Business Connectivity Market Review
Leased Lines Charge Control
Review of BT's cost attribution methodologies

UKCTA Response to Ofcom

Submitted to Ofcom: December 2015

UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at www.ukcta.com.

Due the number of overlapping issues this UKCTA response combines submissions on the second consultations for the Lease Lines Charge Control (LLCC) and Ofcom's Review of BT's cost attribution methodologies. This submission does not necessarily represent the views of EE or Virgin Media, reflecting neither agreement nor disagreement with the views expressed.

Revised LLCC Proposals

Introduction

UKCTA members are concerned that Ofcom has decided to fundamentally revise its proposals for the leased line charge control from its stated position as set out in the June leased line consultation, which appear to significantly favour BT, the regulated firm. In particular, UKCTA members consider the scale of the adjustments Ofcom is now proposing to make in relation to the TI services are unjustified and are partly based on a mis-calculation of the volume reductions anticipated during the 2016 charge control period and the incentives for BT to aid and support migrations to other technologies, principally Ethernet.

BT clearly has strong incentives to attempt to reduce the liabilities as a result of the charge control proposals. Given the information imbalance that exists even between Ofcom and BT, Ofcom should be extremely cautious in accepting any of BT's submissions in terms of revisions to Ofcom's proposals, particularly in relation to the starting charge adjustments (SCAs) where BT has estimated that the SCA for Ethernet and Traditional Interface (TI) should be 1.8% and 0.7% respectively[1]. These are in marked contrast to Ofcom's estimates, even following the revision that has occurred since the June proposals (Ethernet 9% and 10%, TI 7.75% and 5%). Even allowing for the complexity of the modelling, such a significant reduction should start the alarm bells ringing as to the plausibility of BT's assessment.

Cost forecast modelling

UKCTA members are concerned with Ofcom's proposed cost forecast changes. BT raised concerns with Ofcom's June proposals, asserting that Ofcom had incorrectly used Gross Replacement Cost (GRC) weights to calculate Asset Volume Elasticities (AVEs) and applied these to Net Replacement Costs (NRCs) which overstates the extent

[1] Business connectivity Market Review: Update on the proposed leased lines charge controls paragraph 6.13

to which asset disposals or cost reallocations are possible; instead Ofcom should have used NRC weights. Ofcom states that BT was incorrect and in fact they utilised NRC weighted averages, along the lines BT was advocating. This indicates that Ofcom's initial assessment was reasonable and BT's arguments for change were ill-founded. Clearly, as BT misunderstood the modelling approach the whole question of reliability on the modelling is brought into question and the basis for any changes to the June proposals loses credibility and undermines confidence in the cost forecast model. Under such circumstances, UKCTA questions the reliability and suitability of the changes to the proposed cost forecasting approach Ofcom has adopted in reaching its revised proposals, particularly in regard to TI services where the changes have a significant impact on the proposed value of X for the TI basket. With such confusion, we would strongly question whether Ofcom can be certain of its approach and the outcome resulting from such an approach.

In particular we question Ofcom's modelling approach which is based on TI basket volumes declining sharply over the charge control period[2]. We would not disagree that volumes will decline but we do not consider the decline will be as sharp as envisaged, given that TI services where migration to a newer technology is straight forward or desired by end-users have already been completed; those customers that remain on the older technology either want to remain there or face technical problems moving away.
As raised in our response to the June consultation[3], Ofcom appears to assume that migration is happening smoothly and competitively when the situation faced by CPs is very different; there is a lack of a suitable process for migration, particularly where PPCs are used to deliver TDM voice, a situation which BT does nothing to alleviate.

If Ofcom wishes to promote migration away from TI services, as indicated in this consultation, then UKCTA members believe Ofcom should require BT to develop a migration specific process, with only necessary and efficiently incurred costs allowed.

Although the above focuses on TI services, UKCTA members face similar problems with Ethernet migrations from WES to EAD. BT Openreach enforced WES end of life but provide precious little assistance or incentives for such migrations. Rather than easing the migration path, Openreach's focus appears to be on manipulating the process to its own advantage with a lack of incentives offered to encourage migrations. Instead Openreach has reduced WES rental to fulfil its current charge control obligations whilst knowing that all WES circuits will need to be replaced within two years at a migration cost and enforced minimum term worth more than the current charge control reductions.

[2] Business connectivity Market Review: Update on the proposed leased lines charge controls paragraph 5.44
[3] UKCTA response to Ofcom's June Business Connectivity Market Review: Leased lines charge controls and Dark Fibre pricing, para 1.15

Ofcom's current approach to the LLCC appears to focus on protecting the BT position at the expense of BT's customers and end-users. UKCTA urges Ofcom to rethink its proposals in this area.

Glide-paths and starting charge adjustments

UKCTA notes Ofcom's proposals to amend its position in terms of balancing the use of SCAs and glide-paths in cases where charges are significantly above costs. Whilst we would agree that Ofcom should base such a decision on a broad range of relevant considerations when exercising its regulatory judgement, we are concerned that such a divergence from the initial approach has resulted from feedback from a single stakeholder. Given that that stakeholder is the regulated firm that is the subject of the charge controls, we would strongly question whether such revised proposals represent a fair balance across all stakeholders impacted by the decision being taken and as such fails Ofcom's statutory duty for regulation to be fair, proportionate and non-discriminatory.

It is noticeable that BT's proposed approach to balance the use of SCAs and glide paths results in estimated SCAs for Ethernet and TI of 1.8% and 0.7% respectively, significantly below Ofcom's original (9% and 7.75% respectively) and revised (10% and 5% respectively) SCAs. Such a deviation from Ofcom's assessment appears to indicate either a significant misunderstanding of the attribution process by Ofcom or, more likely given the scale of the over-recovery Ofcom has indicated, a skewed interpretation of the attribution process by BT.

It is due to the scale of over-recovery, which is clearly not driven by efficiencies, UKCTA considers that Ofcom should address the over-recovery as quickly as possible by introducing tougher SCAs. The forecast returns for the final year of the current control of around 20% for Ethernet and 30% for TI services, are significantly in excess of BT's cost of capital and should be addressed with tougher not weaker SCAs. This is particularly the case given that Ofcom states that these high rates of return do not appear to be primarily due to outperformance by BT against the efficiency and volume assumptions used in setting the 2013 LLCC, crucially noting that such outperformance appears to be a relatively small factor in explaining BT's high rates of return.

We now turn to Ofcom's comments on ensuring that the regulated firm has an opportunity to recover its efficiently incurred costs. UKCTA would not argue against such an aim but this requirement should not entail any cross subsidisation of markets. It is inappropriate that costs incurred in a non-business connectivity market should be recovered through the LLCC. It is therefore concerning that Ofcom makes reference to the point that the revised SCAs have been set to take account of some costs which are associated with other charge controlled markets because they have not necessarily been fully reflected in the regulated charges for those other markets so the application of SCAs in this case would mean that BT would not have the opportunity to fully recover its efficiently incurred costs associated with these charges[4]. UKCTA disagrees with this approach, which is discriminatory as not all Communication Providers operate in all markets nor at the same degree, so such an approach equates to cross-subsidisation and is anti-competitive. Only costs associated with the business connectivity market should be recovered through the associated charge control.

UKCTA has particular concerns in relation to TI services which, although in decline, are not yet at the 'end of life' stage. Given the situation, there may be fewer efficiency opportunities for TI so Ofcom should not allow any leeway for incentivising BT to introduce efficiencies in the provision of TI services (which may be nothing more than service degradation). Whilst UKCTA accepts that there may well be uncertainty in cost forecasts but for TI services we do not consider that Ofcom should apply a greater emphasis on the use of a glide path for TI just to provide BT with an additional opportunity to recover such costs. Such considerations may be justifiable for Ethernet but not for TI services where there are no investment decisions which could justify a greater emphasis on a glide path.

Given the above, UKCTA would urge Ofcom to ensure that the charge controls determined and use of glide paths and SCAs incentivises BT to support an appropriate, robust, migration process from TI services to alternative services, something that has not been forthcoming to date.

Ensuring a level playing field in Charge control Consultations

There are significant information asymmetries that exist between BT and other stakeholders which greatly impact the ability of those stakeholders to respond and participate on as equal a footing within the charge control consultation process. UKCTA is not at all surprised by Ofcom comments that 'BT was the only stakeholder to engage in detail on our proposed modelling approach'. With much of the model redacted and BT a detailed understanding of its own cost base, it is not a surprise that BT was able to engage in such a way.

UKCTA feel Ofcom could do more to encourage a much higher level of participation and critique from the very stakeholders who will face the pricing consequences of the model's output as much of this consultation is driven by a one sided critique by BT of Ofcom's proposals in areas where other stakeholders were not in the same position to contribute.

While UKCTA accepts that not all information can be shared, we believe more can be and there should be a way for stakeholder to understand confidential parts of Ofcom's modelling, even if it is through third party consultants who sign the appropriate confidentiality limitations.

[4] Business connectivity Market Review: Update on the proposed leased lines charge controls paragraph 6.54

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A new approach to charge control models, where more material is shared on a restricted basis would greatly assist all stakeholders in participating in the process and help counter BT's advantages in accessing all inputs to the model.

Regulatory Accounting

UKCTA has long been an advocate of robust regulatory accounting requirements upon BT. We welcome Ofcom's continued work in this area following on from the comprehensive consultation in the summer. We believe this work stream should be expanded by Ofcom to try and improve the regime for the benefit of all market participants.

We note that BT's questionable conduct continues, with £26M of EE acquisition costs wrongly put forward for allocation to regulated and unregulated services. We are pleased Ofcom has picked up on this, however the fact it requires Ofcom to reference public statutory accounts to do so is greatly concerning. We also note BT's practice of inflating costs in years that are used as the base year for charge controls (which Ofcom are proposing to remedy by taking an average and smoothing this spending). Such practices expose the degree of bias and gamming that remains possible within the regulatory accounting framework.

We urge Ofcom to follow up this work with further detail Cartesian reports looking into attribution, with all future charge controls having the benefit of this approach to ensure transparency for all. Improving the assurance wrap of the accounts should be a priority for Ofcom and we look forward to more work being done in this area. When the accounts are no longer regarded as being impartial, they cease to be the valuable reference tool used to underpin regulatory decisions or aid stakeholder transparency that they need to be. There is much work needed to ensure all areas of the accounts are fair and accurate through a repetition of this type of deep dive exercise. This should occur at least on an annual basis until such time as the change control process around attribution changes has been imbedded and confidence has been restored.

In respect of the proposals set out by Ofcom in this consultation and the last, the mistakes and attribution errors are material and have resulted in consumers being overcharged and regulated prices being set too high for many years. There is no case for them not being remedied immediately. We would repeat our call for greater transparency around just how long they have been included within the accounting numbers, as it is clear that most of these issues have been recurring over many years.

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