THUS plc
1-2 Berkeley Square T 0141 567 1234
99 Berkeley Street
Glasgow G3 7HR www.thus.net

Markham Sivak
Floor 4, Competition Policy
Ofcom
Riverside House
2a Southwark Bridge Road
London
SE1 9HA

By email: markham.sivak@ofcom.org.uk

8 August 2008

Dear Markham

A New Pricing Framework for Openreach: Developing new charge controls for wholesale line rental, unbundled local loops and related services

THUS is pleased to respond to the above consultation dated 30 May 2008.

Overall, we welcome this consultation and believe it represents a constructive basis from which to develop an effective charge control regime for WLR and LLU. THUS makes extensive use of Openreach's WLR products in serving its business customers. THUS does not currently use LLU directly, but we make extensive use of wholesale products from BT (and other CPs) which have LLU as an upstream input. We respond to Ofcom's questions below from our perspective as a business-oriented telecoms provider.

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

Ofcom is proposing the following specific goals for the new pricing framework (paragraph 2.14), in addition to the more general objectives of the TSR:

- to promote efficient, sustainable competition in the delivery of both broadband and traditional voice services;
- to prevent excessive charging and the abuse of SMP by Openreach;
- to provide regulatory certainty for both Openreach and its customers;
- to 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 agree that all these goals are sensible. Given Openreach's current weakness in the areas of innovation and service quality, we would suggest that the goals should make more explicit reference to promoting improvement in these areas. Innovation and service quality are of particular interest to business customers, and the present charge control review is an opportunity to ensure that business users' interests are given appropriate weight alongside the interests of residential users.

THUS plc
Registered Office: 1/2 Berkeley Square
99 Berkeley Street Glasgow G3 7HR
Registered in Scotland No: SC192666

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 essentially comprises charge ceilings on LLU and analogue WLR and cost-orientation on business ISDN2. In general we believe the charge ceilings on LLU and analogue WLR have been a key driver behind the relatively strong take-up of both these products and have contributed to the emergence of sustainable competition. The evidence presented by Ofcom suggests that Openreach has been making a fair rate of return on these products overall, and that there have therefore been no problems with the sustainability from Openreach's perspective.

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?

We agree with Ofcom's summary of the key developments, notably the rapid growth in competition based on WLR and LLU, and the consequent improvements in choice and value for money for residential consumers. For various reasons (continuing service quality problems, lack of 5 hour fix, delays in developing fit for purpose ISDN variants of WLR) the benefits realised by business consumers have been rather less.

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 fact that MPF is cheaper than WLR has encouraged industry to develop LLU voice solutions, substituting their own switched network for that of BT Wholesale (although typically these have been most successful in the residential market). We would take the view that future pricing will inevitably have some impact upon this market, although very minor fluctuations in price are unlikely to change the overall business case for CPs who have so far only invested in one of the two products. We believe that as both LLU and WLR prices are intended to be cost-oriented, cost-orientation should be the overriding factor in defining the market, and the market will develop accordingly.

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 agree that there is a strong case for reviewing the price controls, given that Ofcom had previously indicated that a review would take place on the proposed timescales, and given the significant price movements that have occurred over the last few years in key inputs such as energy and copper. For the reasons given in Ofcom's document, we do not believe that BT's evidence provides a compelling case that charges will need to increase, but it supports the case for 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 the main value of international comparisons is to provide a sanity check of conclusions reached by other means. Although differences in local conditions, exchange rate fluctuations etc may make it harder to draw a direct comparison, the fact that Openreach's prices lie in the middle of the range (for example) suggests that there is likely to be some room for further efficiency improvements.

We note in passing that Ofcom has not included an international comparison for WLR and suggest that this should be included in the next iteration of the charge control review.

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.

Ofcom's preliminary conclusion is that efficiency gains in the range of 1% to 4% a year should be achievable for each year from 2008/09 onwards. Without the benefit of detailed analysis, our preliminary view is that this seems fairly conservative, and that efficiency gains towards the top end of the range (4%) should comfortably be achievable by Openreach.

We do not have any evidence specifically relating to these products, but we note that THUS has consistently made improvements in Selling, Distribution and Administrative (SDA) costs at well above these levels. Eg, in the last financial year, THUS's SDA costs were reduced by 9% in absolute terms and by 16% when expressed as a percentage of turnover.

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.

<u>Business ISDN2 services</u>

The most important decision for Ofcom is whether to include business ISDN2 services in the scope of future charge controls. These were omitted from the charge ceilings set in January 2006 because Ofcom concluded BT's charges were reasonable when compared to the cost stack for the product, and because Ofcom did not wish to increase regulation when it was unnecessary to do so[1]. Although this may have been an expedient decision at the time, it would be entirely anomalous to exclude business ISDN2 from the current charge control.

As noted in the consultation (paragraph A7.40) a line length adjustment was included in the LLU charge control which reduced the E-side and D-side costs for MPF and SMP to reflect the fact that the average length of a copper loop that can be used to provide a 2Mbit/s broadband service is shorter than the average copper loop. Exactly the same considerations apply to ISDN2, which has a line length limit of 5.5km[2]. Given the need to avoid competitive distortions between MPF and WLR, we would strongly encourage Ofcom to make a similar line length adjustment for ISDN2 if it continues to make the adjustment for LLU. (In the alternative, there is a good case to drop the line length adjustment altogether, since it is inequitable from a social policy perspective, effectively requiring people who live too far away from an exchange to receive broadband to subsidise those who live near enough.)

[1] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf, paragraph 1.13
[2] Eg see http://www.broadcastisdn.net/isdn_explained.php

Ancillary services

Ofcom should also consider the following three categories of ancillary services within the scope of the review:

(a) Wholesale Analogue Calling Features (Bypass Number, Call Barring (Incoming and Outgoing), Call Diversion, Call Sign, Call Waiting, Caller Display, Reminder Call, Ring Back, Three-Way Calling, 1471 Extra) (section 1.5.1 of Openreach price list[3])

(b) Wholesale Digital Access Calling Features (section 1.5.3 of Openreach price list[4])

(c) Wholesale Network Features such as call diversion, outgoing/incoming call barring, smart divert, 'choose to refuse', route to credit control, anonymous call reject (section 1.5.2 of Openreach price list[5])

None of the above can be replicated by CPs using their own systems, and all are therefore intrinsically linked to the WLR products with which they are associated. They should therefore be regarded as falling within the SMP markets defined by the wholesale narrowband market review and subject to the relevant ex-ante conditions. In particular, where call features or network services apply to analogue or ISDN2 variants of WLR (but not ISDN30) they should be subject to the cost-orientation condition, and potentially subject to charge control.

(In so far as there is any uncertainty in this regard, we request that Ofcom confirm its understanding of this position.)

Most of these services are priced at either £0.50 or £1.00 per month (ie 5 to 10% of the associated line rental per feature). These are suspiciously round numbers, which suggests that BT may not have set the prices by reference to its cost orientation obligation. If so, there is a risk that Ofcom will go to great lengths to eliminate excessive pricing in the basic line rental, only for BT to claw back excess profits by means of these ancillary services.

We would strongly encourage Ofcom to include these ancillary features and services within the scope of its charge control, and to ensure that BT's regulatory financial reports are structured in a way that will allow BT's ROCE for these features and services to be monitored.

We note that these services are likely to be dominated by sunk costs (in the sense that the incremental recurring cost of providing the service to an additional customer may be close to zero) and may also have significant costs in common (eg if they make use of the same platform). This suggests that there may be legitimate scope for Ramsay-style pricing, subject to the constraint that overall ROCE on the features and services should be equal to WACC. This points towards the features and services being included within a single basket for the purpose of charge controls.

[3] http://www.openreach.co.uk/orpg/pricing/wlr/downloads/ORPLWLR_Feat_Ana.htm
[4] http://www.openreach.co.uk/orpg/pricing/wlr/downloads/ORPLWLR_Feat_WDA.htm
[5] http://www.openreach.co.uk/orpg/pricing/wlr/downloads/ORPLWLR_Feat_Net.htm

Care levels

Openreach typically offers three different Care Level options[6] which promise different speeds of response in dealing with faults. (Not all of care levels are necessarily available with every product). These are closely related to the SLG regime, since the SLAs which trigger compensation payments are defined by the Care Level. Care Level 1 is included in the associated product rental charge, but additional charges are levied for Care Levels 2 and 3.

The Care Level is an intrinsic aspect of the underlying product being purchased – it is not possible for a CP to purchase a standard care WLR circuit and then provide Level 2 or 3 care himself independently of Openreach – so the Level 2 and 3 care levels must be regarded as falling within the SMP product market and subject to relevant ex ante conditions.

It is not clear to us how the additional payments received for Level 2 and 3 care are currently treated within BT's regulatory accounts. However, we believe there is a strong argument for including the costs and revenues associated with these services within the main product rental charge control. This would also be consistent with Ofcom's proposals to allow the efficient costs of operating the SLG regime to be included within the cost stack for the product rental.

As with the features and network services described above, there is a case for allowing a degree of flexibility in setting the differentials between the care levels. Including all the care levels within a single basket would provide the necessary flexibility, and would also give greater flexibility for Openreach to adjust (if appropriate) the SLAs associated with the different care levels, or introduce new care levels such as the long awaited 5-hour fix on MPF.

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?

See answer to Question 6.3 above.

Question 6.5: To what extent should we incorporate the revenues and contributions to costs from non-SMP services in the review?

It would be useful to give at least some consideration to the revenues and contributions to costs from non-SMP services, to the extent that such services share common costs with the SMP products being reviewed. One of the issues for Ofcom in coming up with a fair charge control will be determining a fair and efficient allocation of common costs between SMP and non-SMP products. Having data on the non-SMP products will help ensure that allocations are reasonable. It will also be helpful, should any dispute arise in future over cost-orientation of SMP products, to have some ex-ante definition of how common costs are allocated between SMP and non-SMP products; otherwise the cost-orientation condition risks becomes rather ineffective.

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 are broadly in agreement with the assumptions and adjustments proposed by Ofcom.

Ofcom makes no reference to assumptions or adjustments in respect of BT's cost of working

[6] referred to Maintenance Service levels in the WLR contract

capital. This has historically been an area of particular weakness for BT, both from the point of view of regulatory financial reporting and cost modelling. Ofcom should ensure that it is correctly accounted for in the charge control.

Paragraph A7.27 and A7.28 notes that "*there are several possible bases for the allocation of line card costs, including allocation by the number of lines, regardless of the services provided on that line, and by the number of services, based on the number of channels of the line card that are used. BT has proposed that line card costs should be recovered on the basis of the number of services provided. …The effect of [BT's] approach appears to be to increase line card costs reflected in the WLR charge. Consumers of WLR would therefore be required to pay more for a similar service due to a change in the means of delivering that service*". From subsequent discussion with Ofcom, it would appear that BT's proposed approach would more accurately be characterised as based on number of lines, rather than number of services provided. We consider a per-service approach would be more appropriate, implemented in such a way that consumers of WLR alone would pay a smaller contribution towards the cost of the line card than consumers of WLR plus broadband.

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?

The assumptions in Annex 9 suggest that overall volumes of WLR + MPF will remain steady between 2006/07 and 2011/12, with a shift in mix from WLR to MPF, and that SMPF volumes will decline by approximately 50% in the same period.

Although there are trends which could lead to a decline in WLR+MPF volumes (increasing reliance on mobile/wimax instead of fixed line, possible future growth in cable market share), there are other trends which could increase the volumes (growth in higher bandwidth data using multiple bonded copper pairs, increasing number of households) so Ofcom's assumption seems reasonable.

We are unable to comment on the assumption regarding SMPF volumes, because this essentially depends on the business plans of BT Wholesale and LLUOs.

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

Yes, we agree it is appropriate to update the assessment of Openreach's cost of capital.

The implications of (and for) new infrastructure investment are best taken into account by means of defining a separate cost of capital for such investment.

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?

From our perspective as a business oriented service provider, we see the main challenge relating to achieving dynamic efficiency, and providing sufficient incentive for Openreach to invest in innovation and service improvement.

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?

No comment.

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?

Given the competitive nature of the downstream markets, it is inevitable that price changes at the wholesale level will ultimately feed through to the retail prices paid by consumers.

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 mere existence of a new pricing framework will improve investment incentives for BT and CPs by removing regulatory uncertainty. Improved regulatory certainty regarding copper loops may also have a positive impact on investment decisions relating to NGA.

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?

Ofcom is proposing to allow BT to recover compensation payments to the extent that such costs would be incurred by an efficient operator. Ie, the allowed costs would be based not on BT's current service performance, but on the volume of SLA breaches and associated compensation payments which would be achieved by an efficient operator. We agree that this is a logical and reasonable approach.

In the case of WLR, we consider the following would be representative of the level likely to be incurred by an efficient operator.

	Percentage late	Average days late
WLR new provides	2%	1 day
WLR transfers	0%	n/a
WLR fault repair	5%	1 day
WLR fault rate (per annum)	10%	

Although these may appear relatively demanding targets by comparison with the OTA statistics cited by Ofcom, we would note that in our experience there is a wide gulf between the volume of SLA breaches implied by the OTA statistics and the volume of breaches in which Openreach accepts liability to pay SLGs. For example, OTA statistics typically include all failures to hit SLA, including those where Openreach deems the customer to be at fault and hence refuses to pay compensation, or where Openreach excludes liability for other reasons (such as engineer visit required). Hence, Openreach's current burden of compensation payments (even after the introduction of pro-active payments) will be far lower than might be implied by OTA statistics. We recommend that Ofcom obtains information from Openreach on the actual compensation payments made for WLR and LLU in the first few months of operation of the new proactive regime.

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?

A price control in the form RPI-X or CPI-X is not ideal, but it is difficult to think of a better alternative, and it at least has the merit of being well understood, predictable, and not obviously open to gaming.

As regards the choice between RPI and CPI, we would encourage Ofcom to analyse in more detail how well the components of the two price index baskets align with the BT cost stacks. In general, it would seem appropriate to use the index which has the best 'fit' with the cost stacks, particularly in respect of cost components such as energy and raw materials which are subject to most volatility.

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?

It is vitally important that Ofcom retain separate charge controls rather than aggregating these products within a single basket. As noted above, different CPs have different business models, and small differentials between these products can have a large impact on the relative success of these business models. Giving Openreach the freedom to play around with these differentials would be dangerous and potentially damaging to competition and investment. For the same reasons, business ISDN2 WLR should be in a different basket from analogue WLR.

Question 8.3: Do you have any views on the appropriate structure of a control over all or any individual non-core service?

As noted above, we believe that non-core services (which are subject to SMP) should be included within charge controls. In the case of WLR, we would suggest that non-core services relating to analogue WLR should be in a different basket from those relating to business ISDN2, to prevent Openreach making anti-competitive cross-subsidies. As a general principle, we would be reasonably relaxed about groups of features and services being included within a single basket, subject to Ofcom satisfying itself that BT's consumption of these features and services is not significantly skewed relative to the consumption of external CPs.

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?

Ofcom favours a four year control period with the potential for a review should volumes fall outside anticipated ranges. This seems reasonable to us.

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?

We do not have any strong views on this point, other than to note that re-opening the charge control mid-course is likely to be practically challenging, not least because of the length of time required to conduct a review. We would prefer the new charge control framework to commence as soon as possible.

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?

The most important new service offering for THUS is so-called xMPF, the EoI input to BT Wholesale's planned Wholesale Voice Connect (WVC) product. Given that the product has yet to be launched, we appreciate that it may be difficult to set a starting charge under the new pricing framework, and Ofcom will instead be minded to rely on the ex-ante cost-orientation and non-discrimination obligations imposed in the wholesale local access market review. This is all very well, but we note that competition in these and associated downstream markets will be highly sensitive to small price differentials, eg between xMPF and MPF or xMPF and WLR, and that cost-orientation may be too blunt an instrument to prevent competitive harm. The cost-orientation obligation is often characterised as requiring the product price to lie between the LRIC floor and Stand Alone Cost (SAC) ceiling, but subject to additional 'combinatorial' tests involving other cost-oriented products that share common costs. Given the large element of costs shared in common between xMPF, MPF and WLR, we believe that this interpretation of cost-orientation would give BT considerable flexibility to vary the relative price of these products, including in ways that are detrimental to competition. Clearly Ofcom has powers to exercise its own judgement as to what constitutes an appropriate allocation of common costs in response to a dispute or complaint, but it would be helpful if Ofcom could pre-empt such problems by indicating in advance what it considers would be reasonable. Eg, at present we see no reason why xMPF should be any more expensive than MPF, and there may be good reasons why it should be cheaper.

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)?

See answer to Question 8.6.

Yours sincerely

Richard Sweet
Director of Government Affairs