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**SG-Greffe (2011) D/9413**

Office of Communications (Ofcom)

Riverside House  
2a Southwark Bridge Road  
London SE1 9HA  
United Kingdom

For the attention of:  
Mr Ed Richards  
Chief Executive Officer

Fax: +44 20 7981 3504

Dear Mr Richards,

**Subject: Case UK/2011/1201: Implementation of the charge control relating to local loop unbundling and wholesale line rental services**

**Article 7(3) of Directive 2002/21/EC:<sup>1</sup> No comments**

## **I. PROCEDURE**

On 31 March 2011, the Commission registered a notification from the British national regulatory authority, Ofcom, concerning the price control remedy imposed on the incumbent operator, BT (Openreach), in the wholesale market for local access and the wholesale fixed analogue exchange lines market.

On 20 May 2011, Ofcom re-notified/updated the charge controls proposals as calculation errors had become apparent. Ofcom confirmed that these changes had no impact on the substance of the proposals as initially notified.

The national consultation<sup>2</sup> runs in parallel to the EU consultation under Article 7 of the Framework Directive. The deadline for the EU consultation is 9 June 2011.

On 18 May 2011 a request for information (RFI)<sup>3</sup> was sent to Ofcom and a reply was

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<sup>1</sup> 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.

<sup>2</sup> In accordance with Article 6 of the Framework Directive.

<sup>3</sup> Pursuant to Article 5(2) of the Framework Directive.

received on 23 May 2011.

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

## **II. DESCRIPTION OF THE DRAFT MEASURES**

### **II.1. Background**

Ofcom's last reviews of the (i) wholesale physical network infrastructure access (WPNIA) market and (ii) wholesale fixed analogue exchange lines (WFAEL) markets were notified to and assessed by the Commission under case numbers UK/2010/1064<sup>4</sup> and UK/2010/1139<sup>5</sup> respectively. In both markets Ofcom imposed on the incumbent operator, BT (Openreach), a number of regulatory remedies, including the price control obligation that establishes the basis of charges (i.e. cost-oriented pricing based on forward looking long run incremental cost (LRIC)) and the charge control (i.e. the setting of a price-cap on individual services and/or baskets of services for the next regulatory period).

The charge controls for Local Loop Unbundling (LLU) and wholesale line rental (WLR) charges were last notified to and assessed by the Commission under case numbers UK/2008/0845<sup>6</sup> and UK/2009/0997<sup>7</sup>.

At the time, the Commission issued comments inviting Ofcom to (i) adopt the final measure with regard to WLR prices only once it had finished its review of the fixed narrowband wholesale services market concerned, and to conduct a new market analysis for wholesale network infrastructure access as soon as possible, (ii) re-notify to the Commission, without undue delay, its final decision setting the regulated wholesale prices and price caps for local loop unbundling services, and (iii) monitor market developments with a view to ensuring that the regulated prices for Openreach's wholesale service offerings remain in line with the underlying costs, with a view to ensuring fair treatment for Openreach's wholesale customers in the event of the key assumptions made by Ofcom no longer holding true.

### **II.2. The notified draft measure**

The current notification concerns the price control remedy imposed on BT (Openreach) on the abovementioned wholesale markets. In particular, Ofcom proposes to set the charge controls for LLU and WLR services to run up to 31 March 2014.<sup>8</sup>

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<sup>4</sup> SG-Greffe (2010) D/7658. This market corresponds to Market 4 of the 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 (Recommendation), OJ L 344, 28.12.2007, p. 65.

<sup>5</sup> SG-Greffe (2010) D/18243. This market is not listed in the Recommendation.

<sup>6</sup> SG-Greffe (2009) D/1369.

<sup>7</sup> SG-Greffe (2009) D/10967.

<sup>8</sup> i.e. three years after the current controls expire in 31 March 2011.

### *II.2.1. Costing methodology*

Ofcom proposes to continue using current cost accounting (CCA) and fully allocated costs (FAC) as the basis for setting the LLU<sup>9</sup> and WLR prices.<sup>10</sup> Nonetheless, Ofcom explains that valuing all BT's assets at replacement cost (CCA) is not appropriate because no operator is expected to build a new nationwide access network, and this would only lead to over-compensation for BT. Therefore, Ofcom retains the adjustment of the Regulatory Asset Value (RAV) established in 2005 and values pre-1997 assets on the basis of historic cost accounting (HCA) and post-1997<sup>11</sup> assets on the basis of CCA<sup>12</sup>.

In light of on-going 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 via a new technology. As for the implications of this approach on NGA regulation, Ofcom explains that even if Openreach introduces fibre access technology, it will not be allowed to increase the prices for products with the current level of quality.<sup>13</sup>

Ofcom maintains that BT initially plans to roll out overlay fibre, i.e. leaving its existing copper network in place. Other communication providers will therefore have the choice of buying the existing copper products (which are subject to charge controls) or the fibre network products (which are not subject to cost orientation).<sup>14</sup> If in the future the copper network is removed, Ofcom would expect to apply the 'anchor pricing approach' and require BT to provide a service of equivalent quality to the one provided with existing copper products, at a regulated price, based on the hypothetical continuation of the

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<sup>9</sup> It includes fully unbundled lines (Metallic Path Facility, or MPF) and shared unbundled lines (Shared Metallic Path Facility, or SMPF).

<sup>10</sup> According to the reply to the RFI, Ofcom considers that CCA FAC is equivalent to LRIC plus a markup (for common costs) for the particular charge controls covered by the present notification.

Moreover Ofcom assesses the relative prices that it proposes for LLU and WLR services. Ofcom calculates the price differentials between MPF and WLR (and also between MPF and WLR+SMPF) that result from the adopted cost model (based on CCA FAC) and an LRIC model. In both cases, the price differentials between the proposed charges are lower than the LRIC differentials. Ofcom therefore concludes that there are no efficiency reasons for not setting the charges on the basis of CCA FAC.

<sup>11</sup> In 1997 Ofcom's predecessor, Oftel, decided to value BT's network assets based on how much it would cost to replace them at today's prices (CCA) rather than how much BT spent on the assets when it bought them (HCA).

<sup>12</sup> In the current notification Ofcom has reviewed the valuation made by BT for post-1997 duct assets and concludes that the cost of replacing them cannot have increased by as much as BT's valuation suggests.

<sup>13</sup> Ofcom states that while parallel running is in force, average costs on both networks will tend to be higher than if there was a single network, due to the loss of economies of scale and scope, and this is one reason why costs may initially rise when new technology is introduced.

<sup>14</sup> In this regard Ofcom refers to the review of the WNPIA market, in which it considered that the ability of other communication providers to purchase copper based products would act as a constraint on the price of the fibre based virtually unbundled local access (VULA) service, as would the services offered by Virgin Media via its cable network.

existing copper technology.<sup>15</sup>

Ofcom calculates the charges applicable under the assumption of the hypothetical continuation of copper-only technology (without any NGA), and compares them to using the actual cost model, in which the cost categories related exclusively to NGA have been excluded but common costs have been allocated across services, including NGA.<sup>16</sup> Ofcom finds that the prices resulting from the cost model are likely to be lower than the copper-only based prices and concludes that they are consistent with the 'anchor product pricing' approach, i.e. they do not rise as a result of NGA. In this respect, Ofcom's reply to the RFI confirms that the allocation of common costs across more services ensures consistency with the abovementioned approach.

A comparison between the base case unit costs (forecast by the cost model for 2013/14) and the current prices for LLU (MPF and SMPF) and WLR rental services (in 2010/11) shows that the MPF rental price would remain at the same level, while the SMPF and the WLR rental prices would decrease (by 26.2% and 3.2%, respectively) in three years' time.

	MPF rental	SMPF rental	WLR
Current price to 31 March 2011	£ 89.10 (€ 102.00) <sup>17</sup>	£ 15.04 (€ 17.22)	£ 103.68 (€ 118.69)
Base case cost estimate 2013/14	£ 89.09 (€ 101.99)	£ 11.10 (€ 12.71)	£ 100.62 (€ 115.19 )

### *II.2.2. Price cap based charge control*

Ofcom proposes an RPI<sup>18</sup> — X charge control for the different LLU and WLR services/baskets up to March 2014. Ofcom argues that price caps generally provide strong incentives for dynamic efficiency because they allow regulated firms to earn profits in excess of the cost of capital if they manage to reduce costs below the price level established by the RPI–X formula.

As to the LLU charge control structure, Ofcom intends to set separate individual controls for MPF and SMPF rental and set baskets for ancillary services<sup>19</sup> that are to be grouped around the underlying rental services: (i) MPF ancillary services, (ii) SMPF ancillary services and (iii) comingling services (required for both MPF and SMPF services). Ofcom sets individual price caps not only on each LLU rental charge but also on each of the three baskets.

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<sup>15</sup> In the reply to the RFI, Ofcom acknowledges that the relationship between the incentives to invest in NGA and the LLU prices is complex and has not been considered in detail in the present notification. Nonetheless, Ofcom is of the view that the 'anchor pricing approach' ensures that Openreach has incentives to invest in fibre if, and only if, it believes that consumers are willing to pay more for the higher quality product and/or the investments are justified by cost reductions.

<sup>16</sup> According to Ofcom this is different from a model of existing technology in which common costs would all be allocated only to copper products.

<sup>17</sup> 1 British pound (£) = 1.1448 Euro (€). Exchange rate on 26 May 2011.

<sup>18</sup> Retail Price Index.

<sup>19</sup> By ancillary services Ofcom refers to those services which are required to provide and support LLU and (also WLR) services such as migration and new line provision type services. The basket for comingling services comprises those ancillary services for which LLU operators are required to locate their equipment at Openreach's local exchanges.

As to the WLR charge control structure, Ofcom proposes separate individual controls for WLR and such ancillary services as WLR to WLR transfer<sup>20</sup> and WLR new connection.

The proposed ranges for the charge control on the rental charges are set out in the following table.

Service	Bridging charge ceiling <sup>21</sup>	Charge ceilings for the first period of controls (from start date to 31 March 2012). Base case	Base case	Proposed range for charge controls
MPF rental	£91.5 (€104.74)	£90.00 (€103.03)	RPI-3.5%	RPI-2.0% / RPI-5.0%
SMPF rental	£14.7 (€16.83)	£13.70 (€15.68)	RPI-13.1%	RPI -11.6% / RPI-14.6%
WLR rental	£103.68 (€118.69)	£103.70 (€118.72)	RPI-4.5%	RPI-3.0% / RPI-6.0%

In its reply to the RFI, Ofcom explains that these ranges reflect (i) its assessment of the uncertainty surrounding the assumptions used in determining the base case and (ii) the likely range of outcomes, should a number of key assumptions vary within the sufficiently narrow proposed ranges.<sup>22</sup> Ofcom further argues that these ranges allow stakeholders to comment on the information and evidence at the time of the consultation. After consultation on the ranges, Ofcom will set only one control for each basket/service in the final statement.

### III. NO COMMENTS

On the basis of the present notification and the additional information provided by Ofcom, the Commission has no comments.<sup>23</sup>

Pursuant to Article 7(5) of the Framework Directive, Ofcom may adopt the resulting draft measure and, where it does so, shall communicate it 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/EC<sup>24</sup> the Commission will publish this

<sup>20</sup> MPF to WLR transfers, however, are not to be subject to any control given the low volumes of services.

<sup>21</sup> Ofcom explains that the new charge will not be in place when the current control expires on 31 March 2011; this is because of the appeal against the existing control, which was finally concluded in October 2010. Thus Openreach has offered to adhere to charge ceilings calculated in accordance with the financial models used to set the current controls (adjusted for consistency with the remedies applied following the Competition Commission's Determinations in the appeal against the current controls) to bridge the gap between the expiry of the current controls and the start of the new controls.

<sup>22</sup> For example, this sensitivity analysis measures the effect of rejecting the RAV (and values all the assets on the basis of CCA), a 0.5% decrease in the cost of capital, the acceptance of BT's duct valuation, etc.

<sup>23</sup> In accordance with Article 7(3) of the Framework Directive.

<sup>24</sup> Commission Recommendation 2008/850/EC of 15 October 2008 on notifications, time limits and

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

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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.

<sup>25</sup> Your request should be sent either by email: [INFSO-COMP-ARTICLE7@ec.europa.eu](mailto:INFSO-COMP-ARTICLE7@ec.europa.eu) or by fax: +32 2 298 87 82.

<sup>26</sup> The Commission may inform the public of the result of its assessment before the end of this three-day period.