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Office of Communications (Ofcom)

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For the attention of:
Mr Ed Richards
Chief Executive Officer

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Dear Mr Richards,

**Subject: Commission decision concerning Case UK/2012/1292-1293:
Implementation of the charge controls in the markets for wholesale
local access services and wholesale fixed analogue exchange lines**

Comments pursuant to Article 7(3) of Directive 2002/21/EC¹

I. PROCEDURE

On 3 February 2012, the Commission registered a notification from the UK national regulatory authority, Ofcom, concerning the price control remedy imposed on the incumbent operator, BT (Openreach), on the market for wholesale physical network infrastructure access (WPNIA)² and on the market for wholesale fixed analogue exchange lines (WFAEL).³

¹ Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive), OJ L 108, 24.4.2002, p. 33, as amended by Directive 2009/140/EC, OJ L 337, 18.12.2009, p. 37, and Regulation (EC) No 544/2009, OJ L 167, 29.6.2009, p. 12.

² This market corresponds to Market 4 of Commission Recommendation 2007/879/EC of 17 December 2007 on relevant product and service markets within the electronic communications sector susceptible to *ex ante* regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services, OJ L 344, 28.12.2007, p. 65.

³ This market is not listed in Recommendation 2007/879/EC.

The national consultation⁴ ran from 31 March 2011 to 8 July 2011 (the March Consultation) and from 23 November 2011 to 23 December 2011 (the November Consultation).

On 16 February 2012 a request for information⁵ was sent to Ofcom and a response was received on 21 February 2012.

Pursuant to Article 7(3) of the Framework Directive, national regulatory authorities (NRAs), the Body of European Regulators for Electronic Communications (BEREC) and the Commission may make comments on notified draft measures to the NRA concerned.

II. DESCRIPTION OF THE DRAFT MEASURES

II.1. Background

The implementation of the charge controls for Local Loop Unbundling (LLU) and wholesale line rental (WLR) was the subject of several proposals by Ofcom notified to and assessed by the Commission in 2008/2009.⁶ The latest charge control was set in May 2009 and expired on 1 April 2011. Since then, Openreach has been setting charges according to a voluntary commitment it undertook to adhere to certain charge ceilings (the bridging charges ceilings). This voluntary commitment expires on 31 March 2012.

Ofcom has in the meantime reviewed the WPNIA and WFAEL markets.⁷ Ofcom designated BT (Openreach) as the operator with significant market power (SMP) and imposed on it a number of regulatory remedies, including a price control obligation for copper-based services only.⁸ BT was therefore subject to the obligation to charge cost-oriented prices (basis of charges) and to a price cap for LLU and WLR services (charge control) in order to remedy Openreach's ability to fix or maintain prices at an excessively high level.

Ofcom has in a recent notification (Case UK/2011/1201)⁹ proposed the level, form and duration of the charge control for WLR and LLU services (LLU rental services, WLR rental services and certain ancillary services). This proposal was in the meantime amended and re-submitted to a second public consultation (the November consultation).

⁴ In accordance with Article 6 of the Framework Directive.

⁵ In accordance with Article 5(2) of the Framework Directive.

⁶ Case UK/2008/0854, SG-Greffe (2009) D/1369. With regard to WLR services only, see also Cases UK/2009/0944, SG-Greffe (2009) D/4920 and UK/2009/0997, SG-Greffe (2009) D/10967.

⁷ Cases UK/2010/1064, SG-Greffe (2010) D/7658 and UK/2010/1139, SG-Greffe (2010) D/18243 respectively.

⁸ Ofcom decided at the time not to impose a cost-orientation obligation on the virtual unbundling remedy (VULA), pointing, *inter alia*, to (i) the early stage of development of NGA services and the uncertainty surrounding costs and revenues; (ii) the fact that pricing flexibility would incentivise BT to invest; and (iii) the constraints stemming from the regulated current generation access services and from the services offered by Virgin Media over the cable network. The Commission criticised Ofcom's approach of granting pricing flexibility for VULA.

⁹ Case UK/2011/1201, SG-Greffe (2011) D/9413.

II.2. The notified draft measure

The current notification concerns the implementation of the price control obligation for copper-based services, in particular the setting of the charge controls for LLU and WLR services following the two public consultations.¹⁰ The charge control will cover two years (2012/13 and 2013/14), commencing on 1 April 2012 and expiring on 31 March 2014.

II.2.1 Approach to setting the charge controls

With regard to the *cost basis*, Ofcom proposes to continue using fully allocated costs (FAC) based on current cost accounting (CCA)¹¹ and retaining the adjustment of the Regulatory Asset Value (RAV) established in 2005 as the basis for setting the LLU¹² and WLR prices.¹³ Therefore, Ofcom proposes to value pre-August 1997 assets on the basis of historic cost accounting (HCA) and post-August 1997 assets on the basis of CCA.¹⁴

Specifically with regard to *duct assets*, Ofcom re-assesses the 2005 review of the RAV of Openreach access assets. Ofcom concludes that the RAV adjustment, i.e. valuing pre-1997 duct assets on an HCA basis and post-1997 ducts on a CCA basis, is appropriate.

Ofcom argues that the setting of efficient prices does not require a return to full CCA for ducts because this would not properly reflect the forward-looking opportunity costs as their replacement is not likely and they are a sunk cost. Nonetheless, Ofcom considers that the sunk cost cannot be disregarded either, because such an approach would not be consistent with encouraging dynamic efficiency. Ofcom thus acknowledges that the RAV adjustment allows the recovery of sunk costs to the extent necessary to satisfy dynamic efficiency concerns.

Furthermore, Ofcom finds that the RAV allows BT a reasonable return on pre-1997

¹⁰ As indicated in the information provided at the pre-notification stage, the main changes made to Ofcom's proposal, since the March 2011 Consultation, concern: (i) the defined costs/assumptions (e.g. removal of excess IT costs, lower line length adjustment, change in the WACC, higher predicted rental volumes); (ii) the defined baskets; and (iii) the migration services.

¹¹ See Case UK/2011/1201.

¹² LLU includes fully unbundled lines (Metallic Path Facility or MPF) and shared unbundled lines (Shared Metallic Path Facility or SMPF).

¹³ In assessing the appropriateness of using CCA FAC as the basis for setting LLU and WLR charges, namely whether the appropriate efficiency incentives are granted, Ofcom analyses the relative prices that it proposes for LLU and WLR services. Ofcom thus calculates the price differentials between (i) MPF/WLR and (ii) MPF/WLR+SMPF which result from the adopted CCA FAC cost model and an LRIC model. Ofcom concludes that the price differentials resulting from relevant CCA FAC are appropriate for the purposes of promoting efficiency for the LLU/WLR charge control. In particular, these differentials are likely to be greater than the absolute LRIC difference and are declining towards the LRIC difference over time. In the longer term, Ofcom expects to continue reducing the price differentials to the differences in absolute LRICs.

¹⁴ On 1 August 1997, Ofcom's predecessor, Oftel, decided to switch from the then applied HCA method to a CCA method, thus valuing BT's network assets on the basis of how much it would cost to replace them at today's prices (CCA) rather than on how much BT had spent on the assets when it bought them (HCA). Oftel considered at the time that changing the accounting treatment would not result in BT over- or under-recovering its costs during the subsequent price control period. However, in 2005 Ofcom determined that if wholesale charges were to be set based on a CCA valuation, this would result in BT recovering more than its costs for all the copper access network assets that had already been deployed at the time the change in accounting treatment was made, i.e. on 1 August 1997. It thus decided to apply the RAV adjustment.

investment, while a return to full CCA valuation could lead to over-recovery of costs by BT. In this regard Ofcom explains that, in the case of assets with rising values, such as ducts, moving from HCA to CCA would result in windfall gains for BT over time and that the resultant higher wholesale costs could stifle LLU-based competition downstream of this point.

Ofcom also undertakes a review of the valuation made by BT for post-1997 duct assets, based on the absolute valuation method,¹⁵ and concludes that BT's revision of the cost of replacing post-97 duct does not represent a reliable estimate of the CCA value for the purpose of setting regulated charges.¹⁶ Ofcom thus decides to estimate the CCA value of post-97 duct through RPI¹⁷ indexation of BT duct expenditure since 1997.

In the light of ongoing major *technological changes*, Ofcom applies an 'anchor product pricing' instead of a 'modern equivalent asset' approach. Under the former, the price (and quality) of existing services are 'anchored' by the legacy technology, even if the services are actually provided over a new technology. This means that if Openreach introduces fibre access technology, it will not be allowed to increase the prices for products with the current level of quality. It also leads to common costs being split over a higher number of services, including NGA. This option is deemed appropriate to encourage efficient levels of investment and provide protection for consumers through a period of transition.

Ofcom proposes an RPI^{18-x} charge control for each of the LLU and WLR services/baskets.¹⁹ In this regard, it proposes to adopt a *glide path* and derive the charges for 2012/2013 and 2013/2014 on the basis of a fixed percentage control (the 'x' in an RPI-x formulation) applied over three years starting from the charges in force at the end of 2010/2011. This will, in Ofcom's view, lead to smooth nominal charge reductions for the two largest rental services (MPF and WLR) and closer alignment of SMPF and the ancillary services to cost.²⁰

¹⁵ According to Ofcom, the absolute valuation method requires a large and complex calculation of price multiplied by quantity. BT derives the duct assets' CCA valuation from an estimate of the cost of replacing the duct assets acquired in the last 40 years based on current contractor rates, reduced by a hypothetical scale-discount that might be achieved on these rates if the entire duct network was replaced on a planned national basis over a short period.

¹⁶ Ofcom notes that BT had, in 2010, undertaken a review of the valuation of its duct network and as a result the Regulatory Financial Statement for 2009/2010 included a significant upward revaluation of BT's duct network, with the consequence that the proposed value of duct assets, to be used in the setting of the charge controls, was significantly increased. Ofcom therefore decides to review the treatment of the value of duct assets to be used as an input to the charge controls.

¹⁷ Ofcom also assesses other indicators proposed by Analysis Mason, such as the General Building Cost Index (GBCI) and the All-in Tender Price Index (TPI). The GBCI is a national index that measures the cost of construction works, including materials and labour, while the TPI measures actual tender prices charged for construction work.

¹⁸ Retail Price Index.

¹⁹ Ofcom has decided to continue using RPI rather than an alternative national index (e.g. Consumer Price Index) for the LLU and WLR charge controls.

²⁰ Ofcom considers the alternative of a glide path starting from the interim prices but takes the view that the effect of this would be to embed inappropriately high returns. Ofcom also considers a two-year glide path but deems the higher charges derived not to be appropriate given the scale of over-recovery.

II.2.2 LLU and WLR charge control structure

With regard to the *LLU charge control structure*, Ofcom proposes to set:²¹

- (i) separate individual charge controls for MPF, SMPF rental and key migration services;²²
- (ii) separate basket controls for the remaining MPF and SMPF ancillary services;²³
- (iii) a co-mingling basket for ancillary services used for both MPF and SMPF.²⁴

With regard to the *WLR charge control structure*, Ofcom proposes to set separate individual charge controls for WLR rental and for two ancillary services — WLR transfer and WLR New Connection.²⁵

The proposed LLU and WLR charge controls and the charges applicable to ancillary and migration services are shown in the tables below:²⁶

Service	Price applied until 31 March 2011	Bridging charge ceiling	Charge control for 2012/2013	Charge control for 2013/2014
MPF rental	£ 89.10 (€ 106.25) ²⁷	£ 91.50 (€ 109.10)	£ 87.41 (€ 104.23)	RPI-5.9 %
SMPF rental	£ 15.04 (€ 17.93)	£ 14.70 (€ 17.53)	£ 11.92 (€ 14.21)	RPI-15.9 %
WLR rental	£ 103.68 (€ 123.60)	£ 103.68 (€ 123.63)	£ 98.81 (€ 117.83)	RPI-7.3 %

²¹ In the current notification Ofcom also puts forward detailed conclusions as to the design and structure of the LLU ancillary key migration services and other LLU ancillary baskets. It also addresses other LLU issues, namely those raised by stakeholders during the LLU/WLR charge control review.

²² MPF Single Migration, MPF New Provide, SMPF Single Migration and SMPF Provide.

²³ Grouped in the following baskets: MPF ancillary services basket and SMPF ancillary services basket.

²⁴ The basket for the co-mingling services comprises ancillary services used by operators purchasing MPF or SMPF, including services required to locate their equipment at Openreach's local exchanges (Case UK/2011/1201).

²⁵ Other ancillary services, such as MPF to WLR transfer, calling and network features, pre-validation charges, ISDN to WLR conversion charges, cancellation charges, time-related charges and WLR cease charges, will remain outside the scope of the charge controls.

²⁶ Yearly charges.

²⁷ 1 pound sterling (£) = 1.1923 euro (€). Exchange rate on 21 February 2011.

Service	Charge control for 2012/2013	Charge control for 2013/2014
<i>MPF/SMPF ancillary services</i>		
MPF Single Migration	£ 33.54 (€39.10)	RPI-11.3 %
MPF New Provide	£ 51.16 (€61.02)	RPI-14.2 %
SMPF Single Migration	£ 33.54 (€39.10)	RPI-11.3 %
SMPF Provide	£ 33.54 (€39.10)	RPI-11.3 %
MPF ancillary services basket	-3.6 %	RPI-9 %
SMPF ancillary services basket	-7.6 %	RPI-13 %
Co-mingling ancillary services basket	1.8 %	RPI-3.6 %
<i>WLR ancillary services</i>		
WLR Transfer	£ 3.29 (€3.92)	RPI%
WLR New Connection	£ 50.06 (€59.71)	RPI-10.2 %

III. COMMENTS

On the basis of the present notification and the additional information provided by Ofcom, the Commission has the following comments:²⁸

Forthcoming guidance on costing methodologies

The Commission notes that Ofcom proposes to set LLU and WLR charges principally on the basis of CCA FAC but introduces HCA for some assets in order to (i) reflect the forward-looking opportunity cost and achieve the right balance between allocative and dynamic efficiency and (ii) prevent BT from over-recovering the costs of assets deployed before 1 August 1997. Ofcom thus applies an adjustment to the RAV and values pre-1997 assets on the basis of HCA and post-1997 assets on the basis of CCA. This approach is applied similarly to copper loops, ducts, trenching and poles.

With regard to the valuation of duct assets deployed post-1997 on the basis of CCA, Ofcom also proposes to apply the indexation method and, in particular, to index the annual spend on the network by RPI rather than using the absolute valuation method proposed by BT.

²⁸ In accordance with Article 7(3) of the Framework Directive.

Ofcom also proposes to apply an ‘anchor product pricing’ instead of an MEA approach in order to tackle the ongoing major technological changes that the transition to NGA entails. Ofcom considers, in this regard, that this option is appropriate to encourage efficient levels of investment and provide protection for consumers through a period of transition.

Given the importance of regulating key wholesale access products in the transition period to NGA networks in an effective and consistent manner across the EU, the Commission is currently working on a recommendation on costing methodologies for key access prices. In the light of this, the Commission invites Ofcom to review its analysis upon publication of any relevant recommendations.

Pursuant to Article 7(7) of the Framework Directive, Ofcom must take the utmost account of the comments of other NRAs, BEREC and the Commission and may adopt the resulting draft measures; where it does so, it must communicate them to the Commission.

The Commission’s position on this particular notification is without prejudice to any position it may take *vis-à-vis* other notified draft measures.

Pursuant to Point 15 of Recommendation 2008/850/EC²⁹ the Commission will publish this document on its website. The Commission does not consider the information contained herein to be confidential. You are invited to inform the Commission³⁰ within three working days following receipt whether you consider that, in accordance with EU and national rules on business confidentiality, this document contains confidential information which you wish to have deleted prior to such publication.³¹ You should give reasons for any such request.

Yours sincerely,
For the Commission,
Robert Madelin
Director-General

²⁹ Commission Recommendation 2008/850/EC of 15 October 2008 on notifications, time limits and consultations provided for in Article 7 of Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services, OJ L 301, 12.11.2008, p. 23.

³⁰ Your request should be sent either by email: INFSO-COMP-ARTICLE7@ec.europa.eu or by fax: +32 2 298 87 82.

³¹ The Commission may inform the public of the result of its assessment before the end of this three-day period.