MPF rental charges in lacuna period

TalkTalk response to Mar 2017 consultation

May 2017

NON-CONFIDENTIAL VERSION

1 Summary

1.1 This document is TalkTalk's response to Ofcom consultation regarding pricing of MPF Rental during the lacuna period before the next charge control begins[1].

1.2 We agree with Ofcom's overall approach to set the fair and reasonable charge. However, Ofcom should apply a starting charge reduction to MPF rental prices to reflect the results of the cost attribution review that was finalised in 2015. This review showed that BT had manipulated RFS cost allocations to inflate the price of regulated products by about £250m a year. If Ofcom does not make this starting charge reduction it, in effect, will allow BT to continue to benefit by up to £140m from this historic abuse.

1.3 Lacunae – where Ofcom does not introduce the new charge control until some time after the previous one finishes – have become an all too frequent occurrence in UK telecoms regulation. In some cases, Ofcom have allowed BT to charge excessive prices during these periods resulting in consumers paying tens of millions of pounds too much despite repeated requests from wholesale customers to protect consumers interests and competition. Whilst ideally lacunae should be avoided[2], when they occur Ofcom still has a duty to act to minimise the harm to consumers' interests from BT's dominance.

1.4 We are pleased that Ofcom intends to address the problem of the lacuna for MPF pricing. Below we explain why it is appropriate for Ofcom to set the price and also why the price should include a starting charge adjustment to reflect the results of the cost attribution review.

1.1 Why Ofcom should set the price

1.5 Ofcom has proposed to set the MPF rental price during the lacuna period based on its base case estimate of what the appropriate price in 2016/17 should be (as contained in its WLA Review proposals). We agree with this approach.

1.6 It is, in our view, axiomatic that absent a price ceiling or other strong constraint BT will charge excessive prices for MPF products. BT have entrenched SMP in this market as evidenced by the SMP finding in 2014 (for the period 2014-2017) and the proposed SMP finding for the period 2018-2021. This SMP means that BT has a strong incentive to price wholesale MPF excessively, harming consumers and competition.

1.7 Furthermore, commercial negotiation is very unlikely to result in BT offering a fair and reasonable price. If wholesale customers brought a dispute to Ofcom to

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[1] MPF Rental at Service Maintenance Level 1. Proposed direction specifying the fair and reasonable charge that BT may apply for MPF Rental provided at SML1. March 2017

[2] For instance, by completing market reviews on time or setting a charge control so that it continues (at an appropriate level) after the end of the initial period

determine a fair and reasonable price this would result in uncertainty and a delay in a reasonable price being set.

1.8 Therefore it is clear that Ofcom should determine what is a fair and reasonable on an *ex ante* basis.

1.9 If Ofcom is to set a price, that raises the question of what that price should be. We agree that the price should be set using the base case estimate of the appropriate price in 2016/17, as Ofcom has set out in its WLA Review proposals. This price is based on the most reliable cost data available to Ofcom and so is the best proxy available to Ofcom at this time of a fair and reasonable price (with the exception of the need for a starting charge adjustment).

1.2 Need for a starting charge adjustment

1.10 The MPF rental price in the lacuna period (as well as in 2018/19) should be based on applying a starting charge adjustment ("**SCA**") that reflects the results of the cost attribution review ("**CAR**") review. Without this Ofcom will effectively allow BT to profit by a further £140m as a result of its historic manipulation of cost attributions.

1.11 In its cost attribution review, Ofcom concluded that BT's cost attribution approach had inflated the costs of regulated products by over £260m a year[3] by using a litany of attribution methods that were clearly inappropriate[4]. The impact of this was that wholesale prices had been inflated by a similar amount.

1.12 Ofcom's general approach to setting prices is to use a glidepath approach whereby prices 'glide' from the current level to the forecast cost in the last year. This approach strengthens cost minimisation incentives since BT is able to retain cost reductions for a longer period.

1.13 However, in some cases it is not appropriate to use only a glidepath and an SCA is appropriate – examples include where a charge control is imposed for the first time[5] or where the misalignment between prices and costs is not a result of efficiency or volume effects such as cost attributions. For instance, Ofcom said in the BCMR consultation[6]:

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[3] Ofcom Cost Attribution Review second consultation Nov 2015. Operating costs overstated by £255m (Table 1.4) and MCE by £157m. Using (conservatively) a WACC of 8.6% means total costs (including RoCE) were overstated by £269m

[4] For example: allocating HR costs based on asset when clearly assets do not cause HR costs; attributing most of the cost of property and vacant space to regulated products but attributing all of the profits on property sales to unregulated products; attributing overhead costs associated with overseas operations to UK activities; attributing DSLAM costs to SMPF (DSLAMs are downstream of SMPF); and, BT attributing the vast proportion of cumulo rates costs to regulated products but most rates rebates to unregulated products.

[5] For example for SFI and TRC in 2014. See FAMR Statement Vol 1 June 2014 §18.153

[6] BCMR: Leased lines charge controls and dark fibre pricing consultation June 2015 §6.120. The subsequent statement was based on the same principles but was less clear. We note that – where there have been material changes in cost allocations between regulated and unregulated markets –

In particular, we proposed to apply the following principles in relation to starting charge adjustments:

[…]

Excessively high or low margins driven by:

- *Efficiency and volume changes – we propose to impose a glidepath;*
- *[…]*
- *changes in cost allocations (and accounting errors) between regulated and unregulated markets – we propose to impose a starting charge adjustment; and […]*

1.14 In the previous FAMR review (in 2014) and the BCMR review (in 2016) Ofcom developed and applied a framework for when to apply SCAs (rather than only a glidepath) to set prices. In the BCMR statement, the description of the framework and its application to Ethernet prices ran to over 20 pages[7]. Accordingly, Ofcom imposed material SCAs e.g. SCA of 12% and 24% total reduction in prices in first year for Ethernet[8].

1.15 In particular, Ofcom decided that the results of the CAR should be taken into account in setting any SCA[9] for Ethernet prices. An SCA was also necessary to remove additional future profits resulting from BT's manipulation of the RFS.

1.16 In the current WLA Review Ofcom appears to have overlooked most of this framework. In the WLA Review, Ofcom outlines (in less than one page[10]) its approach for MPF. There is little mention of starting charge adjustments or the analysis and framework in the 2016 BCMR or 2014 FAMR Review.

1.17 As was the case for Ethernet products, an SCA is patently appropriate in the case of MPF to remove the negative effects of BT gaming the cost attribution.

1.18 In the case of LLU products, BT's manipulation of the costs attributions inflated prices by about £68m or 8%[11]. The MPF SML2 price at 30 March 2017 (£87.65) was set in the FAMR 2014 based on the then estimated costs in 2016/17 using pre-CAR cost attributions. If only a glidepath is used to set future prices then the prices in both 2017/18 and in 2018/19 will be based on the pre-CAR cost attributions and so

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there is no sound reason to restrict applying an SCA only to cases where margins are excessively high or low. Else it will allow BT to be rewarded for inefficiency

[7] BCMR Statement April 2016 Vol 2 §4.80-4.121 and §7.1-§7.100

[8] BCMR Statement April 2016 Vol 1 Table 1.5

[9] In the final statement the SCA was not formulaically linked to the CAR results (as was proposed in the consultation) – see BCMR Statement April 2016 Vol 2 §4.86. However, the SCA was evidently increased because of the CAR results.

[10] WLA Review Vol 2 §2.84-§2.89

[11] Based on data from CAR Nov 2015 document. Table 1.3, 1.5 give attribution change for fixed access markets of £177m (opex) and £93m (MCE). Using WACC of 8.6% this gives excess cost of £185m which is 7.9% of total fixed access markets. Applying this to LLU (FAC cost of £861, Table A5.2) this gives total excess of £68m

be inflated. Therefore, future prices should recognise that the 2016/17 price is inflated by making a downward SCA.

1.19 We have estimated future prices based on applying an SCA to reflect the impact of the CAR. We provide the key sources/assumptions in the footnote[12].

1.20 The table below shows our estimates that with an SCA MPF rental (SML1) prices would be about £3.70 lower in 2017/18 and £2.00 lower in 2018/19[13]. Without an SCA BT's revenue/profit will be inflated by about £40m on MPF and (assuming MPF provides a constraint on WLR prices) about £100m on WLR. Much of this £140m will feed through into inflated consumer prices.

MPF SML1 prices	2016/17	2017/18	2018/19	2019/20	2020/21	TOTAL
Ofcom proposal	85.29	84.38	83.50	82.28	81.98	
With SCA	85.29	80.68	81.48	82.28	81.98	
Difference		*3.70*	*2.02*			
MPF lines (m)		7.80	6.82			
WLR lines (m)		17.07	17.88			
Impact on MPF (£m)		29	14			43
Impact on WLR (£m)		63	36			99
TOTAL		92	50			142

1.21 TalkTalk first raised the problem of cost attributions to Ofcom in 2009, Ofcom itself recognised in 2013/2014 that BT had inflated the costs. Ofcom has already allowed BT to continue to profit from its previous abuse by about £185m[14] a year since MPF and WLR prices are still based on the old inflated costs levels. To now consciously allow BT to continue to benefit from its historic abuse for another two years (up to 2019) would be quite extraordinary. Making an SCA for the CAR adjustments is in consumers interests and economically and legally sound.

1.3 Other suggestions

1.22 Below we discuss three other possible amendments/clarifications to the lacuna approach:

- Lacuna pricing for other MPF products

[12] Assumes SCA is 80% of excess attribution (assume 20% of excess attribution is between regulated products rather than from regulated to non-regulated as per Ofcom's own approach). This gives SCA of £5.40 (= £85.29 x 7.9% x 80%). The prices in each year are then based on the SCA and the glide in each of the three years required to reach the final price in 2019/10). The impact figures are for full year

[13] Applying an SCA would result in prices falling then rising, then falling. Provided this is known in advance (which it will be) then there is no harm from this volatility

[14] This is the amount for all fixed access/FAMR products – see footnote 11

- Lacuna pricing for VULA products
- Backdating the lacuna pricing to 1 April 2017

1.23 Ofcom should consider whether it should determine the fair and reasonable price for other MPF products. This should focus on those MPF product(s) where the reduction in revenue in 2017/18 resulting from setting the lacuna prices (including an SCA) is material and/or greatest. We do not have complete information to be able to estimate where the greatest reductions but based on information available the largest impact would probably be on the MPF New Provide basket and be of the order of £15m.

1.24 Ofcom should consider whether it should apply lacuna pricing for VULA.

1.25 We consider that the fair and reasonable price should be backdated to 1 April 2017. In the previous FAMR review in 2014, the charge control price effectively applied from 1 April 2014 even though the charge control was not determined until June 2014. Backdating would be in consumers interests.