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Dear Markham

A New Pricing Framework for Openreach

I am writing to provide SSE's comments on the above consultation. SSE provides retail telephony services based on wholesale products including wholesale line rental (WLR), which is available from Openreach on a regulated basis. We consider ourselves to be a "supplier" of services to end customers and we use this term in a general sense in this response to refer to those communications providers (CPs) having a direct relationship with end customers.

SSE is also an owner of regulated infrastructure assets in the electricity and gas markets and has experience of the price control framework governing the network prices charged to suppliers in these markets. We recognise the importance of providing Openreach with regulatory certainty and the ability to earn a reasonable rate of return on efficient levels of investment. The original "RPI-X" price control frameworks have evolved in energy networks and it may be that approaches and techniques developed for these network businesses may be relevant in setting the pricing framework for Openreach. The sorts of techniques that we have in mind are: dealing with different types of future uncertainty; the development of incentives and the treatment of different types of revenue. We are also aware of debates in the energy industry and in relation to price-controlled airports about the potential for greater stakeholder involvement in developing plans for regulated capital expenditure - this concept may also have some relevance for price control in the communications markets.

We welcome Ofcom's review and believe that it is timely, some two and a half years after the creation of Openreach, for there to be a fundamental review of the costs, services, revenues and investment planned by Openreach with a view to establishing a stable regulatory pricing framework going forward. We recognise that previous controls were set prior to the functional separation of the Openreach entity. Now that Ofcom has access to financial information for Openreach as a ring-fenced entity, it should be possible to develop a pricing framework that takes into account all the appropriate Openreach costs and revenues derived from services using its regulated asset base. Lighter touch regulation is likely to be appropriate in areas where Openreach provides services in a market where there is competition in service provision, but care will still be needed to ensure that cross subsidy and/or distortion of competition in other markets is avoided.

We have provided our response to the specific consultation questions in an appendix to this letter but set out our main thoughts below. We have set these out under several headings for clarity.

<u>Scope of the Review</u>
Openreach was created as a result of the Undertakings, with an asset base corresponding to the "bottleneck" physical assets of BT's access and backhaul networks which Ofcom concluded should be the focus of ongoing regulatory control and be made available to all CPs on an equivalent basis. As such, we believe that Openreach is a regulated entity with significant similarities to other regulated networks and that all aspects of Openreach's costs and revenues should be considered as part of the current review. In particular, any income generated by Openreach based on their ownership of the regulated assets and for services where there is no effective competition should, in our view, be taken into account in assessing the overall return for use of the assets.

<u>Incentives</u>
We would also hope that the review of the framework will consider the overall incentive framework for Openreach. We agree with Ofcom's emphasis on the need to ensure that there are appropriate incentives for Openreach to invest and chief amongst these incentives is the use of an appropriate value for the cost of capital. However, a price control review provides an opportunity to consider the overall framework of incentives on the regulated entity and how these can best be aligned with the interests of its customers. In traditional network price controls, one aim of the framework is for the regulated entity to have the incentive to find and implement cost savings and efficiencies in operation. Along with an emphasis on preserving quality of service, the overall framework therefore seeks to achieve value for money for customers.

<u>Transparency</u>
Ofcom has already outlined the different services provided by Openreach in section 2. However, we feel it would be useful if this could be amplified during the review so that there is increased transparency of what services Openreach is providing and where its costs and revenue streams lie.

An important part of this review of the Openreach Pricing Framework is to achieve clarity on what services Openreach is providing and what is provided by other parts of BT such as BT Wholesale. For example, we understand that the underlying passive connectivity of the access network is the basic service that is being provided in the "metallic path facility" (MPF) product that underpins the retail services provided by CPs using local loop unbundling (LLU). However, the WLR product operates at a higher network level with input from BT Wholesale and could therefore be thought of as an MPF+ product, for which there is currently a differential wholesale price of about £19 per year, according to the information in table 1.1. The review process needs to be clear on what costs underpinning this differential are being considered and whether these lie in Openreach or elsewhere in BT. This example illustrates that costs from other parts of BT may need to be assessed in the review and another area where this is also likely to be the case is the allocation of BT's corporate costs to Openreach.

The development of transparency is important for Openreach's supplier customers to promote trust in the levels of charges they are required to pay, particularly for those services where no there is no alternative provider. One area where we are aware that charges seem to be high is that of engineering work for repair and new line provision, which seem to be structured on a "cost plus" basis with little incentive to provide value for money in these activities.

<u>Proposed Form of Price Control for Openreach</u>
We believe there is a case for considering an <u>overall revenue control</u> for Openreach in conjunction with requiring Openreach to establish a <u>transparent charging methodology</u> for the different services it offers. In our view, this would have several advantages over the current situation where price ceilings have been fixed for only some of the services provided by Openreach.

- It would provide the traditional "RPI-X" incentive for Openreach to look for efficiencies in its operation, as it would be able to keep the revenue benefit of these until the control was reset;

- It could provide a mechanism to protect Openreach from the risk of changes in the volume of core services, if the control was framed to include a volume driver related to changes in the mix of services required by CPs;

- It would remove suspicions of cross-subsidy or double-counting of costs between products where a cost-stack is maintained to support a particular price level and other services where prices are charged on a cost-plus basis as all charges for SMP services would be covered by the charge structure methodology and overall revenue control;

- It would ensure that, within the constraints of the overall revenue control, the relativity between prices for different products reflected underlying cost drivers (see discussion below on considerations for an overall charge structure);

- It would thereby reduce potential distortion of competition in markets downstream of the Openreach assets;

- The framework could allow for additional incentive schemes to allow additional revenues to Openreach to the extent that specific outcomes – desirable from the perspective of suppliers and/or end customers – are achieved;

- It would provide a framework for explicit consideration of Openreach's investment requirements over the price control period – a topic not covered in any detail in this consultation but one that is important for suppliers purchasing Openreach products;

- For services which Openreach is providing in a competitive market, these could be transparently isolated from the bulk of services covered by the price control.

<u>Charge Structure Considerations</u>
As noted above, we suggest that one element of the pricing framework for Openreach going forward should be a transparent model for setting charges that has the confidence of the CP community. We do not suggest that this has to be complex – indeed simplicity would be desirable – and would hope that a basic model could be achieved without too much additional effort beyond the cost assessment that would have to be carried out to set cost ceilings. The benefits of developing a charging model are that the relativity between the output prices for different products could be automatically adjusted to reflect any change in the underlying cost drivers. We see the key objectives in the development of such a model as being:

- To promote cost reflectivity in charges;
- To be simple, transparency and acceptable to Openreach customers;
- To promote competition in services using the Openreach networks;
- To be non-discriminatory between CPs in how charges are set and applied;
- To aim for stability in output pricing.

It would also be necessary to ensure that changes in pricing have a reasonable notice period to allow CPs to react to and plan for any changes. Once all these elements are in place, the pricing model framework would determine the path of charges without further regulatory intervention until the time of the next review, although Ofcom may wish to maintain an overview of how the model is amended and developed in the early stages until confidence develops in the industry with regard to its use.

<u>Future Developments</u>
We look forward to the development of a greater industry understanding of the scope of services provided by Openreach and the source and application of the funding provided to Openreach as a result of the current review. In the hierarchy of communications services provided to end customers, our understanding is that the passive “layer 1” network connectivity services provided by Openreach over its access and backhaul networks are the fundamental building blocks underpinning all other services delivered over the Openreach networks by a range of wholesale providers including BT itself. This reflects Ofcom’s conclusions, in the strategic review, that these enduring “bottleneck” assets should be the focus for continuing regulation, while competition is encouraged in markets downstream of these assets. With developing competition in these downstream areas, formal regulation is likely to be able to be reduced.

We agree with Ofcom’s conclusions and emphasis on the need for regulatory focus on Openreach to underpin competitive developments elsewhere. This reflects the regulatory and price control focus on infrastructure assets in other industries. As in these other industries, we would expect the development of mechanisms for stakeholder involvement in charging, quality monitoring and investment choices based on a common understanding of the scope of the regulated assets and the services they are used to provide. This review is an important step in developing the necessary transparency for this level of stakeholder engagement to evolve.

Over time, we believe that it might be possible for Openreach services to become independent of the precise uses made by suppliers of the connectivity services they purchase. In this scenario, Openreach would manage basic connectivity and capacity of links, perhaps also managing parameters underlying quality of service such as contention ratios and prioritisation of traffic. We develop this idea in our response to question 2.1.

We hope these comments and views are helpful to Ofcom in the developing the price review process. We would be happy to discuss this response further if that would be useful.

Yours sincerely

Aileen Boyd
Regulation Manager

Appendix

Consultation Questions

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

Paragraph 2.14 of the consultation sets out Ofcom's proposed objectives for a new Pricing Framework for Openreach and these are reproduced below.

- 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;
- 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.

We largely agree with these and also the relevance of the listed objectives from the Telecoms Strategic Review - particularly in relation to incentivising investment. However, we would suggest two amendments to Ofcom's list and some further relevant considerations for the review.

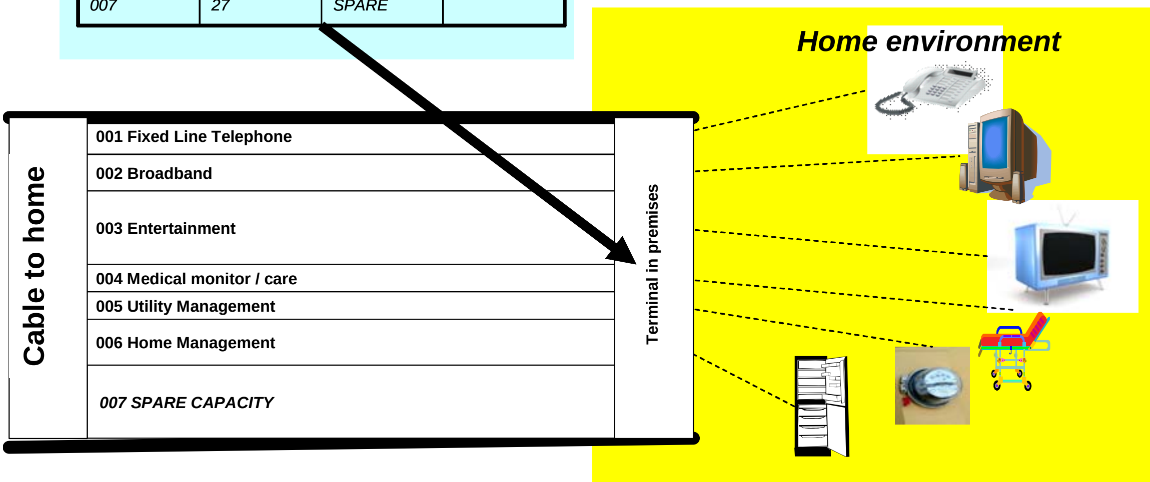
<u>Promotion of Competition in Provision of Higher Level Services using Openreach Connectivity Services</u>

In relation to the objective on promoting competition, we suggest that rather than focussing on specific currently available products such as "broadband and traditional voice services", this should be cast in a more general way such that competition is promoted in any services that use the Openreach regulated assets. This would be consistent with developing neutrality within Openreach as to the precise nature of the downstream services that suppliers wish to provide using the basic Openreach capacity and connectivity services. We believe this would be helpful as the market develops, for we foresee that greater competition might develop in the provision of higher network level wholesale services such as the additional features of WLR relative to the basic MPF connectivity service. All of the higher level communications services which might be developed would require to use the physical connectivity of the Openreach assets.

This links with the discussion in the covering letter on transparency of the services being offered by Openreach. It may also be useful to reproduce a diagram that we provided in our response to an earlier Ofcom consultation on next generation access, where we considered the sort of services that may in future seek to share the basic connection into end customers' houses. This is shown overleaf.

Central Organisation

Central Site Register (Record for this home)			
Identifier	**Technical Capacity 100**	**Provision**	**Provider**
OO1	1	Phone	Post Office
002	10	Broadband	Thus
003	50	TV	Virgin
004	10	Dialasis	NHS
005	1	Metering	Accuread
006	1	Home Mgt	Shield
007	*27*	*SPARE*	



Development of Cost Reflective Charging

The second amendment we would suggest is about charging and, rather than focussing on preventing negative outcomes such as excessive charging and abuse, we suggest that this could be couched more neutrally as "establishing a transparent and cost-reflective charging methodology which provides Openreach with an appropriate level of revenue". We discuss this further in our covering letter.

Other Considerations

We believe the following additional areas are also relevant goals for the pricing review.

- Achieving transparency of the total cost base and different (regulated, unregulated and semi-regulated) revenue streams of Openreach;
- Avoiding cross subsidy between different products and areas of revenue, which can lead to distortion of competition;
- Incentivising Openreach to achieve outcomes that align with the interests of its customers.

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?

The existing framework of fixed charges for certain "core" Openreach products has provided some certainty for suppliers and other CPs on the level of charges to be applied. However, this certainty reduces when the price caps are due for review and may be subject to step changes. Similarly, the form of a fixed cap provides Openreach with uncertainties in revenue due to volume risk. We also believe that, as noted by BT, the current relativities in the price caps may not be cost-reflective and this has implications for competition in downstream markets where the Openreach prices are inputs to other services to customers.

We believe that the transparency and cost-reflectivity of the current pricing framework could be improved. A greater emphasis on charging methodology and incentives might help to dispel perceptions that cross-subsidies may exist, particularly where charges are made for engineering-related work such as new service provisions and repairs. More generally, the development of a new financial framework provides the opportunity to consider explicitly the total incentive framework on Openreach and to seek to align this with the interests of customers and suppliers.

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 development of WLR2 and LLU have both allowed retail competition for provision of service to end customers to develop such that suppliers can provide "one bill" to customers and decide their own price structure and marketing strategy. Our perception is that the growth in choice of supplier has benefited end customers and brought some innovation to the market.

The establishment of the Office of the Telecommunications Ombudsman (OTA) appears to have helped the broadband market to develop by bringing the relevant industry players together to tackle operational issues in providing service to end customers. More recently, the remit of the OTA has been extended to cover WLR issues and together with the strengthening of governance of the industry "Commercial Group", we believe this has had a beneficial effect in bringing industry concerns and issues to the attention of senior management within Openreach.

However, there have been concerns about end-customers experiencing difficulty in changing their broadband supplier and this has led to Ofcom developing General Condition 22 on broadband migrations. In our view, the required customer transfer processes should have been addressed at the outset of the LLU technological developments – and indeed in any similar product development - to ensure that a smooth process from the perspective of the end customer is designed in at the start. Openreach may have a role to play here but of greater importance, in our view, is the need to develop independent governance (accountable to the industry as a whole and potentially also to Ofcom) of a set of rules which determine how transfers between suppliers, and between infrastructures, will take place. Thus we have supported Ofcom's project to achieve a "single migration process" for mass-market products and believe this is key to establishing a level playing field for CPs offering or supporting such services. The development and growth of new services is good for end customers but needs to be coordinated between relevant CPs or the customers will have bad experiences resulting in complaints and an adverse effect on customer confidence in the market, which in turn will undermine the business case for CPs bringing new and innovative services to the market.

Another such technological development which is under discussion and proceeding to the pilot trial stage is that of "next generation access" or greater use of optical fibre in providing communications services to the home. This is a key development in the provision of extensions to the Openreach network and may involve other infrastructures, which themselves may need to link in to the existing Openreach network at some point. In parallel with this, other parts of BT are taking forward the "next generation network" (NGN) deployment of an internet-protocol based core network. The NICC, up to now a regulatory committee reporting to Ofcom on interconnection and inter-operability issues for NGN networks amongst other things, is now establishing itself as a limited company owned and run by its members. We hope that NICC Standards Ltd can carry forward the governance arrangements we have mentioned above for these two linked technological developments such that the experience of customers is protected and enhanced as new products are developed using these new next generation technologies.

It is also important for suppliers that they have a voice in how end products and access products are developed using new technologies and processes. To illustrate the problems that can occur, we note our own experience of using regulated wholesale products.

> Suppliers were able to enter the market to provide calls only to retail customers using the carrier pre-selection (CPS) wholesale product. CPS is set up only to allow customers of BT Retail to be provided with calls by the new supplier – the line must stay with BT Retail. Thus, when the WLR product was developed, which allowed suppliers to provide a single bill to end customers for telephony (line rental + calls) services, CPS could not be

provided on a customer's line which had already moved to take the WLR product unless that customer went back to BT Retail first. In this way, the development of the succeeding wholesale product (WLR) undermined the effectiveness of the previous wholesale product (CPS) as the size of the market for CPS was reduced by the introduction of WLR.

In summary, since 2005, there have been some beneficial developments for customers and suppliers, but there have also been problems. We believe that the potential problems actually affecting end customers are likely to get worse as technology develops. We have therefore been arguing the need for coordination between different parties in the communications market and see some signs that this is beginning to happen. This review of the revenue and pricing framework for Openreach may provide an opportunity to consider the role of Openreach in facilitating these kinds of market developments going forward.

Question 3.2: Within the context of the overall package of changes instituted by the TSR, to what extent has the current pricing structure for LLU and WLR contributed to market developments and how sensitive do you believe future developments will be to changes in the pricing of those wholesale access services?
The current price levels show a significant advantage for the LLU-oriented products, which we imagine has assisted the development of the LLU-based market and the levels of investment in it. We have some concerns, however, that the price levels are somewhat artificial. We have no comment on exactly what will happen if the prices are changed but it would, in our view, be more sustainable for Openreach to have an agreed charging methodology, which would allow the price for these regulated products to develop naturally, following the underlying economics. Provided that prices are allowed to change in a smooth fashion, with plenty of notice, this is likely to be a better environment for suppliers and their customers than one where prices are kept fixed for a period with an unknown adjustment every few years.

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?
We would rely on Ofcom's expertise to interpret the various sources and analysis of Openreach's costs, revenues and rates of return. As discussed in our covering letter, a greater degree of transparency in the costs, services and revenue provided by Openreach would be a useful outcome of the current review.

We consider that it is reasonable to review infrastructure charge controls every few years to ensure they are in step with industry developments. It appears appropriate to review the entire financial framework affecting Openreach at this time, given that it is now two years or so since Openreach was separated out from the rest of BT; the pace of technological and market developments discussed above; and Openreach's own wish for such a review.

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?

We believe that care needs to be taken in considering international benchmarks, since competitive, technological and population characteristics would have to be very similar in order to develop fair comparisons.

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.
We have no specific evidence to put forward on this point. We support Ofcom's approach of looking at a number of methods of assessing the potential for Openreach's efficiency gains going forward.

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.
As noted in our covering letter, we consider that it is important for this review, the first for Openreach as a separate stand-alone entity within BT, to provide transparency on the costs, revenues, services and investment plans of the overall entity Openreach. It should be possible to create an Enterprise Architecture model (a standard IT approach), which would demonstrate what services Openreach is responsible for and the sources of cost, revenue and the operating assets involved in providing those services. We note that Ofcom has already established, at an earlier review, a regulatory asset value (RAV) for the copper-based local access network owned by Openreach and we would expect the overall picture of the Openreach asset base to build on this. We also note that, according to the information provided in Annex 7, a relatively high proportion of Openreach's revenue is derived from non-core services.

In our view, all of the services provided by Openreach should be covered by the review to further the aim of transparency. Where services are provided in an effectively competitive market, competition will set the level of charges and there is unlikely to be any need for explicit price control. However, where the Openreach asset base (by definition, "an economic bottleneck") is used to provide services, it is difficult to imagine situations where competition will be fully effective and we consider that all of these services – even those considered "non core" – should be included in an overall revenue control, with prices set according to a transparent charge structure methodology, which builds on the model of Openreach costs discussed above.

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?
Following on from the response to the question above, we believe that greater use of price controls – in fact, an overall revenue control – should be considered for all SMP services including the "non-core" ones. The revenue control, together with the transparent charging methodology we have advocated, should be able to deal with the matter of common costs.

Question 6.5: To what extent should we incorporate the revenues and contributions to costs from non-SMP services in the review?
Where Openreach provides "non-SMP" services, there should be clarity during the review about what these are, in the interests of transparency. We would support these being treated as unregulated, where they are provided in a competitive market and where appropriate transfer charges are made for the use of any of Openreach's regulated assets and resources. To ensure this is the case, these areas of transfer charges would need to be covered in the review.

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?
We would rely on Ofcom and any appropriate consultants to check the historic and future costs provided by Openreach for this review, as we lack a detailed understanding of the Openreach business model, which we hope will be clearer as a result of the review process. Notwithstanding this, in terms of the specific adjustments mentioned in Annex 7, we have the following comments:

- We agree that the light user scheme should not be part of Openreach's costs and would rely on Ofcom to ensure that any transfer of BT Retail's costs to Openreach is reviewed critically to ensure that it is unwound where appropriate – we have heard, for example, that BT Retail's costs of cancelling transfers using the "Cancel Other" mechanism is included in wholesale charges, which does not accord with the principle of equivalence;
- We comment on the service level guarantees (SLGs) that Ofcom has recently required Openreach to start paying proactively to its customers in our response to question 7.1;
- With respect to the line cards, which BT is replacing as part of the NGN programme, it is not clear whether the new cost is being driven by Openreach or a different part of BT; if the latter, we do not believe there should be a significant disruption to the Openreach cost model as a result, so we support Ofcom's consideration of an appropriate basis for allocation of these costs – one way could be to retain the current division of costs between the different Openreach services using this asset type;
- With respect to the other adjustments mentioned in Annex 7, we support Ofcom in seeking to ensure that previous policy decisions have been reflected as intended in BT and/or Openreach cost models – there is perhaps a role for these types of adjustment to be regularly checked by Ofcom as part of its compliance framework for BT's regulatory financial reporting, which was consulted upon recently.

Question 6.7: Please review the volume assumptions set out in Annex 9. What are your views on future MPF and WLR growth? What factors are likely to be most important in determining the future level balance of demand for wholesale access services?
We note the discussion in Annex 9 on both BT and Ofcom's views on the volumes of Openreach's core services that will be required in future. While outturn prices are likely to have some effect on overall volumes, we believe that other factors that could influence the trends include the possibility of market failures and consolidations.

One further comment we would make on the subject of future volumes is that the basic number of Openreach lines into properties is likely to remain fairly constant according to the Openreach projections in Annex 9. This factor, together with the concept discussed in our covering letter that MPF is the basic connectivity service with other services such as WLR representing a MPF+ product, might allow the construction of a revenue driver for the future price control that reflected the total number of "Openreach lines into properties". This could, if required, be further modulated by a weighted average of the relative volumes of basic and higher level connectivity services supplied.

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?
We believe the cost of capital is a key element of a regulated price setting process. This parameter needs to be set on a realistic basis, avoiding any sudden changes, such that Openreach has a clear incentive to continue to invest. The risk free rate is a key component of the overall cost of capital and we would suggest that Ofcom should not be unduly influenced by the current market uncertainties and should adopt values at the upper end of the range considered, in the interests of preserving a long term, stable view on this variable. In particular, we consider that Ofcom's assumption for the risk free rate looks unrealistic. Historically, utility regulators have tended to assume a risk free rate of 2.5% or greater in real terms.

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?
In our view, the key challenge of this review is to establish a new framework for assessing the overall allowable revenue for Openreach's regulated products taking into account likely investment requirements and for allowing pricing of products to evolve on a cost-reflective basis. The form of the revenue control will be important to ensure that the incentive framework that is developed through the control (e.g. to minimise operating costs but also to invest and innovate) is aligned with the interests of Openreach's customers. With respect to investment, we believe it will be important for the health of the markets using Openreach's services as inputs, that all Openreach customers can provide an input to Openreach's investment plans. The key elements for success, in our view, would be:

- An appropriate cost of capital which means that Openreach is incentivised to invest and look to develop new products that its customers want (dynamic efficiency);

- An "RPI-X" type of overall revenue allowance that provides an incentive for Openreach to cut costs and find efficiencies since it will retain these for a period until the next review (productive efficiency);

- The development of a comprehensive and transparent cost reflective charge structure methodology which allows Openreach to set the charges for its individual services within the price controlled area (allocative efficiency).

Question 6.10: How would price increases for MPF, SMP and WLR affect Communications Providers and the roll-out of LLU? How would this vary if the relative balance of WLR, MPF and SMPF prices were to change?
We have no specific comment on this other than to note that the relative balance of prices should be allowed to reflect underlying costs – not be preserved at an artificial level indefinitely.

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 would expect that changes in wholesale price levels will have a more muted effect on end customers as they are only part of the costs of serving customers.

Question 6.12: What are the implications of a new pricing framework for incentives to new infrastructure investment by BT and other Communication Providers?
The parameters of a new pricing framework will have implications for investment, which will vary depending on the details of how the framework is designed. We believe that there are 3 areas of importance:

- The cost of capital should be set high enough that Openreach is able to invest to build its RAV via projects that will benefit its customers;

- The prices set by Openreach should reflect underlying cost drivers in a stable manner, in order to avoid distorting investment decisions in markets where the Openreach products are an input to other services; and

- We believe that all Openreach customers should have the chance to influence and comment on Openreach proposed investment plans – as Openreach is a regulated entity, we would like to see the development of a mechanism, perhaps via an industry group or governance arrangement, which allows all interested users of Openreach products to provide their views on proposed investment plans rather than this being determined internally by BT only. This would be in tune with developing regulatory practice for greater stakeholder involvement in investment by regulated infrastructure providers.

Essentially, Openreach is the guardian of a regulated asset base providing services to a variety of CPs in the market, against a background of rapid technological change. According to the principle of equivalence, all these CPs are entitled to have a say in Openreach's investment plans, as their payments to Openreach are funding the investment. At the very least, the price control process should allow for interested CPs to comment on Openreach proposed investment projects over the period of the next price review. Over time, we would hope that a framework for greater stakeholder engagement could be developed.

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?
We agree that it is appropriate to include an allowance in Openreach costs for the service level guarantees (SLGs) that Ofcom has recently required Openreach to start paying proactively to its customers. We support Ofcom's approach of seeking to

identify an efficient level of such costs and note that the incentive properties of the SLG payments would be undermined if Openreach was allowed its present level of SLG costs as a “pass-through”. In general, we consider that a regulated entity should be seeking to meet the reasonable expectation of its customers in the areas covered by SLGs and that service failures should be at low levels and tending to be driven largely by events outside the regulated entity’s control. We therefore support Ofcom’s approach of allowing for small percentages of failure and suggest that these are reviewed at each successive price control review.

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?
As discussed in our covering letter and other areas of this response, we believe that an overall revenue control, which could be indexed by RPI-X, is an appropriate form of control on SMP services provided using regulated assets. This would be supplemented, in our proposal, by the development of a transparent charge structure model that allows individual prices to vary depending on underlying economics within the overall revenue constraints. We believe that charge structure models should be constrained to avoid abrupt changes to output prices and there may be a case, depending on the difference between the output charges from such a model and current charge levels, for phasing in significant changes to charges. The continuing effect of any distortions in downstream markets would also have to be considered, however.

Question 8.2: Should charge controls continue to be set separately 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?
Following on from our comments above, we consider that an aggregate revenue control should be set for all the individual services provided by Openreach using the regulated asset base and where it otherwise has SMP.

Question 8.3: Do you have any views on the appropriate structure of a control over all or any individual non-core service?
See response to the two questions above.

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?
A period of 4 to 5 years appears appropriate for the duration of a review and consistent with the periods used in other industries. The design of the revenue control itself can cater for anticipated variations such as changes in volumes and other uncertainties and allow for “re-openers” in extreme circumstances. For example, the water industry has developed a mechanism of “notified items”, where material changes in certain underlying costs can trigger a limited re-setting of the price control parameters.

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?
With respect to volume changes, we believe that a revenue control could be designed to cater for anticipated possible swings in overall volumes of services or between different sorts of access services. See also our response to question 6.7 above. In our view, the start date for a revenue control is most conveniently aligned with the start of a financial year.

Question 8.6: How should the Pricing Framework respond to new service offerings from Openreach? We would welcome examples of new services offerings which your would consider should be encouraged?
Although we have no particular suggestions for new service provision by Openreach, we understand the need to preserve an incentive, in the new price control framework, for Openreach to respond to customers' suggestions and to consider proactively where new services may be useful for their customers. We consider that the following elements may go some way to balancing incentives and safeguards in this area, although further thought would be needed to develop a clear framework.

- Revenue from a new service offering would be considered to be outside the revenue control – a position to be reviewed at the time of the next price control review with the default expectation that, where using regulated assets and resources, the revenue from the new services would be within the price control for future periods. Nonetheless, the period where revenue is excluded from the price control calculations would provide an incentive for Openreach to develop and market such services.

- To guard against abuse of the revenue exclusion noted above, we suggest that it would be appropriate for Openreach to be required to formally notify both Ofcom and an industry group such as the Commercial Group of the new services and their prices before they are introduced. The prices for the new services would be expected to follow from use of the charge structure model that we have proposed is part of the pricing framework going forward. This should be supplemented by evidence that "the industry" has requested or is supportive of Openreach developing the services in question. Again the Commercial Group could be used as the forum for recording this and we see links between this function and our longer-term proposal in response to question 6.12 to develop greater stakeholder involvement in Openreach's investment plans and priorities.

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)?
Provided that the sorts of safeguards advocated above are put in place, we would expect that Ofcom's involvement in assessing charges for the newly developed services would be minimal. However, it would be prudent to allow a mechanism for Ofcom to become involved in the case of challenge or disagreement with Openreach proposals arising from industry discussions at the Commercial Group or where, on their own initiative, they consider that issues of SMP or other distortions might arise.