions are supported by a cogent evidence base. For example, any potential for over-recovery (whether on the "Core Services" or via other services such as backhaul) should be minimised, something that has not been entirely successful during the life of the current price caps (as implied by Ofcom itself in paragraph 4.4 of the consultation document).
- 1.11 However, given that Ofcom states in the consultation document that it has not yet formed a view on the case for an increase (specifically) in the price of MPF relative to WLR, this would appear to indicate that further analysis of the evidence provided by BT is necessary.

2. Legal basis of the review

- 2.1 As Ofcom notes (in paragraphs 2.22 – 2.23) the requisite legal test to be met, where conditions are to be modified, is as set out in section 47(2) of the Communications Act, which requires that any changes are objectively justifiable, and are proportionate to what the condition or modification is intended to achieve. Even if Ofcom does not formally need to amend any of the relevant conditions that apply to Openreach, the requisite legal burden of proof should still be met in relation to any decision made by Ofcom.
- 2.2 In exercising its regulatory functions in general, Ofcom must have regard to its general duties under section 3 of the Communications Act. This includes requirements for Ofcom to ensure that its regulatory activities are accountable, and to have regard to best regulatory practices which, as Ofcom itself frequently espouses, means that it is an "evidence based regulator". These requirements underpin the need for Ofcom's evidence base to meet the appropriate legal standard.
- 2.3 In addition, Ofcom is also required (inter alia) to secure the availability throughout the United Kingdom of a wide range of electronic communications services (section 2(2)(b)), along with the need to have regard to the desirability of encouraging investment and innovation in relevant markets (section 3(4)(d)).
- 2.4 The combined outcome of these requirements means that not only must Ofcom be satisfied that the outcome of this review is objectively justifiable (i.e. supported by a cogent evidence base and, where appropriate, reasonable forecasts), but also that any changes take full account of the impact any changes in the charge controls could have on downstream competition.
- 2.5 Undertaking a thorough, evidence-based approach is particularly important to the present review given that (as Ofcom indicates in paragraph 6.36), the current charge controls, when originally set, were based on limited evidence:

"Prior to the creation of Openreach, it was not possible to predict the implications of the Undertakings on the broadband access market and there was only limited evidence on the likely impact on the market of the new MPF and WLR prices. In the absence of other evidence, the charges were informed to a significant extent by cost

information. Two years on, we have significantly better and broader evidence on the impact of the revised charging regime.”

- 2.6 The importance of Ofcom’s objectives for this present review are further underlined in paragraph 6.47 of the consultation document, where Ofcom recognises that the nature of downstream competition (being based on cable as well as BT’s network) will influence the impact such a review will have on Communications Providers:

“In general, an increase in wholesale prices will tend to increase downstream retail prices. The extent to which this happens will depend on a number of factors, including the extent to which Communications Providers are prepared to absorb any increase in wholesale costs and competition from Communications Providers that do not use BT’s exchanges (especially cable)”.

- 2.7 Such competition has developed, in part, as a result of the level of Openreach’s present charges, with the large reduction of SMPF charges in 2005 acting in many ways as the catalyst to more effective downstream (LLU-based) competition.
- 2.8 Under this review, it is therefore incumbent on Ofcom to interrogate all of BT’s claims of assumed cost increases, and to examine the impact any such rises have on Openreach’s overall returns, taking into account the realisation of attainable off-setting efficiencies. For the reasons outlined in this response, Sky considers that many of BT’s claims to be unsubstantiated or open to interpretation, challenging the charge increases inferred from Openreach’s cost projections. The onus is on Ofcom to ensure that any changes introduced as a result of this review are objectively justifiable.

3. Evolution of the market

- 3.1 It is important to consider the role the current charges have played in aiding the development of such diversified retail competition in what had been a relatively moribund copper access sector in the UK.
- 3.2 WLR and CPS have been successful in providing consumers with lower prices and increased choice of provider but it has not provided much in the way of innovation in telephony functionality. We believe this can be attributed to the lack of infrastructure competition. WLR service providers are reliant on the same set of features from BT. There is little or no opportunity for differentiation. The widespread adoption of fixed line voicemail on BT lines from the mid-1990’s coincided with the roll-out of cable networks who were offering voicemail with carrier class platforms that had started to become available earlier in the decade. Therefore, it can be inferred that infrastructure competition drove innovation in the marketplace. Since then, innovation has stalled somewhat, but we believe that MPF based voice and broadband could provide the stimulus to further service competition.
- 3.3 However, in recent years (and especially since 2005), the present regime has helped foster a highly competitive retail broadband sector. Such competition has been based on both price and innovation, and has largely been led by LLU operators (who, for example, adopted ADSL2+ long before BT itself did). As Ofcom itself recognises, in its Communications Markets Report (August 2007) (paragraph 4.1.2), Ofcom noted that the average cost of a residential broadband connection fell by around 9% during 2006, despite (more than) a doubling of the average blended headline speed to 4.6Mbit/s by June 2007. Ofcom attributed such recent falls in the cost of telecoms services to the accelerated rate of exchange unbundling, with the proportion of UK premises able to receive fixed line and DSL broadband services based on LLU increasing from 40% (Q4

2005) to 72% (Q1 2007). Further improvements will have been experienced since the reporting period of this report.

- 3.4 It should also not be forgotten that Openreach itself has been well placed to benefit from the large scale roll-out of LLU, enjoying returns for the relevant wholesale products well above their regulated WACC. As Ofcom notes in the consultation document (paragraph 2.5), Openreach generated around 40% of BT's group profit from 25% of its group revenues.
- 3.5 However, this transformation in retail competition is far from complete. What's at stake is the continued scope for sustainable, infrastructure-based competition, leading to service innovation (a key objective of the original Strategic Review of Telecommunications). As Ofcom will appreciate, these regulated charges represent a significant cost for an ISP's retail broadband cost base. Many ISPs, including Sky, have built their retail businesses in part on reliance on these charges, with their current and future investment returns from unbundling exchanges being dependent on the absolute level of copper access pricing (alongside that of a number of other key Openreach products such as backhaul, exchange space, tie cables and transaction charges).
- 3.6 The adoption of MPF by LLU operators to deliver bundled voice and broadband, however, remains relatively nascent. The migration to MPF is important because ISPs who bundle voice and broadband over MPF are better able to innovate in their service offerings (as well as in price) in order to differentiate from competitors. As a direct consequence of having overall control of its end users' telephony service through its own core network capabilities, the ISP is able to offer a suite of customised products and services that are complimentary to, and integrated with, the other media and communications services that it sells. These can include enhanced voicemail, web mail, unified messaging, numbering solutions, feature management, VoIP solutions, wideband voice, fixed-to-mobile convergence and TV audio. This list is not exhaustive but the important consideration here is that the exact functionality, price, "look and feel" and launch timescales would be entirely within the control of the MPF operator.
- 3.7 The adoption of MPF allows for competition over more of the value chain compared to WLR (with CPS) + SMPF, thus engendering further scope for retail price reductions. For an SMPF-based LLU operator to consider moving to MPF, there would need to be a sufficient margin between the prices for MPF versus WLR+SMPF. We will discuss this further later on in this document
- 3.8 Another key objective of the Strategic Review of Telecommunications was to encourage timely and efficient investment into new technology but, crucially, if copper access controls are set at too high a level, that could act as a disincentive on Openreach to invest, for example, in other areas such as in new access technology based on fibre. Given the current debate on next generation access business models, it is essential that copper access pricing doesn't artificially suppress fibre roll out or introduce inefficient incentives.

4. Sky's concerns with Openreach's evidence

- 4.1 We have set out below a number of issues that Sky wishes to raise with Ofcom about the quality of the evidence (including forecasts) provided by Openreach, and reported in the consultation document. This is presented by Openreach as support for its assertions that current charge controls are "*unbalanced*" with underlying costs. Ofcom notes that "*the regulated Core Services (WLR, MPF, SMPF) are, on average, less profitable*

than is the case for Openreach as a whole, and their overall profitability exhibits a steeper rate of decline” (paragraph 4.4), which Ofcom attributes to cost inflation and relative growth in MPF lines.

- 4.2 Ofcom should take these points into account when conducting its review. In particular, these concerns underline the importance of Ofcom interrogating Openreach’s evidence (and forecasts) thoroughly, in light of the points raised in section 3 above, and ensuring that any change to the current charge controls is supported by evidence. We would be happy to discuss these points further with Ofcom.

5. Migration to MPF

- 5.1 Sky considers that Openreach’s forecast for migration from WLR/SMPF to MPF is over-optimistic, underestimating the difficulties such a migration entails, and not adequately reflecting the (dis-)incentives on ISPs to undertake such a migration. There are significant challenges for any (SMPF-based) ISP wishing to utilise MPF-based solutions, particularly in scale. Given the importance of the scale of MPF adoption to Openreach’s projected returns, it is therefore essential that any assumptions about migration rates are fully tested against other ISP’s views (which are likely to reflect their respective business cases for migration).
- 5.2 Sky’s own internal projections indicate that the total number of MPF lines in use in the UK by the end of 2011 could be some way below those estimated by Openreach – Sky considers that an appropriate number is [REDACTED] lines, compared to the 10.6 million lines quoted by Openreach (see paragraph 6.29 of the consultation document). Sky’s estimate is based on its views about the difficulties and incentives for undertaking such a migration, as outlined below, together with information from public statements made by other ISPs.
- 5.3 [REDACTED].
- 5.4 Furthermore, we remain concerned at the relatively poor level of MPF fulfilment and assurance performance by Openreach to date, [REDACTED] (particularly in light of the Carphone Warehouse experience, and notwithstanding subsequent improvements sought by the OTA). A considerable amount of business planning and operational preparation is required prior to undertaking any such migration, including:
- General business planning for migration (i.e. including the ability to ramp up migration teams for particular volumes within particular timescales);
 - Gaining commitment from Openreach to particular volumes of migrations within agreed period
 - Developing operational capabilities to interact with the migration process;
 - Putting in place capabilities to manage the customers experience (and their expectations), in particular around:
 - Interruption to dial tone and ability to make calls;
 - Interruption to incoming calls as a result of the number port systems latency;
 - Actual failures in the migration process;
 - Loss of feature sets (e.g. call forwarding / saved voicemail messages / unheard voicemail messages);
 - Ensuring general quality assurance around the migration process; and
 - Developing the capability to reconcile invoices received for migration works.

- 5.5 The business case to be developed, and the operational issues to be handled, must also be assessed on an exchange-by-exchange basis, with solutions to be found, inter alia, to:
- The need for increased capacity with the exchange (bearing in mind that available space is limited, a situation that is expected to deteriorate further);
 - Migration service levels;
 - Treatment of “stranded” assets from legacy SMPF deployment; and
 - Testing of access functionality.
- 5.6 Further, these considerations emphasise why any migration from WLR/SMPF to MPF is unlikely to be a quick process, indicating that Openreach is also over-stating the likely pace of such change (whether on a individual customer basis or for mass migration programmes, or in relation to introducing MPF to an exchange).
- 5.7 For these reasons, all of which impact our view of the scale of migration to MPF **[REDACTED]**, we take a more cautious view than Openreach of the rate of migration that is achievable over the course of the next few years.
- 5.8 In addition, Openreach MPF migration forecasts are likely to be highly dependent upon the supply of MPF by Openreach to BT Wholesale. Most of this activity is likely to be driven by the roll-out of Wholesale Broadband Connect Converged (WBCC), as part of the 21CN programme, whose target launch date has been further delayed to January 2010 (as announced by BT Wholesale on 8 August 2008). Given the historic delays and changes associated with this programme, and key dependencies that need to be in place before product launch, this represents an additional factor that challenges the high MPF volumes in Openreach’s projections.
- 5.9 We also note the considerable difficulties that BT is currently having in trying to achieve its WLR 3 IBMC (“Installed Base Migration Complete”) milestones that form part of the Undertakings. The mass adoption by BT Retail of MPF-based bundled voice and telephony through the use of WBCC from BT Wholesale is likely to present similar operational and systems challenges. We see this as another reason to view Openreach’s projected MPF adoption rates as overly aggressive.

6. Margin between WLR/SMPF and MPF

- 6.1 Sky’s broadband services are, at present, mainly based on SMPF; a small number of MPF lines are used by Easynet for the supply of broadband to business customers, and for Easynet Connect and by UKOnline. Sky Talk residential telephony services are provided either as a calls-only (CPS) service, or as calls with line rental (WLR).
- 6.2 **[REDACTED]** Notwithstanding the operational difficulties outlined in section 6 above, it is apparent that the viability of such a migration programme is heavily dependent on the differential between WLR/SMPF and MPF charges. **[REDACTED]**
- 6.3 Openreach’s cost projections show increasing unit costs for both WLR (5% CAGR) and MPF (4% CAGR) during a period where MPF volumes increase eight-fold, but WLR volumes fall markedly. This is not the pattern that Sky would expect to observe: rather, were Openreach’s MPF forecasts to materialise, it is more likely that the unit costs for MPF would increase at a much slower rate than for WLR during this period. **[REDACTED]**

6.4 We anticipate that the combination of product volume projections and the implied under-recovery of MPF today contribute to the reduction in the implied margin between MPF and WLR/SMPF in Openreach's figures.¹ Whilst we are able to challenge Openreach's migration projections on an informed basis, it is difficult for us to address the authenticity of Openreach's current cost base, given the lack of publicly available information.

6.5 Nonetheless, we anticipate that the projected MPF cost growth is over-estimated and, as set out below, higher levels of cost efficiency could help alleviate any upward cost pressure across Openreach's whole copper access portfolio. Furthermore, given the greater efficiency opportunities through system consolidation and product industrialisation available to MPF, we would expect that the margin between WLR/SMPF and MPF could be broadly maintained.

7. Accuracy and reliability of cost forecasts and scope for efficiencies

7.1 It is important to bear in mind the incentives on Openreach under this review process. Given that charges are based upon current and forecast costs, Openreach has an incentive to cut costs within any charge control period, but not in the long term. This therefore risks the creation of an incentive to overstate costs, and understate efficiency levels. Absent any regulatory mechanism to account for historic over-recovery (which it seems has occurred since 2006), these incentives are likely to persist. Couple these incentives with significant information asymmetry between Openreach and Ofcom and the potential for continued over-recovery risks being unchecked.

7.2 It's very difficult for a third party to examine in detail Openreach's efficiency levels because much of the information is confidential. However, the numbers that Openreach have presented appear unrealistic and, in some cases, without foundation.

7.3 These two key factors therefore limit the extent to which a third party (such as Sky) responding to the present consultation document is able to constructively challenge the evidence and assertions made by Openreach to Ofcom. This underlines the importance that careful scrutiny by Ofcom to the requisite standard of proof plays in this review.

7.4 The case for increasing the charge ceilings rests on BT's argument that its costs are forecast to rise such that the current charge ceilings cause the products to be uneconomic. We accept that costs in some parts of the business will rise and are beyond BT's control. However, it is necessary to examine the rate of these rises assumed, and these rises need not reduce overall returns if off-setting efficiencies can be realised.

7.5 Clearly we are not in a position to form a view of the detailed operational efficiencies that BT has available. However, we note with interest the £300m of efficiencies estimated by KPMG to be available (paragraph A8.24). There is also helpful corroborating evidence contained in BT Group's financial results for FY2007/08 which actually suggests that the historic expectations of Openreach's scope for efficiency were set too low. In the last financial year, BT Group has claimed that £625m efficiency savings were made, equating to 4.3% efficiency gains. For 2008/09, BT is targeting a further £700m gains (or 4.6%). Obviously, if Openreach has historically only been experiencing 1.5% efficiency gains, and is now only targeting further 1%

¹ WLR has historically provided a higher contribution to Openreach's fixed and common costs than MPF, as stated in paragraph 4.4 of the consultation document.

gains over the next 5 years, then its current and future performance appears to be out of step with the rest of BT's business units (including those that operate in competitive markets).

7.6 Using information provided in the consultation document, we are able to assess the underlying changes in unit cost assumptions forecast by BT (tables A7.5–A7.8) and to form a view of whether those forecasts, upon which much of the case for increasing prices rests, are reasonable. Moreover, for some costs we are able to compare the forecasts with similar costs from Sky's own detailed business planning and forecasts. These comparisons highlight many areas where the underlying assumptions used by BT appear to be surprisingly high – and we would therefore encourage Ofcom to examine them closely.

Overall unit costs increase significantly across all products.

7.7 We have summed together the costs for MPF, WLR and SMPF to remove the effect of shifting allocations of common costs between the costs of individual products. Using the combined volumes forecast for MPF and WLR (SMPF volumes are captured within WLR) we can show the overall changes in costs per unit. This provides insight into the level of efficiency that BT has built in to its forecasts.

Figure 1: Significant Growth of BT Unit Costs

BT Line Item	2007/08- 2011/12	CAGR
Pay	24%	6%
Line cards & TAMS	(8%)	(2%)
Accommodation	15%	4%
Stores, contractors and misc	(7%)	(2%)
Corporate overheads	33%	7%
IT	35%	8%
Fleet	18%	4%
Other	(21%)	(6%)
Total Operating Costs	12%	3%
Depreciation	61%	13%

(Source: Ofcom Condoc, tables A7.5–A7.8 and Sky calculations)

7.8 The table shows that there are significant above inflation rises for most cost categories across the forecast period. The increases for *pay*, *IT* and *corporate overheads* are particularly high.

7.9 Further, we have compared the cost forecasts used to justify an increase in the charge ceiling with Sky's own business forecasts of unit cost changes over the same period. [REDACTED]:

- [REDACTED];
- [REDACTED];
- [REDACTED]; and ²
- wage inflation is (clearly) not currently running at 6% in the UK.

7.10 For these reasons we would caution against placing undue weight on these cost forecasts. The nature of cost efficiencies is that it's not always clear in advance where

² [REDACTED]

they will come from. Over time companies learn more efficient ways of doing things, often helped by use of new technology. Just because it is not possible to identify, five years in advance, exactly where such efficiencies will come from, does not mean that some proxy for these efficiencies should not be included.

Sky comparison on efficiency gains

7.11 As a comparison, Sky has sought to realise significant efficiency gains in its supply chain/field activities over the last few years. [REDACTED]

7.12 [REDACTED]

Year-on-year changes look peculiar for many unit costs.

7.13 Using the limited information available we can see that unit costs for some line items follow what appear to be unusual patterns year-on-year. We would expect most costs, particularly *pay* (which makes up around 30% of the total unit cost each year), to follow a clear and reasonable pattern.

Figure 2: Peculiar Year-on-Year Changes to BT Unit Costs

	2006/07 - 2007/08	2007/08 - 2008/09	2008/09 - 2009/10	2009/10 - 2010/11	2010/11 - 2011/12
Pay	7%	4%	6%	8%	4%
Line Cards and TAMs	(3%)	6%	(3%)	2%	(13%)
Accommodation	7%	2%	4%	4%	4%
Stores, contractors & misc	30%	(11%)	4%	1%	(1%)
Corporate Overheads	(5%)	9%	6%	9%	6%
IT	21%	11%	6%	8%	5%
Fleet	(6%)	6%	2%	5%	4%
Other	(21%)	(15%)	(6%)	2%	(3%)
Depreciation	(8%)	17%	17%	11%	7%

(Source: Ofcom Condoc, tables A7.5-A7.8 and Sky calculations)

7.14 The table shows declines in *Corporate Overheads* across 2006/07-2007/08, followed by rises in every other year. Increases in unit *Pay* costs fluctuate significantly each year, with the increase in 2010/11-2011/12 being twice that of the previous year. Unit costs for *Line Cards and TAMs* follow a particularly peculiar pattern, decreasing across 2006/07-2007/08 before increasing, then decreasing, then increasing and decreasing again.

7.15 Although we accept that peculiar patterns often emerge when detailed costings are assessed at this aggregated level, we nevertheless note that these patterns indicate that BT's cost assumptions warrant significant attention by Ofcom at a detailed level.

Over-capitalising depresses return on capital employed.

7.16 We note that in businesses with regulated caps on return on capital there is an incentive to over-capitalise to depress ROCE measures of profitability. While we are not in a position to assess, given the information we have, whether BT is deliberately

over-capitalising in regulated products, we take this opportunity to remind Ofcom that such incentives exist.

8. Cost allocation

8.1 Given the proportion of costs in telecoms businesses, the allocation of common costs between products has a very significant impact on fully allocated costs. The range of legitimate approaches to cost allocation is also quite large.

8.2 We don't have visibility of how Openreach has allocated common costs either its regulatory accounts, or in the forward projections contained in Ofcom's consultation. We respect that: just because Openreach has SMP, it shouldn't mean that it is forced to provide absolute transparency of its cost base to its customers and competitors. Nonetheless, it means we are not able to provide firm data to support our comments on cost allocation.

8.3 However, we would point out that BT has very strong incentives to allocate costs in a particular manner. As we observe Openreach's reported costs over time, we strongly suspect that it is indeed acting on some of these incentives. We set them out here so that Ofcom – who does have full visibility of BT's costs – might seek to test the extent to which BT is acting on these incentives.

BT has an incentive to load costs into Openreach.

8.4 Openreach is the monopoly part of BT. If it is able to raise prices here, through persuading the regulator that its costs are high, this goes straight onto its bottom line. It also makes BT better able to compete elsewhere. We note that Openreach does in fact bear a sizeable recharge of the total BT Group costs. Therefore we would encourage Ofcom to look very carefully at the principles behind the recharge of BT Group cost items onto Openreach.

Openreach has an incentive to load costs onto upstream products.

8.5 Openreach makes more revenue and more profit from downstream products such as WLR, compared to upstream products such as MPF. Therefore it has an incentive to make downstream products cheaper, and upstream products more expensive, and because its prices are cost-reflective, it can achieve that through cost allocation.

8.6 Below, we show the annual % change in unit costs for MPF and residential WLR, as presented in Annex 7 of Ofcom's consultation document.

Figure 3: Year-on-Year Changes to BT Unit Costs for MPF and Residential WLR

MPF	2007/08	2008/09	2009/10	2010/11	2011/12
Pay	(1%)	(1%)	13%	8%	3%
Line Cards and TAMs			42%	34%	13%
Accommodation	9%	1%	5%	4%	6%
Stores, Contractors	9%	1%	9%	(1%)	(1%)
Corporate Overheads	(10%)	(12%)	14%	8%	5%
IT	(5%)	(13%)	15%	8%	4%
Fleet	(19%)	10%	21%	5%	0%
Other	9%	(17%)	(16%)	20%	9%
Operating Cost	(0%)	(1%)	11%	7%	4%
EBITDA	(2%)	3%	(17%)	(14%)	(9%)
Depreciation	(11%)	10%	14%	10%	6%

Residential WLR	2007/08	2008/09	2009/10	2010/11	2011/12
Pay	6%	6%	3%	8%	7%
Line Cards and TAMs	(1%)	9%	18%	11%	(1%)
Accommodation	3%	2%	5%	4%	5%
Stores, Contractors	34%	(11%)	3%	3%	1%
Corporate Overheads	(6%)	12%	3%	10%	9%
IT	24%	17%	5%	9%	7%
Fleet	(5%)	7%	2%	6%	7%
Other	(24%)	(13%)	10%	6%	9%
Operating Cost	3%	4%	7%	8%	4%
EBITDA	(4%)	(5%)	(10%)	(13%)	(9%)
Depreciation	(9%)	17%	17%	11%	8%

(Source: Ofcom Condoc, tables A7.5-A7.8 and Sky calculations)

8.7 These figures suggest that Openreach is, in fact, acting (through its forecasts) on this incentive to load cost into upstream products. Two illustrative examples are:

- Per unit pay costs for MPF are forecast to increase 13% in 2009/10 and 8% the following year. Per unit pay costs for WLR are forecast only to increase 3% and 8% in the same periods
- Corporate overheads and IT costs per unit both declined quite steeply for MPF in 2007/08 and 2008/09. Yet they are forecast to grow by 14% and 15% respectively in 2009/10. For WLR, they are forecast each to grow by 3% and 5% respectively in 2009/10

Openreach has an incentive to allocate costs towards regulated SMP products, and away from non-SMP products.

8.8 This incentive comes from a very similar reason to the one described above. Of course, if SMP services use the same infrastructure, they should bear their share of common costs. They should also bear their share of BT Group costs, and of Openreach's corporate costs. Therefore, we would encourage Ofcom to analyse this area too, and in particular whether Openreach acts on the incentive to minimise cost allocation to non-SMP services.

Openreach has an incentive to vary cost allocation during the life cycle of a product.

- 8.9 Different product elements get bought at different times. For example, during the take-up of a product like MPF, Openreach's customers buy connection products; when volumes are steadier, most of the revenue comes from on-going rental. By allocating costs disproportionately to connection products during the initial growth phase, and then later to rental products, Openreach would be able systematically to over-recover against its regulated rate of return. Again, we would encourage Ofcom to analyse whether Openreach has in fact acted on this incentive.

Openreach would have an incentive to prolong technologies beyond their commercial lives if it is able to allocate costs against declining volumes.

- 8.10 At some stage, the volume of copper lines will start to decline, as fibre and mobile substitute for copper lines. It is important at that point that the cost allocation regime gives Openreach the appropriate incentives for investment. If Openreach is permitted simply to share the same fixed costs amongst an ever smaller number of copper lines, then it has no incentive to upgrade to the next technology. Yet competitive businesses face this imperative all the time.
- 8.11 Businesses switching or upgrading technologies generally bear the cost of that as part of their investment strategy. Regulation should ensure that Openreach faces similar imperatives, if regulation is to mimic the workings of a competitive market and deliver the right incentives for future investment.

The line length adjustment needs updating

- 8.12 When the charge control was set, broadband was only available on a proportion of lines; some lines were simply too long to receive it. Ofcom reflected this fact by calculating the cost of MPF based on a shorter average loop length than the average of all Openreach's lines. This remains the case: some very long lines cannot get broadband, or have a broadband service so slow (e.g. below 512 kbps) that no modern definition of broadband would include it. It remains appropriate to reflect this fact in setting the charge control.
- 8.13 But there is a more important consideration. The average length of lines where MPF is purchased is considerably shorter than the average of all BT's lines. That is because MPF to date has been bought by ISPs who unbundle only larger exchanges in urban and suburban areas. Because of this geographic skew, the average line lengths of MPF lines are substantially shorter than the average of all BT's lines, which includes the much longer lines in rural exchanges. In our view, it would be appropriate also to reflect this fact in some measure in the calculation of the charge control.

9. Appropriate nature of the charge control

- 9.1 In Section 8 of the consultation document, Ofcom considers some possible structures for a new financial framework for Openreach. Out of the possibilities, we consider that RPI-X is the appropriate charge control structure to use going forward.
- 9.2 RPI-X will align MPF, SMPF and WLR charge controls with those adopted for others such as the Network Charge Control (NCC). Given that one of the reasons for reviewing charges now is that they have been fixed whilst there may have been some cost inflation, it is prudent to use a charge control mechanism that can couple prices in line

with some measure of inflation. This should reduce the need for frequent, subsequent reviews and, thus, provide certainty both for Openreach and its customers. RPI is a more reliable, predictable measure than alternative indices such as CPI or factory price indices. Again, this would be consistent with other charge controls.

- 9.3 Predictable pricing of Openreach copper access products is essential for a large scale communications provider, such as Sky, to plan effectively. Important investment decisions are dependent upon the absolute and relative pricing of WLR, MPF and SMPF. A 4-year control would provide adequate certainty: any longer risks the supporting assumptions and forecast data becoming overly inaccurate; any shorter would provide insufficient certainty for communications providers, limiting their ability to plan and invest.
- 9.4 However, we recognise that there is a degree of uncertainty in cost and volume projections to 2012 and it may, therefore, be appropriate to allow for a mid-term review after 2 years should actual costs and returns deviate materially from the projections ultimately used to set the control.
- 9.5 To be clear, we consider that for those services where costs are significant or have different cost profiles should be subject to individual controls. At the very least, these should include;
- MPF Rental
 - MPF New Provide
 - MPF Transfer (including migration and cessation charges)

 - SMPF Rental
 - SMPF Connection

 - WLR Analogue Residential Rental
 - WLR Existing Line Transfer Residential
 - WLR New Line Residential

 - WLR Analogue Business Rental
 - WLR Existing Line Transfer Business
 - WLR New Line Business
 - Tie-cable Connection
 - Tie Cable Rental
 - MPF Room Build
 - MPF Hostel Rental
- 9.6 Furthermore, as a general rule, we expect connection or transfer charges to be in separate baskets or controls compared to rental charges. This would reduce the potential for individual communications providers to be materially advantaged or disadvantaged based on their acquisition and churn profiles.
- 9.7 A basket is an effective way to control returns on individual charges that are relatively inconsequential but are still material to a certain sub-set of communications providers or, more importantly, are material when collected together with other similar charge items. Services included within any given basket should all exhibit similar cost profiles over time. It is particularly important that a basket approach doesn't allow Openreach to systematically over-recover by shifting costs around different cost elements (e.g.

between connection and rental) during the life cycle of a product such that it is able to make higher returns at the expense of its customers.

- 9.8 We agree that it is appropriate to include reasonable costs of not meeting Service Level Agreements (SLAs) in the charge controls. What is considered a “reasonable” level of failure will therefore be key. Clearly, as evidenced by data presented by the OTA, performance is some way off what would be expected from an efficient operator in a competitive market. Setting an allowable level of failure at the target levels set by the OTA is a practical approach to addressing this issue but an obvious problem is that there is no incentive on Openreach to exceed the targets set. Also, to what extent are OTA targets aimed at mimicking performance of an efficient operator? Admittedly, given the large gap in current performance relative to targets neither is likely to be an issue in the short term.
- 9.9 Additionally, we believe that Ofcom should state, for the avoidance of doubt, that additional or consequential losses paid out by Openreach under any relevant contract (over and above any SLG payments) are not recoverable cost items.
- 9.10 These are all therefore issues that will require proper consideration.

Sky

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