Neutral citation [2011] CAT 5

IN THE COMPETITION APPEAL TRIBUNAL

Case Number: 1146/3/3/09

Victoria House
Bloomsbury Place
London WC1A 2EB

22 March 2011

Before:

MARCUS SMITH QC
(Chairman)
PROFESSOR PETER GRINYER
RICHARD PROSSER OBE

Sitting as a Tribunal in England and Wales

BETWEEN:

BRITISH TELECOMMUNICATIONS PLC

Appellant

- v -

OFFICE OF COMMUNICATIONS

Respondent

- supported by -

CABLE & WIRELESS UK
VIRGIN MEDIA LIMITED
GLOBAL CROSSING (UK) TELECOMMUNICATIONS LIMITED
VERIZON UK LIMITED
COLT TECHNOLOGY SERVICES

Interveners

Hearing dates: 20, 21, 22, 25, 26 and 28 October 2010

JUDGMENT

APPEARANCES

Mr Graham Read QC, Mr John O'Flaherty and Mr Ben Lynch, assisted by Miss Anneli Howard (instructed by BT Legal) appeared for the Appellant.

Mr Pushpinder Saini QC, Mr James Segan and Mr Hanif Mussa (instructed by the Office of Communications) appeared for the Respondent.

Miss Dinah Rose QC and Mr Tristan Jones (instructed by Olswang LLP) appeared for the Interveners.

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I. INTRODUCTION

1. On 14 October 2009, the Office of Communications ("OFCOM") issued a determination in respect of certain disputes between British Telecommunications plc ("BT") and various other communications providers regarding BT's charges for partial private circuits, otherwise known as "PPCs". These other communications providers are collectively described in this judgment as the "Altnets" and comprise:

   (1) Cable & Wireless UK ("Cable & Wireless");

   (2) Virgin Media Limited ("Virgin");

   (3) Global Crossing (UK) Telecommunications Limited ("Global Crossing");

   (4) Verizon UK Limited ("Verizon"); and

   (5) Colt Technology Services ("Colt").

2. There was a sixth communications provider in dispute with BT, THUS plc ("THUS"). THUS is now part of the Cable & Wireless group.

3. OFCOM's 14 October 2009 determination ("the Determination") is contained in a document entitled "Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and Colt and BT regarding BT's charges for partial private circuits". The Determination was made pursuant to OFCOM's power to resolve disputes under sections 185 to 191 of the Communications Act 2003 ("the Dispute Resolution Process").

4. The scope of the disputes that OFCOM accepted pursuant to the Dispute Resolution Process was described in the following terms in paragraph 2.44 of the Determination:

> "The finalised scope is therefore to determine whether, in the period from 24 June 2004 to 30 September 2008:
>
> i. BT has or will have overcharged the parties for PPCs (based on whether or not BT's charges for the underlying trunk and terminating elements of those PPCs were, during that time, reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed) and, if so;
>
> ii. by how much the [Altnets] have been overcharged; and
>
> iii. whether and by how much BT should reimburse the [Altnets]."

5. By its Determination, OFCOM determined that:

   (1) BT had overcharged the Altnets by £41.688 million in respect of 2 Mbit/s trunk services purchased by the Altnets from BT in the period 1 April 2005 to 30 September 2008: paragraph 8.94 of the Determination.

   (2) BT had not overcharged the Altnets for 2 Mbit/s trunk services in the period 24 June 2004 to 31 March 2005: paragraph 8.95 of the Determination.

   (3) BT should make repayments to the Altnets in the amounts by which they had been overcharged, with interest set at the Oftel Interest Rate: paragraphs 8.97 and 8.98 of the Determination.[1]

6. BT has appealed the Determination under section 192(2) of the Communications Act 2003 ("the 2003 Act"), this being an appealable decision under section 192(1)(a) of the 2003 Act. The Tribunal must dispose of this appeal in accordance with the provisions of section 195 of the 2003 Act.

7. By its Amended Notice of Appeal dated 6 January 2010 ("the Notice of Appeal"), BT challenged the Determination on a number of grounds. In essence, and putting it (for the moment) very broadly, these grounds were as follows:

   (1) First, OFCOM had misused the Dispute Resolution Process in determining the dispute between the Altnets and BT by way of this process.

   (2) Secondly, OFCOM had erred in law in its construction of the cost orientation obligation that was imposed on BT in 2004, alternatively OFCOM was obliged to apply the cost orientation obligation in a manner different from the true construction of this provision because OFCOM had engendered in BT an expectation regarding the manner in which the cost orientation obligation would be enforced. Either way, BT contended that

[1] OFCOM also examined in the Determination whether BT had overcharged for other PPC services. Paragraph 1.26 of the Determination summarises OFCOM's conclusion in relation to these other services: "We have concluded that BT did not overcharge for the remaining PPC services (i.e. all the 64kbit/s, 2Mbit/s and 34/45Mbit/s terminating services and 140/155Mbit/s trunk services) over the period of the Disputes as its charges did not exceed DSAC or only did so for one year of the five relevant financial years (with evidence that the accounting cost in that year may not have provided a true picture of underlying costs). The rates of return earned on these services were not sufficiently high to support a conclusion that overcharging had occurred."

OFCOM's conclusion in the Determination that BT had overcharged the Altnets was wrong.

(3) Thirdly, assuming OFCOM was correct in finding that there had been overcharging, OFCOM had misused its powers under section 190(2)(d) of the 2003 Act by ordering that the entire amount of the overcharge should be repaid by BT to the Altnets.

8. For its part, OFCOM denied that the Determination was impeachable on any of the grounds advanced by BT, for the reasons set out in its Defence of 31 March 2010 ("the Defence"). In this, OFCOM was supported by the Altnets in a Statement of Intervention dated 28 April 2010 ("the Statement of Intervention"), the Altnets having been given permission to intervene at a case management conference on 11 February 2010.

9. The appeal was heard between 20 October 2010 and 28 October 2010. The Tribunal had the benefit of extensive pleadings and written submissions by all parties, as well as oral opening and closing submissions. Between oral opening and closing submissions, the Tribunal heard evidence from six factual witnesses and three experts.

10. BT called four factual witnesses: Mr Richard Budd, Mr John Morden, Mr Edward Pigott and Mr James Tickel. Mr Budd, who is a senior regulatory economist employed by BT, gave evidence on 21 October 2010 (Day 2 of the hearing). Mr Morden, who is employed by BT as General Manager, Voice and Interoperability, in the Regulatory Affairs Division of BT Wholesale, gave evidence on 22 October 2010 (Day 3). Mr Pigott, the Head of Portfolio Analysis at BT Wholesale, also gave evidence on 22 October 2010, as did Mr Tickel, the Head of Operational Regulation and Economics in BT's Group Regulatory Affairs Department.

11. Additionally, BT made available for cross-examination Mr David Coulson, BT's Head of Regulatory Finance. Mr Coulson was not required to be called for cross-examination by either OFCOM or the Altnets (Transcript Day 1, page 2), and we accept the evidence contained in the witness statement adduced before us.

12. OFCOM called a single witness of fact, Mr Geoffrey Myers, Director of Competition Economics in OFCOM's Competition Group. Mr Myers gave evidence on 22 and 23 October 2010 (Days 3 and 4).

13. The Altnets also called a single factual witness, Mr Nicholas Harding, the Head of UK Regulatory Affairs at Cable & Wireless, who gave evidence on 23 October 2010 (Day 4). Additionally, the Altnets adduced witness statements from Mr Dougald Robinson (Vice-President, European Regulatory Affairs at Global Crossing), Mr Vikram Raval (Head of Regulation at Verizon), Mr Vito Morawetz (Director of Interconnect at Virgin) and Ms Ann Elizabeth Francis (Director of UK Regulatory Affairs at Colt). As with Mr Coulson, we have read their written evidence, and taken it into account.

14. The Tribunal heard from three experts. BT called Professor George Yarrow, who is (amongst other things) the Chairman of Regulatory Policy Institute at Oxford, Emeritus Fellow of Hertford College in the University of Oxford, and visiting professor at the Newcastle Business School. Professor Yarrow, who gave evidence on 25 and 26 October 2010 (Days 4 and 5), submitted a number of reports (one principal report and two supplementary reports), which had been co-authored by him and Dr. Christopher Decker, Research Director at the Regulatory Policy Institute at Oxford and an Associate Research Fellow at the Centre for Socio-Legal Studies in the University of Oxford. Dr. Decker himself did not give evidence, but Professor Yarrow was happy to speak to the entirety of the reports that had been submitted by him and Dr. Decker and, accordingly, we treat (and shall refer to) the evidence in these reports as that of Professor Yarrow alone.

15. OFCOM called Mr Christopher Bolt, presently the statutory arbiter for the London Underground Public-Private Partnership Agreements, and the provider of regulatory advice to a number of companies. Mr Bolt gave evidence on 26 October 2010 (Day 5). The Altnets called Mr Derek Ridyard, partner and co-founder of RBB Economics, a firm specialising in the economics of regulation. He, too, gave evidence on 26 October 2010 (Day 5).

16. Generally, all of the witnesses – factual and expert – did their best to assist the Tribunal in their evidence, and gave that evidence honestly and frankly and with

a high degree of expertise and competence. However, we felt that Professor Yarrow, whilst clearly an eminent and experienced economist, gave evidence that was tendentious, and we have borne that in mind when considering his evidence.

17. BT's challenges to the Determination, which have been summarised in paragraph 7 above, are considered in Sections VI to IX below. However, before these points can be considered in any detail, it is necessary to consider first a number of technical areas which form the essential background to this appeal. In particular, it is necessary to consider the nature of PPCs, how they are sold by BT and who buys them, as well as the regulatory regime that governs the provision and pricing of PPCs. It is also necessary to explore some of the economics that underlies regulation in this area. Finally, it is necessary to set out in some detail the relevant data relating to BT's charges for PPCs. These areas are considered in Sections II to V.

II. PARTIAL PRIVATE CIRCUITS

(i) The nature of partial private circuits

18. BT's "Product Handbook for Partial Private Circuits (PPC)" (the "Product Handbook") defines a Partial Private Circuit (or PPC) as a set of network components that a communications provider is able to buy from BT in order to provide a private circuit to a third party (the third party typically being a customer of the communications provider in question). The PPC routes from a point of handover between the communications provider's own network and BT's network, across the BT network to the third party, to supply a transmission path at the appropriate bandwidth. "PPC" is, therefore, a name that describes the network elements that are used to provide the connectivity between the point of handover and the third party: paragraph 2.1 of the Product Handbook. (We would observe that although the Product Handbook which we were provided with was Issue 4 dated 2010, and so post-dated this dispute, nothing turns on this for the purposes of this definition.)

19. A PPC thus enables a communications provider, if it so desires, to extend its network.

20. BT offers PPCs with a range of bandwidths – for example, 64 Kbit/s, 1 Mbit/s, 2 Mbit/s, 34 Mbit/s, 45 Mbit/s, 140 Mbit/s and 155 Mbit/s. As was noted in paragraph 5 above, the Determination relates to 2 Mbit/s PPCs.

21. The Tribunal was provided with a helpful explanation of BT's PPC product, and how that product was delivered, by Mr Morden. Unsurprisingly, given the nature of the PPC product, BT uses a number of different network components and elements to build a PPC. Although the circuit connects between the third party site and the point of handover, there are a number of possible intervening stages that may comprise that connectivity. Taking the circuit in stages, and beginning with the third party site and ending with the point of handover at which BT's PPC ends, and the communications provider's own network begins, these various stages may be described as follows:

    (1) *Connection at the third party site.* The third party site is connected to the PPC by equipment provided (at least in part) by BT.

    (2) *Connection of the third party site to a BT local exchange.* The third party site is then connected to one of BT's local exchanges. This connection is often referred to as the "local end". The local end between the third party site and the local exchange is usually provided using either copper cable or fibre optic cable depending on the circuit bandwidth ordered by the communications provider.

    (3) *Connection to a BT main exchange.* If the local exchange is *also* a BT main exchange, and that main exchange is the exchange at which the point of handover is located (ie the point where there is transition from BT's network to the communications provider's), then the PPC will be complete at this point. BT will provide equipment for terminating the PPC at the point of handover and enabling the communications provider to connect to the PPC. In practice, however, few PPCs will be so straightforward. Although a PPC will always have third party site equipment, a local end and equipment at the point of handover, there will typically be other elements involved:

        (i) In the first place, the local exchange to which the third party site is connected may not, itself, be a main exchange. If so, a terminating

segment will be required, connecting the local exchange to a main exchange.

(ii) Secondly, it may be that the communications provider does not wish to have the point of handover at that particular main exchange. The communications provider may well wish to have the point of handover at an altogether different main exchange. If so, a trunk segment will be required to enable the communications provider to terminate his PPC at a different main exchange.

22. The present case is concerned with two elements of a PPC, the terminating segment and the trunk segment. As was noted above, a PPC will always have third party site equipment, a local end and equipment at the point of handover. It will also include a main link if the communications provider chooses to interconnect at a main exchange which is not also the local exchange. If so, then this will require a terminating segment. A trunk segment will only be required if the communications provider wants his PPC to terminate at a different main exchange.

23. Theoretically, BT accepted, it was possible for a communications provider to purchase a trunk segment on its own, but in practice this had never happened. Indeed, it is difficult to see why a communications provider would want a trunk segment on its own, and it was BT's evidence (which was not gainsaid by anyone, and which we accept) that no communications provider had ever asked for, let alone purchased, a trunk segment on its own.

24. The converse situation could, however, arise. A communications provider, not wanting connectivity between two main exchanges, would only purchase a terminating segment, and no trunk segment.

25. From BT's point of view, the distinction between trunk and terminating segments is a regulatory one, not one arising out of how the PPC is provided by BT. In paragraph 12 of his witness statement, Mr Morden stated:

> "…trunk segments, certainly when supplied by BT, have never been treated as a separate product, merely one of the elements that make up the Main Link component of a PPC. In other words the industry views a PPC supplied by BT as a single end to end circuit and not the combination of separate individual products. Indeed the Main Link itself consists of elements which I believe Ofcom would regard as part of both a terminating segment and trunk segment."

26. It is, therefore, important to understand at the outset how trunk and terminating segments are defined in regulatory terms. The best source for such definitions is OFCOM's "Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets", published on 24 June 2004. We refer to this review as the "2004 LLMR Statement", "LLMR" standing for "leased lines market review". It is considered in detail below. As part of this review, in accordance with section 79(1)(a) of the 2003 Act, OFCOM identified certain markets, including markets concerning:

    (1) The provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including 8 Mbit/s within the United Kingdom but not including the Hull Area: Annex D of the 2004 LLMR Statement, paragraph 1(a), page 432.

    (2) The provision of traditional interface symmetric broadband origination with a bandwidth capacity above 8 Mbit/s and up to and including 155 Mbit/s within the United Kingdom but not including the Hull Area: Annex D of the 2004 LLMR Statement, paragraph 1(b), page 432.

    (3) The provision of wholesale trunk segments at all bandwidths within the United Kingdom: Annex D of the 2004 LLMR Statement, paragraph 1(d), page 432.

27. Of the markets identified in the preceding paragraph, the first two comprise terminating segments, whereas the third comprises trunk segments. The trunk segment comprises what are known as "Tier 1" nodes, which are connected by very high capacity line systems. At a very high level of abstraction, and ignoring such matters as the third party site equipment, the local end and equipment at the point of handover, it may fairly be said (as the parties themselves noted in the helpful glossary that they provided to the Tribunal) that "terminating segments are all PPC services excluding trunk".

(ii) Sale of PPCs by BT

28. As Mr Morden made clear in his witness statement, the various components comprising a PPC are charged for in different ways. Thus, third party site equipment provided by BT at the third party site is the subject of a one-off

charge, and the connection of that site to a BT local exchange is the subject of a "local end" fixed charge. For the purposes of this judgment, we are not concerned with the prices for anything other than the terminating and trunk segments.

29. Although BT published a wholesale catalogue setting out the various services provided by BT, and also price lists describing the prices of the individual components of a PPC, where a third party communications provider has specified and ordered a PPC from BT, the rental that would be charged to the communications providers would not provide a breakdown. The annual circuit rental would be calculated on a per kilometre charge based on the radial distance of the terminating and trunk segments comprising the circuit. In other words, the PPC is billed as a circuit.

30. The rental charges for terminating and trunk segments would be based upon a *notional* routing. This was explained in a report on "Economic Issues Related to the Assessment of BT's PPC Cost Orientation Obligations" by Mr Tim Keyworth dated 13 October 2008, which was referred to by Mr Morden. At paragraph 13, Mr Keyworth stated:

> "…Communications Providers buy PPCs, but these are divided into terminating and trunk segments to calculate charges. For this, a pricing algorithm is used. The calculation is based on a *notional* routing of a PPC and the fact is that any actual PPC may be routed by a different path altogether. I understand that this is to ensure that the price of the PPC does not depend on the way in which BT chooses to route the PPC. Indeed, it is quite possible that a "trunk service" will not use Tier 1 nodes at all, or be routed across Tier 1 network connections, although in terms of the regulatory classification trunk services are (currently) defined as those between Tier 1 nodes."

31. The same point was also made by Mr Piggott (Transcript Day 3, pages 13-14), where he noted in relation to voice services:

> "…we have a number of components which get combined together to form voice services. If we look at the individual components, very often they are combined together in different proportions to form services. So, for example, if you look at our local to tandem conveyance segment, that is the conveyance of traffic from a BT main switch or tandem switch to the local switch layer. The amount of transmission that is consumed depends on the nature of the switch to which the service is being provided. In some cases you have a tandem switch in the same building, it is a local switch, in which case no transmission is consumed at all, but in other areas the tandem switch will be in a building that is some distance away, perhaps up to 50 kms away and in that case the tandem switch, the local to tandem conveyance segment will consume 50 kms of transmission. Now, there may be some confusion in Mr Myers' statement that the components are always combined together in fixed proportions because we adopt in the pricing an average price which takes together all of the costs of the local to tandem conveyance across the network, and divides that by the total number of minutes. So what you have is very much a situation of the amount of the component that is used is dependent on the

> distance that that traffic travels from one part of the network to another – rather like in PPCs where you have the PPC distance related element of the main link dependent on the length of the circuit."

32. Although Mr Piggott referred to the possibility of confusion in Mr Myers' statement as to this point, we consider that there was not confusion, so much as two viewpoints, that of the seller of the PPC (BT) and that of the purchaser (another communications provider). Mr Myers accepted that the components used to provide a PPC would not be combined in fixed proportions (just as Mr Keyworth and Mr Piggott described: see Transcript Day 3, page 50). But, so far as the purchaser of the PPC was concerned, the price paid was based upon an average and so – as far as the purchaser was concerned – trunk and terminating segments would be combined in fixed proportions (Transcript Day 3, page 50):

> "In reality in any particular case, on any minute of interconnection, the actual routing may deviate from that average. So there is variation, if you like, on the supply side, from BT's point of view in how they actually route calls. However, from the point of view of the purchaser of the interconnection service it is a fixed proportion because they pay the same price for an interconnection service regardless of how BT actually routes the call, because they always pay according to the average usage factors."

(iii) The Altnets' use of, and need for, PPCs

33. Communications providers obviously have very different networks, and this was true of the Altnets. The Tribunal was provided with maps showing the core networks of each of the Altnets. Miss Dinah Rose QC for the Altnets summarised the position as follows (Transcript Day 2, pages 40-41):

> "…different communications providers have very different kinds of networks. For example, Virgin has a network which is a descendant of cable TV franchises. So it has a lot of cable running down individual streets near to particular homes and businesses, but the network is concentrated in particular urban areas where there were cable TV franchises. That means that there may be situations where Virgin does not need to buy PPCs because it can connect directly from its network to business premises. But if it is looking at businesses that have sites in areas where it does not have what used to be a cable TV franchise it may need to buy a long circuit including a lot of trunk because it does not have a network in that area... Cable & Wireless have an extensive national network but without the connections to individual businesses, so they would need to buy short partial private circuits largely consisting of terminating segments but much less trunk."

34. Figure 4.1 at page 32 of the Determination compares the relative spending patterns of the Altnets between 2004/2005 and 2007/2008, distinguishing between trunk and terminating segments. This table shows spend on terminating

segments varying between about 65% and 85%, with spend on trunk segments varying between about 15% and 35%.

35. The Altnets also produced at trial a table breaking down the PPCs purchased by the Altnets. Again, this showed considerable variation. Thus, the percentage of PPCs purchased with trunk ranged from 31% to 83%. Where trunk was purchased, the percentage of trunk with a radial distance exceeding 20km ranged from 13% to 40%.

36. In this context, it should also be noted that BT was itself a purchaser of PPCs. Although it is not necessary, for the purposes of this judgment, to describe in detail the corporate structure by which one part of BT provides PPCs to another part, it is uncontroversial that BT was a purchaser of PPCs, and that it purchased PPCs on a non-discriminatory basis – that is to say, on the same terms as external communications providers.

III. REGULATION OF PPCS

(i) Introduction

37. In 2002, Oftel was replaced by OFCOM as the UK regulator for the UK communications industries. OFCOM (and Oftel before it) was the UK's National Regulatory Authority or "NRA".

38. In 2003, the regulatory regime regarding telecommunications underwent a substantial, European Union driven, change. The UK implemented no less than five EU communications Directives (Directive 2002/21/EC ("the Framework Directive"), Directive 2002/19/EC ("the Access Directive"), Directive 2002/20/EC ("the Authorisation Directive"), Directive 2002/22/EC ("the Universal Service Directive") and Directive 2002/58/EC ("the Privacy Directive"). The first four of these directives were implemented in the UK by the 2003 Act.

39. One of the consequences of the new regime was an obligation on NRAs to carry out reviews of competition in communications markets to ensure that regulation remained appropriate in the light of changing market conditions. This process essentially involved a definition of the relevant market or markets; an assessment of competition in each market, and in particular whether any companies had significant market power (or "SMP") in a given market; and,

finally, an assessment of the appropriate regulatory obligations that should be imposed where there was a finding of SMP. Where SMP was found to exist, some form of regulation was obligatory.

40. A number of market reviews took place. One of these was a market review of leased lines initiated by OFCOM's predecessor, Oftel. This market review resulted in the publication by OFCOM of the 2004 LLMR Statement on 24 June 2004.

(ii) The 2004 LLMR Statement

41. The 2004 LLMR Statement, a detailed and lengthy analysis of relevant market definitions and SMP within the distinct markets, was significant for a number of reasons. In the first place, it is the source of the SMP Conditions that lie at the heart of the present dispute. Secondly, the 2004 LLMR Statement articulated the need for financial reporting obligations on BT, although these obligations were not finally specified until later on.

42. All the parties before us made reference to the 2004 LLMR Statement, so recognising its importance, although they drew differing conclusions from it. However, whatever conclusions one seeks to draw, we do not consider that it can reasonably be said that this document is an insignificant one in the context of these proceedings. In many respects, it is central to these proceedings.

43. We consider the 2004 LLMR Statement to be important both as the source of the SMP conditions that lie at the heart of the present dispute, and as the articulation of the need for financial reporting obligations on BT (even though these obligations were not finally specified until later on). It is appropriate to consider first the SMP conditions that were imposed, and then to consider the financial reporting obligations that were imposed on BT.

(iii) Imposition of SMP conditions

44. An "SMP condition" is a "significant market power condition": section 45(2)(b)(iv) of the 2003 Act. OFCOM's power to set conditions – including SMP conditions – is contained in section 45(1) of the 2003 Act. The procedure that must be followed, and the conditions that must be satisfied, before an SMP condition can be imposed are described in sections 78 to 93 of the 2003 Act.

Without setting out or citing the entirety of these provisions, the following points may be noted:

(1) Section 78(1) provides that "a person shall be taken to have significant market power in relation to a market if he enjoys a position which amounts to or is equivalent to dominance of the market".

(2) By virtue of section 79(1), before making a market power determination, OFCOM must identify (by reference, in particular, to area and locality) the markets which in their opinion are the ones which in the circumstances of the United Kingdom are the markets in relation to which it is appropriate to consider whether to make the determination and carry out an analysis of the identified markets. This, as is clear (for example) from section 80, is a consultative process.

(3) When, after this process is complete, OFCOM makes a determination that a person has significant market power in an identified market, it may impose such SMP conditions as are authorised by section 87 of the 2003 Act as it considers appropriate. Such conditions may include:

    (i) A condition requiring the dominant provider not to discriminate unduly against particular persons: section 87(6)(a).

    (ii) A condition requiring the dominant provider to publish all information as may be directed for the purpose of securing transparency in relation to such matters: section 87(6)(b).

    (iii) Conditions imposed pursuant to section 87(9). This section provides:

> "The SMP conditions authorised by this section also include (subject to section 88) conditions imposing on the dominant provider –
>
> (a) such price controls as OFCOM may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities;
>
> (b) such rules as they may make in relation to those matters about the recovery of costs and cost orientation;
>
> (c) such rules as they may make for those purposes about the use of cost accounting systems; and
>
> (d) obligations to adjust prices in accordance with such directions given by OFCOM as they may consider appropriate."

(4) Section 88 contains additional requirements that have to be satisfied where conditions are imposed pursuant to section 87(9). This section provides:

> "(1) OFCOM are not to set an SMP condition falling within section 87(9) except where –
>
> (a) it appears to them from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion; and
>
> (b) it also appears that the setting of the condition is appropriate for the purposes of –
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> (i) promoting efficiency;
>
> (ii) promoting sustainable competition;
>
> (iii) conferring the greatest possible benefits on the end-users of public electronic communications services.
>
> (2) In setting an SMP condition falling within section 87(9) OFCOM must take account of the extent of the investment in the matters to which the condition relates of the person to whom it is to apply.
>
> (3) For the purposes of this section there is a relevant risk of adverse effects arising from price distortion if the dominant provider might –
>
> (a) so fix and maintain some or all of his prices at an excessively high level, or
>
> (b) so impose a price squeeze,
>
> as to have adverse consequences for end-users of public electronic communications services."

45. In the 2004 LLMR Statement, OFCOM concluded (under section 79 of the 2003 Act) that BT held SMP in a number of markets, including the three markets described in paragraph 26 above: Annex D of the 2004 LLMR Statement, paragraphs 1(d) and 2, pages 432-433. As a result, OFCOM "in accordance with section 48(1) of the Act and section 79 of the Act hereby set pursuant to section 45 of the Act the SMP services conditions on [BT] as set out in Schedules 1 and 2 respectively to this Notification to take effect, unless otherwise stated in those Schedules on the date of publication of this Notification": Annex D of the 2004 LLMR Statement, paragraph 3, pages 433.

46. The SMP services conditions applicable in the case of the provision of trunk segments are set out in Schedule 1 to Annex D (pages 435ff of the 2004 LLMR Statement) and take effect as "Conditions H": pages 476ff of the 2004 LLMR Statement. SMP services conditions were also made in the case of terminating segments up to and including 8 Mbit/s. These take effect as "Conditions G":

pages 435ff of the 2004 LLMR Statement). Copies of the relevant parts of these SMP conditions are appended hereto as Annex A.

47. These SMP conditions are considered in greater detail below, but they included:

    (1) A cost orientation obligation in relation to terminating segments: Condition G3.1 (page 439 of the 2004 LLMR Statement).

    (2) Charge control in relation to terminating segments: Condition G4.3 (page 440 of the 2004 LLMR Statement).

    (3) A cost orientation obligation in relation to trunk segments: Condition H3.1 (page 480 of the 2004 LLMR Statement).

48. The substance of the cost orientation obligation in Condition G3.1 and Condition H3.1 was an obligation on the "Dominant Provider" (for present purposes, BT) to secure and to be able to demonstrate to the satisfaction of OFCOM that each and every charge offered, payable or proposed for Network Access covered by the condition in question was reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs and an appropriate return on capital employed.

49. It will be necessary to consider in some detail the meaning and nature of, in particular, Condition H3.1, which is the cost orientation obligation which OFCOM determined BT had breached.

50. The charge control imposed by Condition G4.3 provides that BT "shall charge no more than the amounts set out in Annex A to this Schedule for each of the products set out in that Annex".

51. It is common ground that BT did not seek to appeal against the 2004 LLMR Statement, as it could have done.

(iv) Imposition of financial reporting obligations

52. In addition to imposing SMP conditions, the 2004 LLMR Statement also considered (in Chapter 10, entitled "Cost accounting and accounting separation conditions") the imposition of additional cost accounting and accounting separation conditions. Chapter 10 stated:

> "10.1 This chapter discusses the financial reporting obligations that may be imposed on BT..., to ensure that a number of the obligations set out in Chapters 5 to 9 are met. In particular, obligations of cost orientation, price controls and non discrimination can require the imposition of financial reporting regimes to monitor dominant providers' compliance with these obligations...
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> ...
>
> 10.10 Given the imposition of LRIC with an appropriate mark-up for the recovery of common costs on...BT..., and a charge control for BT, Ofcom is proposing that BT...should maintain appropriate cost accounting systems, that demonstrate that the obligations of cost orientation and...the charge control are being met. This will enable Ofcom to monitor compliance with those obligations.
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> ...
>
> 10.13 In order to demonstrate cost orientation of a service or product, it is necessary for the dominant provider to establish cost accounting systems that capture, identify, value and attribute relevant costs to its services and products in accordance with agreed regulatory accounting principles, such as cost causality. A key part of this process is the stage which identifies those parts of the underlying activities or elements that directly support or are consumed by those services or products. These elements are referred to as network components. As these components are frequently used to provide more than one product or service, it is also necessary to determine how much of each component is used for each service or product that should be cost-orientated. The service/product costing methodology applies the utilisation of these components (which are characterised by common usage measures) to the appropriate service product."

53. The 2004 LLMR Statement only decided in principle that financial reporting obligations should be imposed on BT. The nature of these obligations were themselves subject to a consultation process. On 22 July 2004, OFCOM published a final statement and notification entitled "The regulatory financial reporting obligations on BT and Kingston Communications final statement and notification". We shall refer to this document as the "Financial Reporting Notification".

54. The Financial Reporting Notification imposed a number of conditions on BT:

    (1) Condition OA2, giving OFCOM the power to make directions under the conditions.

    (2) Condition OA5, obliging BT, on an annual basis, to prepare regulatory financial statements, secure an audit opinion on them, deliver the regulatory financial statements to OFCOM and publish the regulatory financial statements.

    (3) Condition OA26, obliging BT to identify and describe wholesale services, wholesale activities and network services in a Wholesale Catalogue.

55. Pursuant to Condition OA2, OFCOM published "Direction 3 for BT: Preparation, audit, delivery and publication of Regulatory Financial Statements" (page 88 of the Financial Reporting Notification). Direction 3 directed that BT "shall, for the purposes of condition OA5 and as appropriate, prepare, secure an appropriate audit opinion in respect of, deliver to OFCOM and publish the Regulatory Financial Statements in accordance with Annexes A, B and C to this Direction" (page 89 of the Financial Reporting Notification). Annex A required the production of various financial statements, including "SoCC Ext", which was a "statement of costs and charges for wholesale service supplied in the market, other than those which are only Internal Wholesale Services (as set out in annex 34)" (page 91 of the Financial Reporting Notification).

(v) BT's 2 September 2005 "Primary Accounting Documents"

56. On 2 September 2005, BT issued a document entitled "Primary Accounting Documents". In its introduction, the Primary Accounting Documents described the regulatory regime that had prevailed in the UK since 2003, and listed the various market reviews that had taken place, including the 2004 LLMR Statement. The introduction went on to state (at page *ii*) that "[a]s a result of the above market reviews, Ofcom has deemed that BT has Significant Market Power (SMP) in the following separately identified markets". Thereafter, some 29 markets were listed (on pages *(iii)* and *(iv)*) including the three described in paragraph 26 above (which appear as items 10, 11 and 13 in the list on page *(iii)*).

57. The introduction went on to note (at page *iv*) that "[a] requirement for regulatory financial reporting has been imposed on BT for those SMP Markets…where it is deemed a necessary remedy". These requirements were then summarised, including a summary of the effect of the Financial Reporting Notification. In particular, the introduction noted (at page *v*):

> "BT's regulatory financial reporting obligations are *ex ante* obligations that will be imposed under Communications Act Sections 87(9) to 81(11) *[sic]* for wholesale cost accounting, 91(5) and 91(6) for retail cost accounting and 87(7) and 87(8) for accounting separation. The regulatory financial reporting obligations are being imposed by Ofcom to monitor and enforce other *ex ante* obligations, eg for cost orientation, cost recovery, price controls and no undue discrimination. Regulatory financial reporting requires BT to demonstrate compliance with these obligations in certain SMP markets.
>
> These cost accounting and accounting separation requirements are detailed in the final statement and notification in 'the regulatory financial reporting obligations on BT and

> Kingston Communications', which was published on 22 July 2004 as amended by the Final Statement and Notification entitled "Changes to BT's regulatory financial reporting framework" issued by Ofcom on 31 August 2005 (together "the Final Statement and Notification")."

58. According to the introduction, the purpose of the Primary Accounting Documents was to set out the framework under which BT's regulatory financial statements were to be prepared (page *vii*).

(vi) Regulatory financial statements published by BT

59. We have considered the manner in which BT reported the costs of the individual PPC components in its regulatory financial statements for each financial year from the year ended 31 March 2003 onwards.

60. The regulatory financial statements published by BT in each year contained detailed tables stating BT's costs and charges for its wholesale services. In respect of each component of the relevant wholesale service, BT reported four figures: (i) the DLRIC "floor"; (ii) FAC; (iii) the DSAC "ceiling"; and (iv) the average charge levied by BT in the relevant year. We consider the meaning of the terms "DLRIC", "FAC" and "DSAC" in paragraphs 91 to 98 below.

61. BT drew attention to a change in approach as between the regulatory financial statements for the financial years ended 31 March 2003 and 31 March 2004, and those for the financial year ended 31 March 2005 (ie the financial year subsequent to the publication of the Financial Reporting Notification on 22 July 2004). Whereas, in the two earlier years, BT had provided details of the individual component floors and ceilings for trunk segments at each bandwidth (ie 2 Mbit/s, 34 Mbit/s, 140/155 MBit/s, etc.), it did not provide this level of granularity in the financial year ended 31 March 2005, referring simply to "wholesale trunk segment services" and providing a single set of costs and charges in respect of trunk segments of all bandwidths.

62. BT submitted that this was indicative of an understanding within BT, in the wake of the 2004 Financial Reporting Notification, that it was not required to satisfy a "first order" cost/price test, by reference to DSAC ceilings, in respect of each individual trunk segment component.

63. Miss Rose, for the Altnets, pointed out that the regulatory financial statements for the financial year ended 31 March 2006 reverted to the previous practice, namely to identify floors and ceilings in respect of trunk segments at different bandwidths, and thus it appeared to be clear to BT from that point onwards that it was necessary to identify separately the costs and charges for each of the services within the regulated wholesale market for trunk segments. It was not in dispute that in each financial year since the year ended 31 March 2006, wholesale trunk segments at individual bandwidths were identified as separate services available for purchase.

64. We consider the significance of BT's regulatory financial statements in the course of the judgment.

IV. THE ECONOMICS OF COST ORIENTATION

(i) Introduction

65. Condition H3.1 requires that prices charged be "reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed" (as does the similarly worded Condition G3.1).

66. Breaking this down, these conditions require that the prices charged by BT:

    (1) Be reasonably derived from the costs of provision based on a forward looking long run incremental cost approach.

    (2) Allow for an appropriate mark up for the recovery of common costs.

    (3) Include an appropriate return on capital employed.

67. There are number of economic concepts buried in these conditions, which need to be grasped before the conditions can be properly understood. These are concepts that are helpfully explained not only in the witness statements and expert reports that the Tribunal received in evidence, but also in such documents as BT's Primary Accounting Documents (in particular, Section 5) and the Determination itself (in particular Annex 11).[2]

[2] In both the Determination and in the witness statement of Mr Myers, certain cost concepts were illustrated by reference to a simple example of an ice cream van selling various products.

(ii) "Reasonably derived from the costs of provision based on a forward looking long run incremental cost approach"

(a) Incremental cost

68. Incremental cost is the cost of producing a specified additional product, service, or increment of output over a specified period of time. The incremental costs of a product are those costs which are directly caused by the provision of that product in addition to the other products which a firm may also produce.

69. In other words, the incremental cost of a product is the difference between the total cost in a situation where the product is not provided and the total cost in another situation where the product is provided.

(b) Long run incremental cost

70. Costs can be fixed or variable. Fixed costs are those costs that remain the same irrespective of activity levels of the firm, whereas variable costs are those costs that vary directly with the level of output. When considering which costs are fixed and which are variable, the time period is key. In the short-run, some costs (particularly capital costs) are fixed. The shorter the time period considered, the more costs are likely to be fixed. But in the long run, all costs are variable.

71. Long run incremental costs – or "LRIC" – is a forward-looking approach to costing that values assets on the basis of the cost of replacing or providing them today. In other words, LRIC treats all costs as variable, and simply looks to the cost of replacement or provision in assessing cost.

(c) Common costs and stand-alone cost

72. The LRIC of a product can be contrasted with the stand-alone cost of a product. The stand-alone cost (or "SAC") of a product is the cost of providing an increment of that particular product on its own, including all "common costs" which would necessarily be incurred in a single product firm but which in practice are shared with other products in a multi-product firm.

73. Common costs are those which arise from the provision of a group of products, but which are not incremental to the provision of any individual product. If the

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At Annex B, we have drawn upon (and adapted) the same example by way of illustration of the cost concepts described in the following paragraphs of this judgment.

incremental costs of each product are removed from the total cost of providing all products, what are left are the common costs. The stand-alone cost of a product is the sum of the incremental cost of the product, plus all the costs which are common between that product and other products. The stand-alone cost is therefore higher than the incremental cost.

74. Where a firm prices in such a way as to cover only the incremental costs of the product (ie the product's LRIC), sales of that product make no contribution to the firm's common costs.

75. On the other hand, where a firm prices one of its products at SAC, then if the firm were to charge more than LRIC for any of the other products, it would over-recover its common costs, and so earn profits in excess of its cost of capital.

(d) Contestable market theory

76. The costs measures considered above are important in the context of the contestable market theory, articulated in 1982 by Baumol, Panzar and Willig.[3]

77. A contestable market is one in which the complete absence of barriers to entry means that incumbent firms, even if they are monopolists, are constrained to price no higher than cost by the threat of entry of rival firms. The highest price that a multi-product firm can charge for any individual product or service in a contestable market is given by the *efficient* SAC of that good or service.

78. The relevant touchstone is the *efficient* SAC because, if the incumbent firm is inefficient, then even if it prices at below its (inefficient) SAC, the price charged may nevertheless be sufficiently high to attract some other competitor. A price above the level of the efficient SAC will attract entry by a single product firm, because it will be able to make a profit in this market (assuming, as the theory does, no barriers to entry). Competition between the firms would then bring the market price down to the level of efficient SAC.

79. Matters become more complex when the fact that firms will often sell many products or services, sharing common costs, is taken into account. For prices to be sustainable in a contestable market, it is then not enough for each individual

[3] Baumol, Panzar and Willig *Contestable Markets and the Theory of Industry Structure* (Harcourt Brace Jovanovich, 1982)

price to be at or below its SAC, but for each and every combination of services also to be below the efficient SAC for the combination. If this is not the case, while entry to supply only the individual products is not profitable, it may be profitable for firms selling groups or combinations of products with shared common costs.

(e) The problem of common costs

80. Of course, the theory of contestable markets is just that – a theory – and electronic communications is far from being a contestable market. SAC does, however, give a measure of what a competitive outcome would be in the absence of barriers to entry. As such, it is used as a test for identifying prices that are excessive. In the case of a single product firm, a price significantly and persistently above SAC is to be regarded as excessive and unreasonable.

81. A problem arises in the case of multi-product firms, where it is possible to price an individual product well below SAC, whilst nevertheless over-recovering common costs.

82. Some method of ensuring that common costs are recovered – but not over-recovered – is clearly essential. This was recognised by OFCOM in paragraph A11.6 of Annex 11 of the Determination:

> "Because of the existence of significant common costs between BT's activities, BT will only recover costs overall if at least some of its charges are above LRIC. However, there may be many different ways of attributing these common costs to different services, none of which may be uniquely correct or uniquely reasonable. The maximum proportion of these common costs which it is reasonable for BT to recover from any given service is generally given by SAC, which includes all (relevant) common costs."

83. In short, whilst it is obvious that if a multi-product firm prices at LRIC it will make a loss (because there will be no recovery of common costs), and if it prices at SAC it will make an unreasonable profit (because there will be *multiple* recovery of common costs), it is much less obvious how common costs are to be treated.

84. Condition H3.1 simply states that prices should "[a]llow for an appropriate mark up for the recovery of common costs". The wording of Condition G3.1 is similar. The question, not answered in these conditions, is what is "an appropriate mark up for the recovery of common costs"?

(ii) "An appropriate mark up for the recovery of common costs"

85. There are a number of ways in which common costs can be allocated so as to identify whether a firm is over-recovering in relation to its common costs. Three were considered before the Tribunal:

(1) Combinatorial tests.

(2) Fully allocated cost.

(3) Distributed stand alone cost.

86. As the Determination noted, in the quotation in paragraph 82 above, none of these approaches can be said to be uniquely correct or uniquely reasonable. In paragraph 46 of his first report, Professor Yarrow quoted another professor, Professor Hausman:

> "[A]llocations such as fully allocated cost, equal allocation of cost and so on are inherently arbitrary. Nevertheless, the results of such allocations have very important consequences for regulated prices. These regulated prices in turn have important effects on competition, economic efficiency and consumer welfare."

87. This is a perfectly fair statement provided the term "arbitrary" is appropriately qualified. Mr Ridyard made this point in his evidence to the Tribunal (Transcript Day 5, page 56):

> "This term "arbitrary", I would like to explore what that means. I certainly agree, and I think it's absolutely clear, that there is no one single correct answer to how you allocate common costs. It requires some sort of mechanistic decision rule in order to allocate common costs across individual products. There is no single correct answer as to how you do that. So in that sense it's arbitrary, in the sense that someone, somewhere, has had to exercise some judgment to devise that rule. Whether it's arbitrary, in the sense of being unpredictable or capricious or a pejorative notion of arbitrary, I think depends on the facts of the case."

88. We consider each of these three methods in turn below.

(a) Combinatorial tests

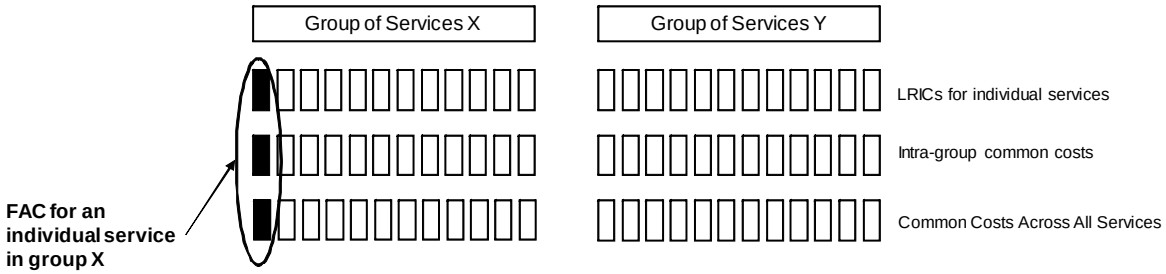
89. One way of assessing whether a particular charge for a particular product might be regarded as excessive or not, is to consider whether the prices for different combinations of products lie between the LRIC and SAC of those combinations. Where all the different combinations satisfy this test, there is no over-recovery of common costs.

90. A problem with this approach, however, is that depending upon the size of the product portfolio of the firm, and the types of common costs, the number of combinatorial tests could be impracticably high.

(b) Fully allocated cost

91. Fully allocated cost is an accounting concept designed to ensure that all of a firm's costs (both incremental and common) are attributed to its activities. All costs – whether incremental or common – are distributed amongst a firm's various products according to a particular formula. As such, if a firm sets its charges equal to unit FAC, all things being equal, it would be expected to recover (but not over-recover) all its costs, including all of its common costs. These costs typically also include an allowance for a return on capital.

92. In his statement, Mr Myers included (in Annex 1) a diagram illustrating the concept of FAC as follows:



93. There are numerous methodologies for generating FAC estimates. Typically, firms use some form of activity-based costing, which involves allocating all costs (both incremental and common) to individual activities and products. Other approaches can involve simply allocating common costs to products in line with the incremental or variable costs incurred.

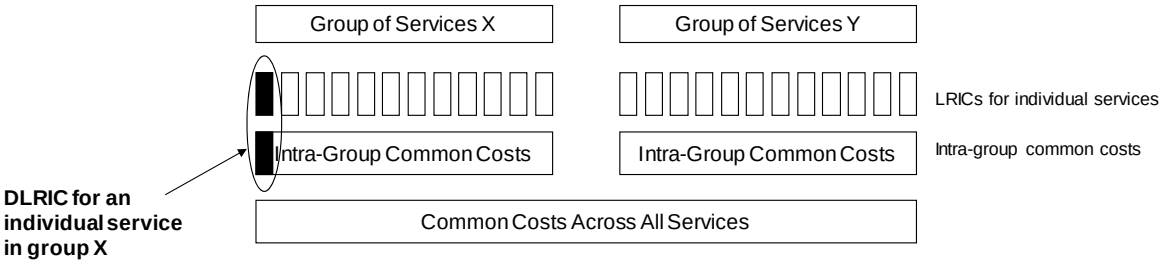
94. As FAC involves allocating all the firm's common costs across all products, the costs for individual products would normally be above LRIC and below SAC. However, the FAC approach allows no flexibility in terms of pricing – common costs are allocated according to a formula.

(c) Distributed stand alone cost

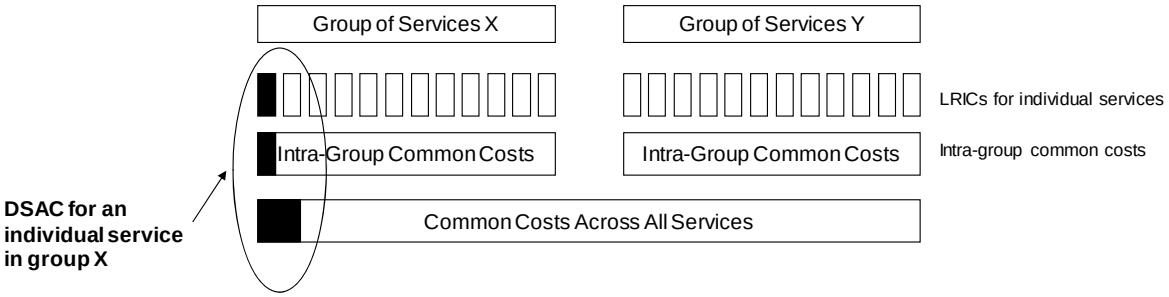
95. Distributed stand alone cost ("DSAC") and distributed long run incremental cost ("DLRIC") are related concepts. They are both based upon what Mr Myers

termed (in paragraph 25 of his statement) "broad increments" in the products or services sold by any one firm, much wider than any individual product or service. LRIC and SAC are then calculated by reference to that broad increment.

96. Again, Mr Myers helpfully illustrated these diagrammatically (although in this case, he was reproducing diagrams that had appeared in the Determination). DLRIC may be illustrated as follows:



97. DSAC may be illustrated as follows:



98. The DLRIC of each product or service within the broad increment is thus its LRIC plus a share of the fixed common costs of that increment. Its DSAC equals its DLRIC plus a share of common costs across all increments (in the case of BT determined by the equiproportionality principle).

(iii) "An appropriate return on capital employed"

99. The final element in Conditions H3.1 (and G3.1) requires "an appropriate return on capital employed". The return on capital employed is calculated according to the following formula (set out in footnote 180 of the Determination), which was uncontroversial:

$$\text{ROCE} = \frac{\text{Revenue} - \text{Adjusted cost (excluding the cost of capital)}}{\text{Adjusted mean capital employed}}$$

100. It was also uncontroversial that an appropriate return on capital employed was of the order of 12%.

V. THE RELEVANT DATA REGARDING PRICING

(i) Introduction

101. We are conscious that, in setting out the relevant data regarding BT's pricing for PPCs, before articulating, still less determining, the matters in dispute between BT and OFCOM, we are in one sense putting the cart before the horse: precisely which data *is* relevant depends upon the resolution of the issues in dispute.

102. Nevertheless, because a great deal of what was said in evidence and in argument before us was based upon the pricing data, it is necessary for this pricing data to be considered now. This Section considers first the accounting model used by BT in order to produce this data, and the data that was produced by BT using this model. It then goes on to consider the data that OFCOM used, in the Determination, to justify its conclusion that BT had overcharged the Altnets in respect of 2 Mbit/s trunk services purchased by the Altnets from BT in the period 1 April 2005 to 30 September 2008. Finally, we consider the data relied upon by BT to controvert OFCOM's conclusion.

(ii) BT's cost accounting model and the data produced by BT

(a) The model

103. BT's long run incremental cost methodology is described in Section 5 of its Primary Accounting Documents. In particular, this Section states:

(1) In Section 5.1 (under "Introduction"):

> "BT is required to prepare statements of **Long Run Incremental Costs** (LRIC). These statements are prepared annually and form a part of the Current Cost Regulatory Financial Statements.
>
> The LRIC Model: Relationships & Parameters (R&P) should provide an appropriate method of implementing the principles contained within the Accounting Documents. The R&P describes in detail how BT has applied the principles contained within the LRIC Methodology section of the Accounting Documents to construct cost volume relationships and to calculate LRICs."

(2) At page 48, it is noted that BT's LRIC methodology is applied only to network component costs and is reported only for activities within wholesale markets.

(3) In Section 5.2.2 (under "Cost Convention"), it is noted:

> "It is possible to carry out LRIC calculations on either a "bottom up" or a "top down" basis. A "bottom up" approach requires assumptions on how an efficient operator would be structured and what type of costs this would lead to. A "top down" basis takes actual costs and applies a LRIC methodology.
>
> A "top down" LRIC model is used taking actual reported costs to calculate the LRICs. The cost data is obtained from the CCA AS system, which uses the Financial Capital Maintenance convention."

During the course of argument, BT suggested that one of the reasons that DSAC was an inappropriate test for cost orientation was because is was not calculated on the basis of *efficient* cost, but rather on the basis of *actual* cost. As we have noted in paragraphs 77 and 78 above, contestable market theory is based upon *efficient* SAC. In theory, there is no reason why DSAC cannot be calculated by reference to efficient costs. However, as this section of the Primary Accounting Documents notes, BT in fact carried out its calculations on a "top down" basis (ie by reference to actual costs). Inevitably, this meant that DLRIC and DSAC were also computed on this basis.

(4) BT's "Inland Network Model" is described in Section 5.3.1 (under "Increments"):

> "The diagram in Figure 5.3.1 below shows the increments that are to be modelled. The boxes above the dotted line represent the main increments to be measured. The circles represent where those main increments are analysed further into smaller increments. The shaded boxes below the dotted line represent the areas where fixed common costs exist across increments. The shaded boxes are shown spanning the increments to which they relate.

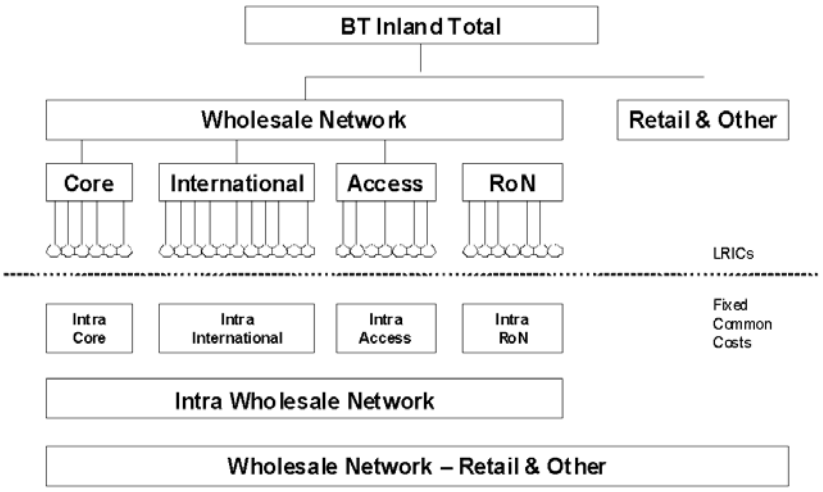


Diagram 5.3.1 Increments to be modelled"

(5) Within this model, partial private circuits are contained within the "Core" increment.

104. As was noted in paragraph A11.15 of Annex 11 of the Determination, this model was used not only for calculating LRIC, but also (amongst other things) DLRIC and DSAC. DLRIC and DSAC were also considered in Section 5 of BT's Primary Accounting Documents:

(1) Section 5.3.3 (under "Network Components, Combinatorial Tests and DLRICs") states:

> "The LRIC methodology can be applied to any increment. Thus it is possible to calculate the LRICs of the network components comprising Core as well as the LRIC of the Core increment itself. In the same way, the LRIC of services could be calculated if the services themselves are defined as an increment.
>
> The sum of the LRICs of network components will be smaller than the LRIC of an increment made up of these components in aggregate because of the existence of fixed common costs. Thus if all components within Core were priced to equal or exceed their LRICs it would not guarantee that the aggregate revenue was equal to or exceeded the LRIC of Core. This requires the fixed common costs to be included somewhere in the prices of the components. In principle the fixed common costs can be recovered from any component provided that in aggregate they are recovered.
>
> A way of ensuring that fixed common costs are recovered in the revenues is to conduct combinatorial tests whereby the aggregate revenue of services straddling the fixed common costs are required to equal or exceed the LRIC of these services measured as a single increment.
>
> Combinatorial tests have not been specified in the case of the Core increment. Instead, the recovery of the Intra Core Fixed Common Costs has been prescribed by Ofcom through the use of distributed LRICs ("DLRICs") in determining cost floors. This restricts pricing flexibility by settling a price floor for components in excess of the actual LRICs. Ofcom uses this restriction in order to avoid complex combinatorial tests."

(2) Section 5.3.5 (under "Distributed Stand Alone Cost (DSACs) of Network Components"):

> "A similar approach is taken with Stand Alone Costs in order to derive ceilings for individual components. The economic test for an unduly high price is that each service should be priced below its Stand Alone Cost. As with price floors this principle also applies to combinations of services. Complex combinatorial tests are avoided through the use of DSACs, which reduce pricing freedom by lowering the maximum price that can be charged. This results in ceilings for individual components that are below their actual SACs."

(b) The data produced

105. On 25 June 2008, Cable & Wireless, THUS, Global Crossing and Virgin submitted disputes to OFCOM regarding BT's PPC charges. COLT submitted a similarly worded dispute on 20 October 2008. In all, it was alleged by the Altnets that they had been overcharged by BT by some £180m. This calculation was obviously based upon the financial statements that had been published to date by BT.

106. On 25 July 2008, OFCOM decided that it was appropriate to resolve the disputes that had been submitted to it by Cable & Wireless, THUS, Global Crossing and Virgin. (A similar conclusion was reached on 2 December 2008 as regards the COLT dispute.)

107. In June 2008, at about the time that the Cable & Wireless, THUS, Global Crossing and Virgin disputes were being referred to OFCOM, BT advised OFCOM that it intended to re-state certain PPC data within its financial statements for 2006/2007. The reason for this was that BT had overstated the volume of internal PPCs sold and the revenue attributable to those services. BT corrected its methodology when preparing its 2007/2008 regulatory financial statements and published re-stated data in September 2008 (correcting it again in April 2009). BT did not publish restated financial statements for 2004/2005 or 2005/2006, although it confirmed to OFCOM that certain of the PPC data contained in these statements had also been inappropriately prepared.

108. OFCOM therefore used its powers under section 191 of the 2003 Act to request that BT provide internal and external revenue and volume data for each PPC service, and to calculate the respective DLRICs, FACs and DSACs for these services. BT was required to prepare and provide this data for each of the years in dispute (2004/2005 to 2007/2008) on the same basis as the 2007/2008 regulatory financial statements. BT provided this data to OFCOM in October and November 2008, and it was this data that was used in order to assess whether BT had been overcharging for PPC services.

109. Thus:

    (1) Data for the year 2006/2007 was published with BT's 2007/2008 regulatory financial statements.

(2) Data for 2006/2007 and 2007/2008, as well as all previous years going back to 2004/2005, was obtained by OFCOM pursuant to its section 191 powers.

110. A draft determination, using this data, was published by OFCOM on 27 April 2009.

111. BT's 2008/2009 regulatory financial statements were published on 18 August 2009. This data, once available, was also used and considered by OFCOM.

112. Although the 2006/2007 and 2007/2008 data had been audited by PricewaterhouseCoopers, OFCOM nevertheless itself commissioned consultants Analysys Mason to carry out an independent review of the restatement and supporting systems and processes that were used to prepare the restatement. Analysys Mason concluded its review on 25 November 2008. OFCOM concluded, in paragraph 6.19 of the Determination, that "[w]e are therefore satisfied that the 2007/2008 regulatory financial statements (along with the amended unit costs published by BT on 9 April 2009) provides the best available PPC information for 2006/2007 and 2007/2008."

113. For years prior to 2006/2007 (ie 2004/2005 and 2005/2006), OFCOM required BT to reconcile the data back to the published accounts, and reviewed the reconciliations. OFCOM accepted the revised data, concluding (in paragraph 6.23 of the Determination) that this data "constitutes the best available information in relation to 2004/2005 and 2005/2006" for the purpose of resolving the disputes.

(c) Adjustments to BT's data

114. OFCOM also considered making, and did in fact make, a number of adjustments to BT's base data. It is not necessary, in this judgment, to consider these adjustments in detail. They are described in paragraphs 6.58 to 6.179 of the Determination. The adjustments made to the data by OFCOM resulted in adjustments to the calculations for, amongst other things, FAC and DSAC.

115. These adjustments were made between the April 2009 draft determination and the Determination, which was published in October 2009. They were justified by OFCOM in the following terms paragraph 5.81 of the Determination:

> "The adjustments made by Ofcom to BT's regulatory accounting information…are necessary to ensure that we use the best available information at the time to resolve the Disputes. We did not undertake substantial new investigations into the validity and accuracy of BT regulatory accounts for the purposes of resolving these Disputes. Rather, we sought to reflect the adjustments that had previously been identified as part of the work leading up to the 2009 LLCC Statement [ie the 2009 Leased Line Charge Control Statement] and/or were identified in the Altnet Dispute Submission."

116. OFCOM considered that the adjustments could not be ignored "as they have a material impact on the outcome of our analysis" (paragraph 5.82 of the Determination).

117. Mr Coulson, who (as we have noted) was not required to be called for cross-examination by either OFCOM or the Altnets, took issue with this in his witness statement:

> "24. The total impact on the value of the repayment from BT of all of the adjustments on each year is relatively small: in 04/05 it is close to zero, in 05/06 it is £0.2m, in 06/07 it is £1.7m and in 07/08 it is £1.6m.
>
> 25. In the Final Determination, at paragraphs 5.81 to 5.82, Ofcom explains that these adjustments were warranted since they were made as part of the work on the Leased Line Charge Control ("LLCC") Statement and it could not ignore "these inaccuracies" because of their "material impact". This is highly surprising and I believe wrong because: (i) it implies that some inaccurate data has been replaced by some accurate data, which is almost certainly not the case since almost all of Ofcom's adjustments contain an element of judgment or assumption; and (ii) the adjustments for the LLCC were made with the specific purpose of creating a forecast model to set future prices across a whole range of services. It does not automatically follow that these adjustments are appropriate to, or have some materiality on, the retrospective data for resolving the PPC disputes. Finally, it is hard to see how Ofcom can consider the impact of these adjustments as having a material impact when in absolute terms the impact is clearly small relative to the total amount that Ofcom found to be overcharged."

118. In the ordinary course, it might be hoped that the relevant data (if not its significance) could be agreed. What OFCOM refer to as the "BT base data" clearly is now agreed, and we refer to it below. The need for the adjustments to that base data is obviously still controversial, albeit that (no doubt because the changes were marginal) this formed no ground of appeal on BT's part.

119. Nevertheless, the history of the data is relevant for two reasons:

(1) In the first place, it contributed significantly to the length of the Dispute Resolution Process in this case. The disputes of all Altnets except for COLT were accepted by OFCOM in July 2008, but a draft determination was only published in April 2009, and the Determination itself not until October 2009. The process thus took a period of about 15 months, when ordinarily (according to section 188(5) of the 2003 Act) it should be complete within 4 months. This, as we consider further below, was a point relied upon by BT in support of its contention that OFCOM had misused the Dispute Resolution Process in this case.

(2) Secondly, when considering the pricing data, although we place primary reliance on the BT base data as adjusted by OFCOM (there being no appeal against this aspect of the Determination), we do keep in mind the unadjusted BT base data also. In the following paragraphs, we shall therefore refer to "adjusted" and "unadjusted" BT base data.

(iii) Data relied upon by OFCOM

120. OFCOM looked at the PPC services provided by BT on a disaggregated basis. That is to say, it considered charges for terminating services separately from charges for trunk services. As paragraph 1.19 of the Determination notes, "[w]e have concluded that it is appropriate for us to consider BT's PPC charges on a disaggregated basis, meaning that we considered the charges for individual terminating segment services separately from those for individual trunk services".

121. As regards the charges for trunk segments, OFCOM considered separately the charges for individual trunk services. In other words, it differentiated between bandwidth. As has been noted, the Determination was in relation to charges for 2 Mbit/s trunk services.

122. The correctness of this disaggregated approach is one of the key points in this appeal, and it obviously informed OFCOM's approach in terms of which data OFCOM considered relevant, and which data it considered irrelevant.

123. Having ascertained the relevant data, OFCOM assessed BT's compliance with the SMP conditions that had been imposed on it by the 2004 LLMR Statement

in the following way, which is summarised in paragraph 1.21 of the Determination:

> "Our methodology can be summarised as follows:
>
> (i) As a first order test, we assessed whether the charges levied by BT for each PPC service under dispute exceeded the relevant cost ceiling, ie the DSAC, for that service. This is the cost ceiling test that we established in the *Guidelines on the Operation of the Network Charge Controls* (the "Guidelines") published by Oftel in 1997 and 2001. BT appears to have applied the Guidelines in that BT's regulatory financial statements recognise DSAC as being the relevant first order test for compliance with cost orientation.
>
> (ii) We did not apply the above DSAC test mechanistically but also considered:
>
> a. The magnitude and duration of the amounts by which charges exceeded DSAC; and
>
> b. Whether charges above DSAC could have caused economic harm to BT's customers or to the consumers of retail leased line services.
>
> (iii) We also took into account evidence on rates of return on a fully allocated cost ("FAC") basis, as providing a useful indicator of potential overcharging, when used in combination with the other approaches above.
>
> (iv) As regards charges below DSAC, we considered whether they nevertheless constituted overcharging, taking into account whether the charges were included in a price control, the magnitude and duration of the shortfall compared to DSAC, the rates of return, and any evidence of the effect in the market.
>
> (v) We assessed other potentially relevant types of evidence, but concluded that they were not sufficiently relevant or reliable in this case to alter our conclusions. This evidence included:
>
> a. BT's cost data on individual service SAC and a sub-set of combinatorial tests;
>
> b. BT's circuit analysis; and
>
> c. The evidence on international benchmarking submitted by BT."

124. Clearly, there is a great deal in this summary that is controversial and challenged by BT. These points are addressed later on in this judgment. In terms of data, however, the following is clearly relevant to OFCOM's approach:

(1) The price charged by BT for 2 Mbit/s trunk segments over time, as compared with DSAC and FAC.

(2) BT's return on capital in relation to 2 Mbit/s trunk segments.

125. For convenience, we set out this data below.

(a) The price charged by BT for 2 Mbit/s trunk services over time, as compared with DSAC and FAC

126. BT's charges for 2Mbit/s trunk services were set out by Mr Myers in a table at paragraph 53 of his witness statement.

	2004/2005	**2005/2006**	**2006/2007**	**2007/2008**	**2008/2009**
Price (£ per km)	£15.89	£102.95	£103.30	£103.21	£103.16
DSAC (£ per km)	£16.76	£63.41	£82.00	£47.45	£43.25
Price as % of DSAC	95%	162%	126%	217%	239%
FAC (£ per km)	£8.90	£36.68	£37.61	£27.17	£24.90
Price as % of FAC	178%	281%	275%	380%	414%

127. The percentage figures, but not the nominal figures of £ per km, appear in Table 7.1 (at page 108) of the Determination.

128. The above figures include OFCOM's adjustments to BT's base data. The table below provides a comparison (just as between percentage figures) with the unadjusted data. It also includes similar figures relating to BT's prices for 2 Mbit/s terminating sections.

	2 Mbit/s trunk		**2 Mbit/s terminating**	
	Price as a % of DSAC (as adjusted by OFCOM)	**Price as a % of DSAC (unadjusted)**	**Price as a % of DSAC (as adjusted by OFCOM)**	**Price as a % of DSAC (unadjusted)**
2004/2005	95%	Not available	44.2%	54.2%
2005/2006	162%	190.7%	59.2%	54.1%
2006/2007	126%	138.8%	53.1%	54.2%
2007/2008	217%	213.5%	71.4%	57.1%
2008/2009	239%	231.6%	66.2%	80.8%

129. These figures derive from Table 7.1 (page 108) and Table 7.2 (page 109) of the Determination.

(b) BT's return on capital

130. Mr Myers set out his assessment of BT's return on capital for 2 Mbit/s trunk in paragraph 56 of his statement, as follows:

	2004/5	2005/6	2006/7	2007/8	2008/9
Internal and external sales					
ROCE at prices actually changed by BT	76%	102%	126%	135%	142%
ROCE following repayments ordered by OFCOM	76%	95%	119%	114%	120%
ROCE if prices (both external and internal) had been set at DSAC	51%	49%	89%	44%	42%
External sales only					
ROCE at prices actually changed by BT	47%	104%	126%	135%	142%
ROCE following repayments ordered by OFCOM	47%	49%	89%	44%	42%
ROCE if prices (external only) had been set at DSAC	51%	49%	89%	44%	42%

131. BT's ROCE at the prices it actually charged derive from Table 7.3 (page 121-122) of the Determination. The remaining figures were calculated by Mr Myers, but were accepted by Mr Budd as numerically correct (Transcript Day 2, page 50).

(iv) Data relied upon by BT

(a) BT's approach to pricing

132. BT was clear in its Notice of Appeal that OFCOM had misdirected itself in terms of the pricing data it had looked at, and in the test that it had applied to that data in order to ascertain whether or not there had been a breach of the cost orientation provision contained in Condition H3.1.

133. BT was rather less clear in terms of identifying exactly what its approach to cost orientation was. This point was raised by the Tribunal on the first day of the proceedings with BT's counsel, Mr Graham Read QC (Transcript Day 1, pages 4-5):

"Mr Read …Sir, I see you have a question.

The Chairman Well not so much a question but more a flag that I hope will be dealt with at some point when you are opening or through your witnesses, but it would be helpful to have clearly articulated what BT thought it was aiming for when setting prices in terms of its SMP condition, because clearly everyone knew there was a condition to comply with, there is now a debate as to what that condition entails, but clearly BT ought to have had a view at the time of setting prices what its cost orientation obligation was. It would be very helpful to know, with some precision what BT was aiming for in prices.

Mr Read It certainly is dealt with in the witness statements, sir, and the point that I do want to make about this is that one of the problems that BT had with this was that it was looking at the material from a number of different angles, and I will illustrate that as we go through the documents.

The core point being, and this is where we think the real dividing line is between the approach that Ofcom has adopted in the final determination that we say effectively having a pass/fail test – DSAC pass or fail – and what BT says is the position is that BT says you look at all the evidence, you do not just concentrate on one parameter for gauging whether you have passed or failed, you have to look at the whole thing in the round, which includes a whole series of factors and one of the key factors we will in due course be saying is relevant in that is whether or not there truly is any economic distortion going on in the market, because obviously I do not want to take this too far out of turn because one needs to go through the historical origins, I think, of how PPCs were set up and the cost orientation obligation actually was instigated in order to see the parameters by which cost orientation was being viewed, certainly at the time in question and, in particular one needs to see, for example, what happened in 2005, the way that BT was presenting material to the Regulator then to get a handle on really the way that what BT was trying to do was to really look at the totality of the evidence and put the totality evidence there, rather than focusing on a singular fixed pass/fail test. I think that that in this case is really the battle line and, indeed, dare I say it the real sore point for BT in that it feels that what Ofcom has done is [adopt] one test to the exclusion of everything else and, indeed, actually employed an analysis which has the effect of disregarding evidence right, left and centre, whereas what BT has always said is that one needs to look at the totality of it and all the evidence together."

134. Of course, when assessing whether there has been compliance with a cost orientation obligation, it may be that the range of evidence relevant to assessing compliance is wide. But the point about Condition H3.1 – and, indeed, Condition G3.1 – is that it is forward looking in that BT was expected to seek to comply with it in terms of the prices it set from the moment the condition came into force. (OFCOM stressed the *ex ante* nature of the cost orientation obligation in, for example, paragraph 5.87 of the Determination; and BT also was clearly aware of this, as the introduction to its Primary Accounting Documents, quoted in paragraph 57 above, shows.) Mr Read's answer to the Tribunal dealt only with the backward-looking question of how, after the event,

compliance with the condition would be measured. But his answer left out of account the forward-looking question of what BT was aiming to do in the prices it set.

135. Mr Read also put the Tribunal's question to Mr Morden, whose answer did cover this forward-looking aspect of cost orientation (Transcript Day 3, pages 1-2):

> **"Q (Mr Read)** The Chairman asked me:
>
> "It would be helpful to have clearly articulated what BT thought it was aiming for when setting prices in terms of its SMP condition because clearly everyone knew there was a condition to comply with, there is now a debate as to what that condition entails, but clearly BT ought to have had a view at the time of setting prices what its cost orientation obligation was. It would be very helpful to know with some precision what BT was aiming for in prices."
>
> Now have you anything to say on that?
>
> **A (Mr Morden)** Only for the prices. I joined BT wholesale with the purpose of launching PPCs. My aim in pricing, as with the products, was to sell as many PPCs as I could to my customers, to the Altnets, so price was obviously a big element in that. It was a competitive market, I had hoped to sell as much as I could, so I had to meet a number of different perspectives in pricing. I have to cover my costs, and I also did not want to price too high, because that would have discouraged take up of my product, and I wanted to launch it, I wanted it to be successful. In terms of a precise target for cost orientation I did not have a figure, where I knew that beyond this figure I would not be cost orientated any longer, but I had no intention of raising prices and I felt that Ofcom and Oftel before them had examined the prices on a number of occasions. We had put in a lot of data models' analysis to try and show that we were cost oriented, and they had taken no action either to reduce the price or to inform me that any of the decisions or assumptions we had made were wrong. So I felt that providing I didn't raise price, which I had no intention of doing, it was at a cost orientated level and would remain so. I believe cost orientation is fairly imprecise, so I never had the precise number that I was aiming at.
>
> **Q (Mr Read)** Did you at any stage consider further the pricing that you were actually setting prices?
>
> **A (Mr Morden)** I always considered the pricing. I always considered it in terms of my compliance with cost orientation and also the impact on my customers.
>
> **Q (Mr Read)** So did you adopt any methodology at all for dealing with how you would actually view it vis-à-vis cost orientation?
>
> **A (Mr Morden)** As I say in my witness statement, the sort of thing that we did on a regular basis was to look at the output and management accounts. That's how I judge my product, because the management accounts show precisely how much revenue volumes of products I was selling and gave me some indication of cost. So I could look at those accounts on a monthly basis to see whether the costs that I was expecting or the efficiency improvements that I was hoping for were coming through, and if there was anything unexpected in it. So that would give me an idea of the return overall that I was making on the PPC product, because I had to cover the costs. I have no intention of increasing the price beyond that. I did have to make it so that BT wanted to provide the PPCs."

136. Mr Saini, for OFCOM, returned to this point when cross-examining Mr Morden (Transcript Day 3, pages 8-9):

"Q (Mr Saini)	So, how do you decide that you are going to comply with the cost orientation obligation?
A (Mr Morden)	Largely it comes down to, or largely I was using, rate of return. Remember, I have no intention of pushing prices up. So my concern was to make sure that I was covering my costs.
Q (Mr Saini)	Would it be fair to say that, as far as you were concerned, as long as the rate of return for PPC as a whole, that is aggregating trunk and terminating was all right, you were happy?
A (Mr Morden)	Yes. Okay.
	…
Q (Mr Saini)	I do not want to test you on things you do not know about but – so, just to clarify, would it be the case that those who are doing the accounting within BT, in other words, those who prepare the regulatory financial statements and who are no doubt responsible for the primary accounting documents, do not speak to you within the PPC product management team?
A (Mr Morden)	No, I mean, the regulatory accounting function was working closely with me. They were the principal architects of the letter that I sent in August 2005.
Q (Mr Saini)	Would you agree with me that BT would have sufficient information internally, in its management accounts, to be able to ascertain whether it was likely to exceed DSAC by the end of the year?
A (Mr Morden)	No, because I could not predict where DSAC was going to be at the end of the year.
Q (Mr Saini)	But you would agree with me that at the end of one year, when you substantially exceeded DSAC, which we know was the position on many occasions.
A (Mr Morden)	Yes.
Q (Mr Saini)	It was necessary for BT to take steps to bring its costs into line so that […] DSAC would not be exceeded in future.
A (Mr Morden)	As I say, you could not predict where DSAC was going to be the following year. The steps I took was to ensure that my rate of return for PPCs as a whole was not excessive.
Q (Mr Saini)	Yes, so it does just come back to your point that, as far as you were concerned, as long as you aggregated the products, and you had the right rate of return, you did not really care about the individual prices?
A (Mr Morden)	I think that's probably right, yes."

137. Thus, Mr Morden essentially looked at rate of return on the aggregated PPC product. He paid little or no attention to the cost "floors" and cost "ceilings" published in BT's regulatory financial statements. This was made very clear in

his exchanges with Mr Saini (Transcript Day 3, pages 7-9). The information was published too late for him to take it into account in his pricing. Mr Morden was a scrupulous and careful witness, and we deal later on (in paragraphs 298 to 303 below) with his point that relevant data regarding cost orientation was not available until after a decision had been taken on pricing.

138. Professor Yarrow's conclusion as to what BT was doing in terms of pricing was as follows (Transcript Day 4, pages 81-82):

> **"Q (Mr Saini)** As I understand your report, what BT have told you is that the way that they satisfied themselves that they were complying with the DSAC test was by aggregating between trunk and terminating, now is that correct or not?
>
> **A (Prof Yarrow)** No, no, it's not correct. We didn't ask that question.
>
> **Q (Mr Saini)** Okay, perhaps I may have misunderstood your report, if you would please go to page 692 in your first report, para 111, if I may read that – this is after your description of DSAC as a screening test:
>
> "On this basis (that comparing prices with DSACs is a screening test), the view might be taken, and we believe it is a view that was taken by BT, that sets of products with prices that all fall below the relevant DSACs are highly unlikely to give rise to concerns that cost orientation obligations have been violated."
>
> **A (Prof Yarrow)** Yes.
>
> **Q (Mr Saini)** As I understand it, you were instructed by BT that that is how they believed they were complying with DSAC. Is that correct?
>
> **A (Prof Yarrow)** No.
>
> **Q (Mr Saini)** So what does that mean?
>
> **A (Prof Yarrow)** It means that the Regulatory Financial Statements were pretty transparent about what was happening to DSACs and so on for individual products, everybody could pick them up, and since you can see observations where some products were below DLRICs, and some were above DSACs, and since Ofcom hadn't jumped on that and since BT didn't seem particularly bothered about it, we inferred that they took the view – which we think is the right view – that in relation to DSAC, and we should come to DSAC, when you are dealing with DSAC, which is a separate set of issues, that what you need to do is to take a rather general overall approach to what the pattern of prices and costs are to produce several cost orientation obligation questions.
>
> **Q (Mr Saini)** So it is your inference from the existence of the Regulatory Financial Statements that that is what BT were doing? You were never told that by anyone, you inferred it?
>
> **A (Prof Yarrow)** We inferred it and also it seems to me to be the rational interpretation. If you were going to use DSAC which, I think the Tribunal have already heard, is a very unusual concept without any pedigree in economics, if you are going to use this rather unusual concept you had better use it rather cautiously, and therefore not just do a mechanistic calculation of a single product or a single small set of products."

139. A recurrent theme in BT's evidence and in its submissions was that high charges from trunk segments were justified by the very low prices that BT was allowed to charge for terminating segments. The prices for the terminating segments sold by BT were not only the subject of a cost orientation obligation, but also a charge control. BT's case was that when its charges for terminating segments were considered, BT was under-recovering and making an unreasonably low return. This is a matter that was controversial. In his evidence, both oral and written, Professor Yarrow placed a great deal of reliance on OFCOM's 2009 Leased Lines Charge Control Statement, which did conclude that the price for 2 Mbit/s terminating segments was not correctly aligned with costs and that an increase was justified. What he omitted to say – until he was cross-examined on the point by Miss Rose – was that OFCOM's charge control statement had been appealed, and this decision reversed (Transcript Day 5, pages 1-10).

140. We make no finding as to whether BT was or was not under-recovering in relation to terminating segments generally or 2 Mbit/s terminating segments in particular. There is no need to do so for the purposes of this judgment. The importance of the point lies in the data that BT contended was relevant in terms of assessing its compliance with Condition H3.1, which is very different from that relied upon by OFCOM.

141. It is clear that the rate of return on the overall PPC product (ie aggregating trunk and terminating segments) was considered very important by BT. These figures are set out below. Additionally, we consider the DSAC for trunk and terminating segments aggregated, since these would obviously be relevant measures on BT's approach. Finally, we consider the individual DSAC, DLRIC and FAC figures that were reported for various component elements of PPCs over time in BT's regulatory financial statements.

(b) Rate of return on the overall PPC product

142. In his statement, Mr Budd set out the approximate rates of return earned by BT in providing PPCs to communications providers other than BT. In other words, these rates of return ignored internal sales within BT. This information had been provided to Mr Budd by Mr Pigott.

143. The reason given by Mr Budd for carving out internal sales was as follows (paragraph 12 of Mr Budd's statement):

> "…the total returns set out by Ofcom do not distinguish between returns earned on sales to [external communications providers] and total sales (which include sales to other parts of BT as well as to external customers). Because the mix of sales to internal and external customers is different, and different services earn different returns, there will be a difference between overall returns made on internal sales and on external sales. BT provides external customers with relatively less trunk segments compared to terminating segments so BT has been earning less on sales to [external communications providers] than the 12.2% shown by Ofcom for total sales."

144. In other words, because (as the table in paragraph 128 above demonstrates) the price per kilometre for terminating segments was lower than that for trunk segments, the rate of return was correspondingly lower. Because BT purchased (relatively speaking) more trunk than external communications providers, stripping out such internal sales would have the effect of reducing the rate of return.

145. Taking this approach, however, gives the following rates of return, first on the basis that no repayment had been ordered by OFCOM (as *per* the Determination), and secondly on the basis of the repayment ordered by OFCOM (as *per* the Determination):

	2004/5	**2005/6**	**2006/7**	**2007/8**	**2008/9**
Rate of return (assuming no repayment by BT as *per* the Determination)	-0.1%	11.2%	5.4%	18.1%	12.6%
Rate of return (assuming a repayment by BT as *per* the Determination)	-0.1%	6.8%	3.2%	10.0%	10.1%

146. According to Mr Budd, this gave an average return of 9.7% (assuming no repayment) and 6.4% (assuming a repayment), both averages well below the cost of capital.

147. Stripping out internal sales is – as we have already noted – controversial between OFCOM and BT. In the Determination, the rate of return *including* BT's internal sales is set out in Table 7.3 (pages 120-121):

	2004/5	2005/6	2006/7	2007/8	2008/9
Rate of return (assuming no repayment by BT as *per* the Determination)	3.9%	13.1%	11.4%	21.3%	15.9%

148. This gives an average of 12.2% for the five year period, just above the cost of capital. The average for the four year period 2005/6 to 2008/9 (in respect of which OFCOM made a finding of overcharging in the Determination) is 14.2%, well above the cost of capital (Determination, paragraph 8.30; Mr Myers' statement, paragraph 123).

149. However, according to Mr Pigott (as reported by Mr Budd in paragraph 11 of his statement), the impact of the price reductions following the Determination was to reduce the average return on capital employed over these years (ie 2004/5 to 2008/9) to 8.7%, below the cost of capital.

150. Mr Myers, in his statement, took issue with this. In paragraph 124 of his statement, he said:

> "In my view the rates of return derived by Ofcom are more appropriate to assess the impact of the Determination than the different figures in the Budd statement:
>
> a. One reason for the difference is that the Budd statement assumes that the price reductions also apply to BT's internal sales on the argument that this shows the impact on BT's network returns. Ofcom's calculation excluded any repayments by BT to itself. Such repayments were not required by the Determination and are an internal transfer within BT (as the Budd statement recognises in footnote 6). The rates of return in the Budd statement are therefore artificially depressed by including a hypothetical repayment which the Determination did not require. Furthermore, this hypothetical repayment is not economically meaningful, because it would be paid by BT to itself, resulting in no change in BT's overall profitability. Adjusting the rate of return estimate in the Budd statement to exclude such hypothetical repayments by BT to itself, the figure increases from 8.7% to 11.5%.
>
> b. Another difference is that the Budd statement includes 2004/5 in the average. However, 2004/2005 should not be included because Ofcom did not find overcharging in 2004/5, so there was no impact of repayments in this year. Furthermore, since (according to BT's accounting figures) BT's ROCE on terminating segments is especially low in this year, it presents a distorted impression to include 2004/5. Excluding 2004/5 from the rate of return calculation in the Budd statement (in addition to excluding the hypothetical repayments on internal sales), the figure increases from 11.5% to 14.2% (ie Ofcom's figure in the Determination)."

151. Assuming (contrary to Mr Myers' paragraph 124(a)) that his point is not accepted, the figure in paragraph 124(b) becomes 10.4% (Transcript Day 3, page 31).

152. For the moment, we simply set out the figures put forward by the various parties. The figures themselves were agreed. What was not agreed was precisely *which* figures were relevant for the purposes of assessing overcharging. That is a question we turn to after the nature and operation of Condition H3.1 has been determined.

(c) DSAC on an aggregated basis

153. Looking simply at BT's external PPC revenues as a percentage of DSAC, the following figures are given in Tables 7.1 and 7.2 (pages 107-108) of the Determination):

	PPC in aggregate	
	Price as a % of DSAC (as adjusted by OFCOM)	**Price as a % of DSAC (unadjusted)**
2004/2005	40.6%	53.7%
2005/2006	61.3%	62.0%
2006/2007	51.5%	57.9%
2007/2008	69.3%	58.9%
2008/2009	66.4%	71.9%

(d) Individual DSACs and FACs

154. As we have described in paragraph 60 above, BT reported PPC costs in its regulatory financial statements, which contained figures for DLRIC, FAC and DSAC. Generally, although not in the case of every year, this information was provided with a high degree of granularity. This information is set out in Annex C.

155. Generally, this data bore out the point noted in paragraphs 132 to 141 above. Prices for terminating segments tended more to breach the DLRIC "floor"; and prices for trunk segments tended more to breach the DSAC "ceiling".

VI. BT'S CONTENTION THAT OFCOM MISUSED THE DISPUTE RESOLUTION PROCESS

156. BT put this contention in two ways. First, it was contended that, on the true construction of sections 185 to 192 of the 2003 Act, OFCOM had no jurisdiction to determine the disputes between the Altnets and BT by way of the

Dispute Resolution Process. This question was ordered by the Tribunal to be determined as one of two preliminary issues. These issues were determined by the Tribunal in a judgment dated 11 June 2010 ([2010] CAT 15, the "Preliminary Issues Judgment"). As regards the preliminary issue on jurisdiction, the Tribunal held that OFCOM did have jurisdiction to determine these disputes by way of the Dispute Resolution Process.

157. Secondly, it was contended that, as a matter of discretion, OFCOM should have declined to accept or declined to resolve the disputes under the Dispute Resolution Process. BT made four points, which are summarised in paragraph 70 of the Notice of Appeal:

(1) There were alternative means for resolving the disputes, which were preferable to the Dispute Resolution Process.

(2) OFCOM should have summarily dismissed the disputes.

(3) OFCOM should have applied any discretion it had in considering the disputes against the detailed investigation that it carried out.

(4) OFCOM should have employed its discretion under section 190(2) of the 2003 Act to make no determination.

158. These four points are considered in turn below. Additionally, and perhaps as a fundamental factual issue underlying all these points, BT contended that the length of time that it had taken OFCOM to resolve these disputes demonstrated how unsuited the Dispute Resolution Process was in this case. In the Notice of Appeal, BT stated:

> "45. The fundamental issue is that Ofcom has taken over 15 months to hold that BT has breached its SMP Condition H3 because of alleged overcharging on 2 Mbit/s trunk. This included extensive analysis into arcane accounting adjustments, taking up over 30 pages of the Final Determination…
>
> 46. BT contends that the approach Ofcom has taken is the antithesis of what the Dispute Resolution Procedure is intended to achieve…"

159. As we have noted, the Dispute Resolution Process is intended to be a quick one. Section 188(5) requires a determination to be made within 4 months of the acceptance of a dispute. According to section 188(6), if it is practicable for OFCOM to make the determination sooner, it should be made as soon as practicable.

160. However, we do not consider that there is anything intrinsic to the matters in the dispute between BT and the Altnets that would render resolution unachievable within four months in other cases, even if these cases raised similar issues. The exceptional circumstances in this case were that BT's financial statements required correction, and the need for correction was identified at the time when OFCOM accepted the disputes between BT and the Altnets. We have described these circumstances in paragraphs 107 to 111 above. Corrected figures were not available until September 2008 (in the case of 2006/2007 and 2007/2008) and October/November 2008 (in the case of prior years). This caused a delay of 4 months. A draft determination was published within 5 months of November 2008, in April 2009.

161. We are a little sceptical as to the benefit of the "adjustments" that OFCOM explored between the draft determination and the Determination itself, and in ordinary circumstances (where there is no error in BT's audited regulatory financial statements) we would expect the figures in these statements to stand without great investigation, re-checking or adjustment by OFCOM. That, after all, is one of the purposes of regulatory financial statements: to ensure that the appropriate data is published to enable compliance with SMP conditions to be monitored. In this case, OFCOM's approach may, perhaps, be justified because BT's originally published regulatory financial statements could not be relied upon.

162. We certainly do not consider, however, that these particular factual circumstances indicate that the Dispute Resolution Process was inappropriate in the present case.

163. We now proceed to consider BT's four points regarding discretion.

(i) The first point: OFCOM should have used alternative means to resolve the disputes

164. BT's contention was that the Dispute Resolution Process was confined to "current" or "prospective" disputes and that the determination of "retrospective" or "historical" disputes was precluded. It was contended that, either as a matter of law or as a matter of discretion, the Dispute Resolution Process should not (for this reason) have been used to resolve the present disputes.

165. The question of whether there was such a limitation on the Dispute Resolution Process, confining it to "current" or "prospective" disputes was considered by the Tribunal in the Preliminary Issues Judgment, and rejected by it, for the reasons given in paragraphs 64 to 96 and 102 of that judgment. Accordingly, BT's contention that, as a matter of law, OFCOM was obliged to resolve the disputes by an alternative process, failed.

166. Given the Tribunal's conclusion that the Dispute Resolution Process draws no distinction between "current" / "prospective" / "non-historical" disputes on the one hand, and "retrospective" / "historical" disputes on the other (to use various of the labels used by BT to articulate the distinction it was contending for), it follows that if, as a matter of discretion, OFCOM had declined to determine the disputes on this basis, it would have acted on the basis of an irrelevant consideration, and so unlawfully.

167. That may well be the end of BT's point. However, it was not wholly clear from the Notice of Appeal whether BT was also contending that (leaving to one side the "historical" / "non-historical" dichotomy that the Tribunal has rejected), there were (in any event) alternative means for resolving the disputes, preferable to the Dispute Resolution Process.

168. In the Preliminary Issues Judgment, the Tribunal accepted BT's submission that the Dispute Resolution Process could not be considered in isolation from the other provisions in the 2003 Act (see paragraph 97). In particular, it is necessary to take into account the provisions contained in sections 94 to 104 of the 2003 Act, referred to in the Preliminary Issues Judgment as the "Compliance Process". These enable OFCOM to enforce conditions made under section 45 of the 2003 Act (see paragraph 98). Section 104 of the 2003 Act creates a statutory duty on persons subject to conditions to comply with them, such duty being owed to every person who might be affected by a contravention of the condition (see paragraph 99).

169. However, as was noted in the Preliminary Issues Judgment:

    (1) There is nothing in the 2003 Act to suggest that the Compliance Process should be confined to certain disputes and the Dispute Resolution Process

to other, different disputes (see paragraph 101 of the Preliminary Issues Judgment, and paragraphs 164 to 166 above).

(2) There is, therefore, a substantial potential parallel jurisdiction between the Compliance Process and the Dispute Resolution Process, which is, however, anticipated and dealt with by various provisions in the 2003 Act, which were considered in paragraph 104 of the Preliminary Issues Judgment).

(3) Subject to these provisions, OFCOM's ability to decline to determine a dispute that has been referred to it under the Dispute Resolution Process is very limited, as is made clear in section 186(3) of the 2003 Act and as was described in paragraphs 60 and 104(b) of the Preliminary Issues Judgment.

170. We do not see how – given the wording of section 186(3) – OFCOM could properly have declined the disputes in this case. Accordingly, BT's first point must fail.

(ii) The second point: OFCOM should have summarily dismissed the disputes

171. BT's second point is that "[a] procedure whereby the regulator was entitled to consider a dispute and summarily dismiss it without becoming embroiled in a detailed consideration of material appeared expressly contemplated in" *T-Mobile (UK) Limited v OFCOM* [2008] CAT 12 (paragraph 64 of the Notice of Appeal). Paragraph 65 went on to say:

> "Such a procedure would be an obvious and necessary adjunct to the requirement that Ofcom "must" accept and decide a dispute. Whilst Ofcom has no discretion (for example on the basis of administrative priorities) to reject considering the dispute, it does have a discretion to forestall an over-elaborate and unnecessary regulatory investigation if it is clear that either the [communications providers'] dispute is inherently unsustainable or there is a far better regulatory approach (such as s 94) which can be adopted."

172. To the extent that this point turns on OFCOM's discretion in terms of the procedure by which a dispute is resolved under the Dispute Resolution Process, we consider it in the context of BT's third point, which expressly raises this question.

173. BT's second point appears to be based on the suggestion that, having accepted a dispute under the Dispute Resolution Process, OFCOM can simply dispose of

the dispute without determining it on the merits. Such a suggestion would appear to allow OFCOM to derogate from its duty – namely to resolve the dispute – and we reject it as wrong in law.

174. BT cited *T-Mobile (UK) Limited v OFCOM* [2008] CAT 12 in support of its contention (paragraph 64 of the Notice of Appeal). BT relied upon paragraphs 177 and 179. Paragraphs 177 to 179 provide:

> "177. In many cases, including the present ones, the dispute will arise in the context of an existing commercial agreement where one of the parties is trying to vary the terms. OFCOM has made it clear in the guidance it issued in July 2004 on dispute resolution that it "will not accept a dispute without evidence of the failure of meaningful commercial negotiations". It requires the parties to provide documentary evidence of commercial negotiations on all issues covered by the scope of the dispute and a statement by an officer of the company, preferably the CEO, that the company has used its best endeavours to resolve the dispute through commercial negotiation. This stance reflects the wording of Recital (32) of the Framework Directive which provides that "an aggrieved party that has negotiated in good faith but failed to reach agreement should be able to call on the national regulatory authority to resolve the dispute". The onus lies on the party proposing the variation to provide to the other party and to OFCOM the justification for the change in the terms upon which the parties have hitherto been prepared to do business. This would be the position in any situation where one party to a binding contract proposes a variation of that contract.
>
> 178. The fact that the dispute is referred to OFCOM must mean either that the other contracting party does not accept the justification put forward by the party proposing the variation or that it asserts that there are counter influences cancelling out the justification or perhaps both. OFCOM's first take is therefore to examine the reasons put forward for the proposed change in terms and decide whether they are justified. In considering this question OFCOM must have regard to what is fair as between the parties and what is reasonable from the point of view of the regulatory objectives set out in the Common Regulatory Framework directives and in the 2003 Act.
>
> 179. If it is clear that the reasons put forward do not support the change proposed, then the dispute may be resolved simply by upholding the rejection of the proposal by the recipient of the OCCN and ordering the parties to continue doing business on the terms and conditions that have so far applied. Similarly, if it is clear that the objections raised by the recipient of the OCCN are without foundation, then OFCOM can resolve the dispute by upholding the proposed change and make the appropriate orders."

175. These paragraphs, it is clear, are not sanctioning an approach that OFCOM can, under the Dispute Resolution Process, summarily dismiss a dispute without resolving it. That would be perverse. Rather, what is being said is that there may be occasions where a dispute can be resolved on the merits – one way or the other – summarily. There is nothing in the Act precluding OFCOM from deciding that there is no basis to a dispute without conducting a detailed investigation, and giving only brief reasons, when in its view the matter is sufficiently clear to enable it to reach a determination in this way.

176. Where there is a clear answer to a dispute, OFCOM should articulate it and determine the dispute as soon as practicable. In short, we agree with paragraph 106 of the Defence:

> "The argument that having decided it was appropriate to handle the Disputes, Ofcom should have chosen not to resolve them (by summary dismissal) and instead adopted a different regulatory approach, under sections 94-103 of the Act, must simply be wrong in law."

(iii) The third point: OFCOM should have applied its discretion in considering the disputes against any detailed investigation

177. In paragraph 67 of the Notice of Appeal, BT stated:

> "There seems [to be] no statutory reason why Ofcom should not have some discretion as to precisely how it considers a dispute under the Dispute Resolution procedure. Ofcom "must consider the dispute" under s188(2)(a) of the Act, but no explicit requirements are placed on Ofcom as to how such consideration should be conducted. Clearly any consideration must be done in an acceptable regulatory manner and in accordance with the [common regulatory framework]."

178. That is all BT says on this third point.

179. It seems clear that OFCOM must conduct itself in a manner that enables disputes accepted by it to be resolved in accordance with its duties under the 2003 Act and the statutory timetable, absent exceptional circumstances. But it is difficult to see how this point goes to support BT's contention that the Dispute Resolution Process was, in this case, in some way, misused. If it is being suggested that the investigation might have been carried out more efficiently by OFCOM, but would have lead to the same result, then it is difficult to see how this benefits BT.

180. If, on the other hand, it is being contended that the investigation should have been insufficiently thorough so as not to reveal overcharging, then the point is obviously wrong. Clearly, OFCOM must act in a manner intended to lead to the correct resolution of disputes, and if it is being suggested that OFCOM should have somehow pulled the punches of the process in such a way that the outcome would have been different, then we reject this.

(iv) The fourth point: OFCOM should have employed its discretion under section 190(2)

181. BT's fourth point – which was shortly put in paragraphs 68 to 69 of the Notice of Appeal – contends that OFCOM could simply elect, summarily, to decline to exercise any of its powers under section 190 of the 2003 Act. Section 190 is considered in greater detail in paragraphs 336 to 338 below. BT's point seems to be that OFCOM could use its discretion under section 190 effectively to bring a dispute it had accepted under the Dispute Resolution Process to an end, without substantively determining it. In other words, the point is very similar to BT's second point, and wrong for exactly the same reasons.

182. Plainly, there is a discretion under section 190(2), but it is a "hard" discretion confined to requiring OFCOM to follow through on the conclusions it has drawn pursuant to the Dispute Resolution Process.

(v) Is BT's appeal on this point out of time?

183. One further point was raised by OFCOM in its skeleton argument, although the point does not appear in the pleadings. This was the point that OFCOM's decision to accept the disputes under the Dispute Resolution Process was itself an appealable decision that should have been appealed by BT within two months of the decision. Accordingly, so OFCOM contended, BT's Notice of Appeal was out of time.

184. Although the point was raised only in submissions, and not in the pleadings, we deal with it. We accept that OFCOM's decision to accept the disputes was a decision within section 192(1)(a) of the 2003 Act. The harder question is whether OFCOM was right, and that this decision must be appealed within the required time, or else any right of challenge is lost, absent exceptional circumstances.

185. This question was considered by the Tribunal in *Orange Personal Communications Services Limited v Office of Communications* [2007] CAT 36. That case concerned a question of OFCOM's jurisdiction to accept a dispute under the Dispute Resolution Process. Although Orange had, in fact, lodged a precautionary appeal, the Tribunal considered that it was in the public interest for the Tribunal to rule on the issue (paragraph 109), particularly in

circumstances where all parties were agreed that it would be preferable if a party wishing to challenge jurisdiction did not have to lodge a precautionary appeal.

186. The Tribunal's conclusions were as follows:

(1) There was – at the time OFCOM accepted a dispute under the Dispute Resolution Process – an appealable decision that could be appealed. Indeed, the Tribunal made the point that one would expect a party alleging that OFCOM had (for example) acted irrationally in accepting a dispute, would want to act quickly to forestall OFCOM's investigation of the dispute so that the situation would be resolved appropriately as soon as possible (paragraph 123).

(2) However, "[a] party which brings an appeal against a final determination is entitled to raise in that appeal an allegation that OFCOM lacked jurisdiction to investigate the matter referred to it. That ground may be one of a number of grounds in which the final determination is challenged. But the appellant is not precluded from raising the point by the fact that it could have brought an appeal against the initial decision to assume jurisdiction but chose not to do so" (paragraph 113).

187. We agree with this approach. Clearly, there are some issues (jurisdiction being a prime example) where an appealable decision is generated at the time OFCOM accepts a dispute under the Dispute Resolution Process, but where that issue remains live and in being as a present (alleged) deficiency in the final determination, capable of being appealed later (at the time of determination). Whether this is true of all issues is a matter that does not arise for decision in the present case, and we expressly do not deal with it. We would only observe that in many cases, it will be preferable for OFCOM's decision to accept a dispute to be challenged not at the outset, but when a final determination has been made. This for at least two reasons: first, it avoids the undoubted inconvenience of multiple appeals; and secondly, appeals at the outset of the Dispute Resolution Process may well have the effect (this being a matter for OFCOM) of delaying the Dispute Resolution Process until the appeal has been resolved.

188. In the present case, we consider that all four of BT's points were appropriately raised by BT in its Notice of Appeal. As regards the first of these points, we consider that BT could have appealed the decision to accept the disputes sooner, but that it was not obliged to do, and that it was entitled to raise the point in the Notice of Appeal. As regards the other points, the position is even clearer: these points had not even arisen at the time OFCOM accepted the dispute, but occurred during the course of the process of resolving the disputes. Even if BT could have appealed such matters during the course of the dispute, we consider that the course BT adopted was much to be preferred, and was one open to BT.

VII. OFCOM INCORRECTLY APPLIED CONDITION H3.1

(i) BT's contentions that OFCOM had misapplied Condition H3.1

189. OFCOM's determination that BT had overcharged for 2 Mbit/s trunk services was reached after the following process:

(1) The data that OFCOM examined (as has been described in paragraphs 120 to 129 above) related not to PPCs as a whole, but to disaggregated services within the PPC range of services. In short, OFCOM distinguished first between trunk and terminating segments and then, within trunk, distinguished between bandwidths. Hence the specificity of OFCOM's finding that there had been overcharging in connection with 2 Mbit/s trunk services.

(2) OFCOM assessed whether this data demonstrated overcharging by applying DSAC as a first order test to the charges for 2 Mbit/s services. OFCOM's approach was summarised in paragraph 1.21 of the Determination, which is set out in paragraph 123 above.

190. BT challenged many aspects of this process. BT suggested that there had been a failure by OFCOM to pay proper regard to question of economic harm; that OFCOM's disaggregated approach was wrong; and that OFCOM had adopted an incorrect approach to or an incorrect test for the question of whether prices were properly orientated towards cost.

191. We consider these points in detail below, but observe at the outset that it is necessary to consider the points taken by BT in relation to Condition H3.1 in the correct order. Thus, by way of example, it would be a wrong approach to

consider the test for cost orientation without first considering the question of *which prices* must be cost orientated in the first place. The fact is that one question is logically anterior to the other.

192. Accordingly, the judgment considers these issues in the following order:

(1) *Which prices are orientated to cost according to Condition H3.1.* Is it the price in aggregate of PPCs or the prices of individual components of PPCs or some position between these two extremes? This we consider further in Section VII(iii) below.

(2) *How it is determined whether prices are orientated to costs.* In other words, what test is applied in order to determine whether or not prices are excessive? This we consider further in Section VII(iv) below.

(3) *The relevance of "economic harm".* This we consider further in Section VII(v) below.

193. Before we consider these issues, however, it is necessary to consider the legal basis for BT's contention that OFCOM had misapplied Condition H3.1. This we do in Section VII(ii) below.

(ii) The legal basis for BT's contentions

194. BT advanced two broad and closely interconnected contentions. Both were to the effect that OFCOM had, in the Determination, wrongly applied Condition H3.1. The first of these contentions was that OFCOM had misapplied Condition H3.1 because it had misconstrued it.

195. BT's second contention was that even if OFCOM's construction of Condition H3.1 was correct, OFCOM was obliged to enforce Condition H3.1 in a manner different to the true construction of that provision. BT advanced three distinct grounds for suggesting that, even if it lost on the issue of construction, Condition H3.1 should not be applied in accordance with that construction.

196. We consider these contentions in turn below.

(a) Construction

197. The approach to construction depends upon whether a private law instrument (like a contract) or a public law instrument (like an Act of Parliament) is being

construed. We were referred to no authority or provision expressly describing the juridical nature of SMP conditions. OFCOM cited to us the decision of Cranston J in *Data Broadcasting International Limited v The Office of Communications* [2010] EWHC 1243 (Admin), [2010] ACD 77. In this case, Cranston J considered the juridical nature of broadcasting licences granted under the Broadcasting Act 1990. He concluded at paragraph 88:

> "In my view these licences are not contracts. A contractual analysis distorts their juridical character. The licences are public law instruments. They constitute statutory authorisation permitting the licensees to undertake activities which would otherwise be unlawful and, in this case, place them under particular obligations, breach of which exposes them to the risk of the imposition of statutory financial penalties or ultimately to revocation of the licences. In granting them, the licensing authority acts pursuant to its statutory duties and functions, and there is no intention to enter into any private law legal relations with the licensees. There is no express agreement between the parties in the contract sense. In the main the conditions in the licences are derived directly from statutory provisions."

198. Subject to one significant qualification, which arises out of the difference between a licence to do something and a condition, and which we consider further in paragraph 199 below, we agree with this analysis and agree that it applies to SMP conditions. The classification of an SMP condition as a public law instrument is consistent with the manner in which SMP conditions are imposed. As has been described in paragraph 44 above, SMP conditions are imposed following a market review and (importantly) they are imposed without the consent of the person on whom they are binding. The analysis is also consistent with the manner in which SMP conditions can be enforced following the Compliance Process considered in paragraph 168 above.

199. The qualification that we would identify is that a condition – in terms of subject-matter – is a very different thing from a licence. A condition can have a whole range of different content. The SMP conditions here at issue, which were imposed by the 2004 LLMR Statement, in many cases directly affect the basis upon which private law (ie contractual) relations between BT and other communications providers were conducted.

200. It was uncontroversial before us that BT provided PPCs to communications providers who contracted with BT. This was, for instance, helpfully described in Mr Morden's statement (paragraphs 14 to 18). To a large extent, the contractual terms between BT and other communications providers would be a matter of

freedom of contract. However, that private law freedom was expressly constrained by the SMP conditions imposed by the 2004 LLMR Statement. Thus, taking Conditions H as an example:

(1) BT was obliged to provide Network Access to persons reasonably requesting it (Condition H1.1).

(2) BT was precluded from discriminating against particular persons or against a particular description of persons (Condition H2.1).

(3) As has been noted, BT was subject to the cost orientation obligation contained in Condition H3.1.

In other words, the SMP conditions here in issue (specifically Condition H3.1, although the same can be said for a number of the other conditions imposed as a result of the 2004 LLMR Statement) comprise a form of public law "overlay" affecting the private law rights and freedoms of (in this case) BT.

201. Public law instruments like statutes and, we consider, SMP conditions are – like contracts – to be construed in the context of the factual matrix in which they are set (*Black-Clawson International Limited v Papierwerke Waldorf-Aschaffenburg AG* [1975] AC 591 at [646]). What comprises the relevant matrix of fact in any given case depends upon the nature of the instrument being construed. As was noted by Lord Hoffmann in *Attorney-General of Belize v Belize Telecom Limited* [2009] 2 All ER 1127 at [16], the law "permits reference to all the background knowledge which would reasonably be available to the audience to whom the instrument is addressed".

202. Whereas in the case of a contract, the relevant factual matrix will extend to what was reasonably available to the contracting parties, in the case of a public law instrument, which (as in the case of an SMP condition) is promulgated to the world at large, the relevant factual material will only extend to the material reasonably available to the public at large (and so will typically be narrower than the relevant factual matrix in a contractual context).

203. In the present case, we consider the relevant factual matrix to be quite limited, and to be confined to the relevant statutory framework for the imposition of SMP conditions (specifically, the 2003 Act and the EU directives comprising the common regulatory framework) and to the published documents that led up

to the SMP conditions imposed in this case (including, in particular, the 2004 LLMR Statement).

204. Clearly, documents post-dating the imposition of the SMP conditions in this case cannot form part of the factual matrix, being after the event. As regards documents in the more distant past – like for instance – Oftel's "Guidelines on the Operation of the Network Charge Controls", published in 1997 and 2001 – we recognise that they contribute to an understanding of how the regulatory controls and related concepts evolved. However, in terms of construction of the SMP conditions, they are of mainly historical interest, and tend to be of marginal, if any, assistance.

(b) The contention that, even OFCOM's construction of Condition H3.1 was correct, OFCOM was obliged to enforce Condition H3.1 in a manner different from the true construction of that provision

205. BT made three points in this regard. Although different, the points all had this in common: they sought to contend that even if the construction of Condition H3.1 went against BT, BT was nevertheless entitled to have that condition enforced or applied in a manner different to its true meaning.

206. BT's points were as follows:

(1) *The section 3(3) point.* Here, BT's contention was that OFCOM had, in breach of its statutory obligation (contained in section 3(3)(a) of the 2003 Act) failed to have regard to the principles under which regulatory activities should be transparent and consistent: BT's written opening submissions, paragraphs 31-41; BT's written closing submissions, paragraphs 15(a) and 18-24. Section 3(3)(a) makes no specific reference to fairness (it refers to "consistency"), but it is trite that public bodies like OFCOM are obliged to act fairly: see, for example, Fordham, *Judicial Review Handbook*, 5th ed (2008), paragraph 60.1. The thrust of BT's contention was that it had been led to believe that Condition H3.1 would not be applied in the manner in which OFCOM in fact applied it (BT's written opening submissions, paragraph 39):

> "BT contends that the material in Appendix 2 to the [Notice of Appeal] and elsewhere shows that, far from making clear how Ofcom would approach BT's cost orientation obligation, there was a significant amount of material indicating that it

> would not approach the obligation in the way it has now done in the [Determination]."

In essence, BT's point was that no measure should be applied to "any party concerned until they have been made aware of it" (BT's written closing submissions, paragraph 19). Of course, BT was aware of Condition H3.1: its point was that it was *not* aware of how that provision would in fact be applied.

(2) *Legitimate expectation.* BT's contention was that OFCOM has created in BT a legitimate expectation in it that Condition H3.1 would not be applied in the manner that it came to be applied: BT's written opening submissions, paragraph 38; BT's written closing submissions, paragraphs 15(b) and 25. Essentially, BT contended that OFCOM had made its position on Condition H3.1 clear and had, by its conduct during the Dispute Resolution Process and in the Determination, resiled from that position. (We should note that BT's written opening submissions did, also, refer to estoppel, in footnote 82. The factual basis for the estoppel was the same as that for legitimate expectation.)

(3) *Modification of SMP conditions.* BT's contention was that OFCOM had failed, in the Determination, to follow the prescribed rules in the 2003 Act for the modification of SMP conditions: BT's written opening submissions, paragraphs 42-52; BT's written closing submissions, paragraphs 15(c) and 26.

207. BT's third point – relating to the modification of SMP conditions – is dealt with in paragraphs 314 to 319 below. BT's first two points – the section 3(3) point and the legitimate expectation point – are both concerned with what are essentially factual questions about precisely what OFCOM (and indeed, Oftel) said and did over time in order to engender an expectation on the part of BT that Condition H3.1 would be applied in a particular way. We consider these factual questions as they arise in the paragraphs below. Before moving on to these detailed questions, we consider a number of general points regarding the section 3(3) point and the legitimate expectation point:

(1) The protection of legitimate expectation has a prominent place in English public law. In *R v Inland Revenue Commissioners ex p MFK Underwriting Agents Limited* [1990] 1 WLR 1545 at 1570, Bingham LJ stated:

> "If a public authority so conducts itself as to create a legitimate expectation that a certain course will be followed it would often be unfair if the authority were permitted to follow a different course to the detriment of one who entertained the expectation, particularly if he acted on it. If in private law a body would be in breach of contract in so acting or estopped from so acting a public authority should generally be in no better position. The doctrine of legitimate expectation is rooted in fairness."

(2) Just before this passage, Bingham LJ emphasised that conduct relied upon to create the legitimate expectation must be "clear, unambiguous and devoid of relevant qualification". That is a point that has been made many times in other cases (eg *R v Jockey Club, ex p RAM Racecourses* [1993] 2 All ER 225 at [236]: "a clear and unambiguous representation").

(3) Here, the starting point for analysing any legitimate expectation on the part of BT is that BT has *lost* on the question of construction. Although of course it is possible for a public body to represent that it will not apply a provision like Condition H3.1 in a particular way, the clarity of the condition is, in our view, a relevant factor. If the meaning of Condition H3.1 is clear, then what BT will have to establish is that OFCOM quite clearly stated that – despite this clear wording – Condition H3.1 would be applied in a different way. Bingham LJ's comparison of legitimate expectation to breach of contract and estoppel is very apposite.

(4) In addition to there being a sufficiently clear statement or representation from the public authority, the person seeking to enforce the legitimate expectation must either be entitled to rely on that statement or representation or at least it must have been reasonable for that person to have done so: *R v Jockey Club, ex p RAM Racecourses* [1993] 2 All ER 225 at 236.

(5) As we have held in paragraphs 198 above, Condition H3.1 consists of a public law control over BT's private law freedom of contract. The condition was publicly promulgated. Members of the public themselves have an expectation that public law instruments will be interpreted and

applied according to their terms. Here, we are very conscious that were BT to have a legitimate expectation in relation to Condition H3.1 that was *different* to that of the Altnets, applying Condition H3.1 in accordance with BT's legitimate expectation might very well be unfair to the Altnets. We consider this to be a relevant factor in assessing whether BT's reliance on any statements or representations that may have been made by OFCOM was reasonable.

(6) The relationship between BT's section 3(3) point and its legitimate expectation point is a difficult one. As we have noted, a legitimate expectation is founded upon the *clarity* of the representation or statement made by the public authority. By contrast, BT's section 3(3) point appears to rely upon OFCOM's obligation under section 3(3) of the 2003 Act to act transparently and consistently, whilst emphasising OFCOM's failure to meet these standards. In other words, BT's contentions in respect of its section 3(3) point appear to be based upon OFCOM's *lack of clarity*, and so appear to undermine its contentions in respect of its legitimate expectation point.

(7) It is implicit in BT's section 3(3) point that a failure on the part of OFCOM to comply with section 3(3) of the 2003 Act must have consequences. BT never articulated what these might be. Our conclusion is that section 3(3) does not of itself create any additional obligations on OFCOM beyond those ordinarily conferred by public law.

208. We shall now proceed to consider in turn the three aspects (set out in paragraph 190 above) in which BT contended OFCOM had misapplied Condition H3.1. In respect of each aspect, we consider first the question of construction and then the question of legitimate expectation.

(iii) Which prices are cost orientated by Condition H3?

(a) The cost orientation provisions

209. As was noted in paragraph 41 above, the 2004 LLMR Statement described a number of different markets and imposed SMP conditions in respect of each of them. Conditions H are more lengthily entitled "The conditions imposed on British Telecommunications plc under the Communications Act 2003 as a result

of the analysis of the market for the provision of wholesale trunk segments at all bandwidths in which British Telecommunications plc has been found to have significant market power".

210. The cost orientation obligation imposed on BT is contained in Condition H3.1, and reads as follows:

> "Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition H1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs and an appropriate return on capital employed."

211. The first question that falls to be considered is what charges are covered by the condition? Was OFCOM correct in considering, discretely, the charges for each separate trunk service offered by BT?

(b) BT's contentions

212. BT contended that OFCOM's approach was wrong. In paragraph 94 of the Notice of Appeal, the point was baldly stated as follows:

> "BT contends that Ofcom has committed a manifest error by applying its cost orientation methodology to the prices of trunk segments in isolation from those of terminating segments, when the two types of service are inextricably linked as the constituent components of PPCs. Ofcom has compounded that error further by looking at the individual components of the trunk service rather than all bandwidths together."

213. BT advanced five grounds in support of its contention (summarised in paragraph 97 of its Notice of Appeal):

(1) OFCOM's disaggregated approach ignored the product actually sold.

(2) OFCOM's justification that its focus must follow previously defined market analysis was both wrong in principle and could not be a justification for focussing on sub-components.

(3) The disaggregated approach was inconsistent with a proper economic approach to cost orientation.

(4) OFCOM's construction of the cost orientation condition was artificially restrictive and an inappropriate, retrospective, response to its own contemporaneous failure to specify how it would apply the condition.

(5) OFCOM's disaggregated approach was inconsistent with the approach previously adopted by OFCOM.

214. Only one of these points – the fourth – actually addresses what we consider must be the starting point for any question about BT's cost orientation obligations, which is the true construction of Condition H3.1. We will consider the question of construction first, and then revert to the other points made by BT.

(c) Construction

215. Part 1 of Conditions H contains provisions relating to the definition and interpretation of the conditions. Paragraph 1 provides that:

> "These conditions shall apply to the market for the provision of wholesale trunk segments at all bandwidths within the United Kingdom…"

216. By contrast, paragraph 1 of Part 1 of Conditions G makes it clear that:

> "These conditions shall apply to the market for the provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including eight megabits per second within the United Kingdom…"

217. It seems, therefore, very clear that the various conditions imposed by the 2004 LLMR Statement apply to clearly defined markets: Conditions H apply to trunk segments and Conditions G apply to terminating segments. It would, therefore, follow that the cost orientation condition contained in Condition H3.1 applies to trunk prices and trunk prices alone.

218. Mr Read, for BT, sought to articulate the difference between this approach (which was OFCOM's, supported by the Altnets) and BT's in an exchange with Mr Saini, for OFCOM, on Day 1 (Transcript Day 1, pages 71-72):

> "**Mr Saini** …if one focuses first of all on the Condition itself… – Condition H1 – As I understood the position this morning - and Mr Read will correct me if I am wrong – it is now accepted by BT that when reference is being made to the provision of network access Condition H3.1, that network access is access to trunk segments. A large part of our skeleton argument is spent on dealing with what we have understood to be the contrary position. I hope I am happy to say that it is now accepted that Condition H3 required BT to show that its prices for trunk segments were cost oriented.
>
> **Mr Read** I do not want to interrupt my learned friend at this stage, but it was one of the points that I did not perhaps spend as long as I could have done dealing with our position on Condition H3. What I certainly do accept is

> that this is a condition focussed upon the trunk market and therefore the trunk sections. I do not necessarily accept that network access in this context means trunk alone. I certainly do not accept that when you come to consider the cost orientation condition imposed in respect of the trunk market that you ignore what is going on with the terminating market as well. Now, I do not know whether that helps my friend or hinders him. But that is BT's position – that network access does not per se mean network access confined to the trunk segment itself. But I do fully accept that this condition is imposed in the context of trunk segments. Obviously that is an important point because one of the things that is being said against us is the fact that our interpretation makes a similar provision in the terminating segment in the G3 that I have already shown you otiose. Well, we do not accept that. I think, I hope that I have made it perfectly clear that we do accept that Condition H3 is focussed on trunk segments. That may, or may not, help my learned friend, but that is the way we are putting the case."

219. Mr Read's point reiterated the fourth point made by BT in paragraphs 121-127 of its Notice of Appeal. In paragraph 126 it is asserted:

> "A charge for the whole circuit (including both trunk and terminating segments is a "*charge…payable…for Network Access covered by Condition H1"*. The fact that the same charge may also be covered by a separate cost orientation condition (in particular the cost orientation conditions for high and low bandwidth terminating segments) does not exclude the need to assess cost orientation by reference to the full network access provided (namely the circuit sold)."

220. BT's point is that if a circuit includes trunk segments, then what is cost orientated is the charge for the *whole circuit*, including trunk, rather than simply the trunk segment itself. Given the fact that Conditions H are expressly confined to trunk, this is obviously a difficult submission to make good.

221. BT's point was that "Network Access" as a term of art did not refer simply to the narrow trunk component, but to the PPC as a whole, and that a charge payable for network access had to be read as relating to the overall charge in relation to any PPC containing an element of trunk.

222. This requires a consideration of the meaning of "Network Access".

223. Part 1 of Conditions H provides, in paragraph 3, that:

> "Save for the purposes of paragraph 1, except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them and otherwise any word or expression shall have the same meaning as it has in the Act."

224. The term "Network Access" is capitalised, but not otherwise defined. Accordingly resort must be had to the definition of that term in the 2003 Act,

which is defined in sections 151(1) and 151(3) (section 151(1) referring on to section 151(3)):

> "(3) In this Chapter references to network access are references to –
>
> (a) interconnection of public electronic communications networks; or
>
> (b) any services, facilities or arrangements which –
>
> (i) are not comprised in interconnection; but
>
> (ii) are services, facilities or arrangements by means of which a communications provider or person making available associated facilities is able, for the purposes of the provision of an electronic communications service (whether by him or by another), to make use of anything mentioned in subsection (4).
>
> (4) The things referred to in subsection 3(b) are –
>
> (a) any electronic communications network or electronic communications service provided by another communications provider;
>
> (b) any apparatus comprised in such a network or used for the purposes of such a network or service;
>
> (c) any facilities made available by another that are associated facilities by reference to any network or service (whether one provided by that provider or by another);
>
> (d) any other services or facilities which are provided or made available by another person and are capable of being used for the provision of an electronic communications service."

225. BT sought to contend (eg in paragraph 124 of its Notice of Appeal) that the provision of trunk services alone could not amount to the provision of "Network Access". If the definition of Network Access were confined to meaning "interconnection of public electronic communications networks" there might be some force in this, but it is plain that "Network Access" has a much wider meaning than this, extending to (for example) "any apparatus comprised in such a network or used for the purposes of such a network or service". It plainly can include a 2 Mbit/s trunk segment without other segments that make up the circuit.

226. Accordingly, we conclude that Condition H3.1 – on its true construction – applies to trunk services alone.

227. Both OFCOM and the Altnets suggested that a strong point in favour of this disaggregated approach, was that an aggregated approach (in particular, one aggregating between trunk and terminating segments) would have the effect of conflating distinct schemes of regulation. We agree with this submission. Such an approach could effectively undermine specific charge controls directed to

particular services, for example the charge control imposed in relation to terminating segments. Were BT permitted effectively to cross-subsidise a "low" price for one service (eg terminating segments), by charging more for another service (eg trunk segments), and by aggregation using the low price of the former to bring down the aggregate of the prices for the two services, then plainly the charge control/cost orientation regime would be substantially undermined.

228. According to Condition H3.1, "each and every charge offered" must be cost orientated. We consider that the effect of these words is to render the test for cost orientation applicable separately to each discrete trunk service – ie the charge for each bandwidth must be cost orientated. This makes sense: the purchaser of 2 Mbit/s trunk will want to know that the particular service he is buying is cost orientated. He will doubtless be rather less concerned with the cost orientation of services he is not purchasing. What is more, considering charges for different trunk bandwidths together permits cross-subsidisation. For instance, the charge for 2 Mbit/s trunk could be excessively above cost, whereas the charge for 8 Mbit/s trunk could be well below cost, resulting in a price that in aggregate might be cost orientated, but which would be significantly to the disadvantage of purchasers of 2 Mbit/s trunk. We consider this to be a powerful pointer in favour of this construction of Condition H3.1.

(d) BT's other points

229. We turn now to the other points advanced by BT in support of its contention:

(1) First, BT states that OFCOM's approach ignores the product actually sold. What are sold, according to BT, are PPCs, not trunk or terminating segments. As a proposition of fact – and as is clear from our description of PPCs in paragraphs 18 to 36 above – this is right. But the fact is that PPCs comprise a number of elements, and for regulatory purposes, trunk and terminating segments are distinguished (and, indeed, listed separately in BT's catalogue). The fact that BT would not, but for regulatory intervention, distinguish between markets for trunk and markets for terminating is irrelevant. That is the regime laid down by the 2004 LLMR

Statement, which does distinguish between such markets, and the SMP conditions imposed simply reflect this.

(2) Secondly, BT asserts that it was wrong for OFCOM "to rely on the market definitions generated in 2004 as a reason for ignoring the overall charges of the product already sold". With great respect, this cannot be right. The immediate basis for OFCOM's approach is not the 2004 LLMR Statement, but rather the SMP conditions imposed as a result of that statement, which differentiate between markets. Having concluded that the meaning of these conditions is clear, we fail to see how either OFCOM or this Tribunal could sanction an approach to cost orientation that disregarded the clear meaning of Condition H3.1.

(3) Thirdly, BT contends that OFCOM's approach was inconsistent with a proper approach to cost orientation. This point is simply a repetition of BT's assertion that prices for PPCs should be cost orientated, and not prices for trunk and terminating segments separately. But this is to again ignore the wording of the SMP conditions. If BT so vehemently disagreed with the market definitions contained in the 2004 LLMR Statement, and so the effect of the conditions imposed as a result, then these decisions could and should have been appealed.

(4) (Fourth was BT's construction point, which has already been considered in paragraphs 215 to 228 above.)

(5) Fifthly, and finally, BT contended that OFCOM's approach was inconsistent with the approach adopted previously by OFCOM. This is a question of "legitimate expectation" and is considered further below.

(e) Legitimate expectation and the section 3(3) point

230. As we noted in paragraph 207(5) above, we consider that our conclusions regarding the true construction of Condition H3.1 have a bearing on BT's legitimate expectation contentions. If the meaning of the Condition is clear, then in order to create a legitimate expectation entitling BT to have Condition H3.1 applied differently requires BT to demonstrate a clear statement or representation by OFCOM that Condition H3.1 would not be applied according to its proper construction.

231. Here, we are considering *which* prices are orientated to cost according to Condition H3.1. If BT is seeking to contend that it had a legitimate expectation that Condition H3.1 would be applied on an aggregated, rather than a disaggregated basis, it is what Oftel and OFCOM said and did in relation to this, that matters.

232. We consider that neither Oftel nor OFCOM can have made any relevant statements regarding aggregation/disaggregation prior to the market review that lead to the 2004 LLMR Statement. This is because the 2004 LLMR Statement was a consequence of the change in regulatory regime that we have described in paragraphs 38 to 40 above. That regime required a definition of relevant markets and an assessment of competition in those markets. As we have described (paragraphs 41 to 51 above), the 2004 LLMR Statement defined a number of markets, including one in relation to trunk.

233. The SMP conditions imposed on BT as a result of this market review tracked the definition of markets in the 2004 LLMR Statement. The conditions themselves (as we have described in paragraphs 215 to 228 above) make absolutely clear their scope, tying that scope to specific markets.

234. We have concluded that Conditions H make absolutely clear which prices are to be cost orientated – namely, trunk prices. That is entirely consistent with the market definition contained in the 2004 LLMR Statement.

235. Any statements relating to markets or scope of regulatory control prior to the leased lines market review *ex hypothesi* cannot have been made in relation to the markets as defined in the 2004 LLMR Statement. Accordingly, there can be nothing in the period that is capable of generating a legitimate expectation. We do not understand BT to contend the contrary, but if BT was contending that its legitimate expectation arose out of pre-market review statements or events then we consider such an expectation to have been an unreasonable one.

236. As we have said, we regard the 2004 LLMR Statement, and the scope of Conditions H, to be extremely clear. We do not consider there to be room for any legitimate expectation that does not accord with the true construction of Condition H3.1 as we have stated this in paragraphs 215 to 228 above.

237. In a large organisation like BT, there are no doubt many people with many different viewpoints regarding the prices that are subject to the cost orientation provision contained in Condition H3.1. But it is, we consider, noteworthy that Mr Pigott appeared (correctly) to consider that Condition H3.1 only applied to the prices for trunk segments (Transcript Day 3, page 20).

238. Accordingly, we do not consider BT to have had any legitimate expectation that Condition H3.1 would be applied on an aggregated basis. We also consider BT's section 3(3) point must fail because the prices that are cost orientated by Condition H3.1 are clearly identified by that provision.

(iv) The test for determining whether price is orientated to cost

239. Having decided *which* prices are orientated to cost by Condition H3.1, it is next necessary to consider *how* it is determined whether these prices are in fact cost orientated. As has been described in paragraph 123 above, OFCOM's approach was to use DSAC as a first order test of compliance, but then to consider (by reference to various second order tests) whether (notwithstanding breach of the DSAC test) it was nevertheless inappropriate to conclude that there had been a failure to comply with the cost orientation obligation.

(a) BT's contentions

240. In its Notice of Appeal, BT made three points:

(1) First, BT contended that DSAC is fundamentally flawed as a "first order test", and that there were or are better tests: paragraphs 137 to 187 of the Notice of Appeal.

(2) Secondly, BT contended that there was a lack of transparency and legal certainty in terms of OFCOM's use of DSAC: paragraphs 188-202 of the Notice of Appeal.

(3) Thirdly, BT contended "prior to applying and enforcing the DSAC test as a cost orientation rule pursuant to s87(9) of the Act, Ofcom has failed to address the relevant risk of adverse effects from price distortion and consumer detriment. It has simply assumed that prices above DSAC are excessive without conducting a proper analysis of the effects of BT's

charges on [communications providers], customers and consumers": paragraph 203 of the Notice of Appeal.

241. A fundamental point to note at the outset is that Condition H3.1 does not actually refer to DSAC at all. It does not *impose* DSAC as the test for cost orientation. Before considering BT's contentions, which we have summarised in the preceding paragraph, and which all relate to DSAC, it is necessary to consider, as a matter of construction, precisely the nature of the cost orientation obligation that Condition H3.1 imposes on BT. This we do in paragraphs 242 to 249 below.

(b) The nature of the cost orientation obligation contained in Condition H3.1

242. It is clear from the wording of Condition H3.1 that it is left to the dominant provider – that is, BT – to decide how and what to charge for its services, provided always these charges are "reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed".

243. As we noted in paragraph 66 above, there are three elements to the cost orientation obligation in Condition H3.1. The prices charged by BT must:

(1) Be reasonably derived from the costs of provision based on a forward looking long run incremental cost approach.

(2) Allow for an appropriate mark up for the recovery of common costs.

(3) Include an appropriate return on capital employed.

244. We have considered the economic meaning of these terms in paragraphs 67 to 100 above. The concepts are very specific and clear. Given that the imposition of SMP conditions is fundamentally economically driven, being a response to a dominant provider having significant market power in an identified market, it is obvious that these economic concepts are central to the true construction of Condition H3.1.

245. Applying these concepts, it is clear and we hold that Condition H3.1 operates in the following way:

(1) *Stage 1: Deriving prices from LRIC.* In the first instance, prices must be reasonably derived from LRIC. This means that, essentially, SAC is to be disregarded when setting prices, and the prices are to be based upon (or reasonably derived from) incremental costs. In other words, in the first instance, prices are to be set *without reference* to common costs.

(2) *Stage 2: A mark-up for common costs.* It is well recognised – for the reasons given in paragraph 83 above – that if a firm prices all products or services at LRIC, common costs fall out of account, and will not be recovered. The firm will make a loss. This is recognised in the second stage of Condition H3.1, which permits "an appropriate mark up for the recovery of common costs". As we have noted (paragraphs 85 to 95 above), there are a number of ways in which common costs can be allocated between services/products, and Condition H3.1 does not stipulate which, save to say that the mark-up (and so, the method of allocation for common costs) must be "appropriate".

(3) *Stage 3: The cross-check.* Condition H3.1 expressly states that prices shall include an appropriate return on capital employed. At first blush, this provision may seem redundant, since interest on borrowed capital is a common cost that should be reflected in prices derived using Stages 1 and 2. However, return on shareholders' equity is not an accounting cost but still should be "appropriate". The provision is an important one, because it ensures that prices orientated in accordance with Stages 1 and 2 are fair in this respect.

246. We have noted that Stage 2 does not impose a method of allocating common costs, but leaves it to BT to select an appropriate method. In short, BT is given a discretion in terms of how it allocates common costs, which discretion is circumscribed by the need for the method of allocation to be "appropriate".

247. Given that a specific method for the allocation of common costs is *not* imposed by Condition H3.1, it is not surprising that the condition imposes on BT an obligation to "demonstrate to the satisfaction of Ofcom" that Condition H3.1

has been complied with. It would be most surprising if Condition H3.1 did not contain a provision enabling OFCOM to monitor compliance.

248. The thrust of BT's attack was on the use of DSAC – which, as an approach to the allocation of common costs – clearly features at Stage 2. Stage 2, therefore, needs to be considered in greater detail.

249. BT's discretion at Stage 2, and OFCOM's right to monitor the exercise of that discretion, operates in the following way:

(1) It is, in the first instance, for BT to decide how to allocate common costs. Were BT to do so "appropriately" then – provided this was capable of demonstration to the satisfaction of OFCOM – we do not consider that it would be open to OFCOM to impose upon BT an alternative method of allocating common costs, even if that were also an "appropriate" method. (As we have noted, there is no one way of allocating common costs, and we consider that there will generally be several "appropriate" ways.)

(2) If, however, BT were unable to demonstrate to the satisfaction of OFCOM that it had allocated common costs appropriately, this would amount to a breach of Condition H3.1. Before us, this was referred to as the "burden of proof" point, and BT suggested that it was in some way unfair for such a burden to be imposed on BT. We disagree. Not only is this the clear meaning of Condition H3.1, it is also a necessary corollary to the discretion conferred on BT in terms of how common costs are allocated.

(3) Assuming, for the moment, non-compliance with Condition H3.1, the next question that arises is how it is tested whether BT's prices for the relevant product or service are or are not cost orientated. Such a question might well arise in the course of a Compliance Process or – as here – in the course of a Dispute Resolution Process. Even assuming that BT has failed to demonstrate that its cost orientation obligation has been complied with, this does not necessarily mean that BT's prices are not cost orientated. All that has happened, is that BT has failed to demonstrate that they *are* cost orientated. In our view, in such circumstances, it is for OFCOM – given that BT has failed to demonstrate compliance – to test whether common costs have been appropriately allocated.

250. In the light of this conclusion as to the construction of Condition H3.1, two further questions arise:

(1) First, has BT demonstrated compliance with Condition H3.1 and – specifically for the purposes of the present dispute – demonstrated that common costs have been appropriately allocated? This question is considered in paragraphs 251 to 275 below.

(2) Secondly, if not, is the method selected by OFCOM an appropriate method of determining compliance with Condition H3.1? This question is considered in paragraphs 276 to 305 below.

(c) Has BT demonstrated that its prices were cost orientated?

251. BT was, in this case, faced with a fundamental difficulty, in that clearly it had orientated its prices by reference to aggregated PPC costs. As noted above, we do not consider that this approach complies with Condition H3.1, which requires the prices for specific trunk services to be cost orientated.

252. In other words, once BT has lost this first point of construction, its ability to justify its cost orientation approach became extremely hard. Nevertheless, it is important to consider the evidence that BT put forward in support of its prices. Essentially, BT contended that its pricing was or could be justified by reference to:

(1) Combinatorial tests.

(2) Its circuit analysis.

(3) International benchmarking.

We consider each of these matters in turn below.

Combinatorial tests

253. Professor Yarrow, on his own evidence, was "not a fan of combinatorial tests" (Transcript Day 4, page 91). A little later, he had this exchange with Mr Saini (Transcript Day 4, page 92):

> **"Q (Mr Saini)** Is it your view that combinatorial is a bit of a waste of time?
> **A (Prof Yarrow)** On the whole, probably yes…"

254. As a general proposition, we do not agree with this. As we have described in paragraphs 89 to 90 above, combinatorial tests are one way of assessing whether or not a firm is over-recovering its common costs, and in some cases will be an entirely appropriate approach. The drawback of combinatorial testing, as we have also noted, is the number of permutations or combinations that may have to be undertaken where a firm sells a large number of products/services that share common costs. In some cases – and this is one of them – this purely practical difficulty may render combinatorial testing inappropriate.

255. The problem is simply stated: it may very well be that the price for a single product lies between LRIC and SAC; but that does not mean that the firm is not over-recovering its common costs. As the Determination notes in paragraph 7.118:

> "...it would not be sufficient to demonstrate that the charges for an individual service are/were below the (efficient) SAC for that service. The existence of significant common costs requires BT to also demonstrate that those common costs are/were not over-recovered from all the services that share them. Therefore, BT must also undertake a series of combinatorial tests to ensure that each and every combination of services that shares common costs with the service in question (in this case 2Mbit/s trunk) does not lead to an over-recovery of common costs."

256. Had BT demonstrated an absence of over-recovery of common costs through a series of combinatorial tests, then this would have been an appropriate way of demonstrating an appropriate mark-up for the recovery of common costs. However, at the end of the day, it was common ground that such combinatorial tests as were conducted by BT during the course of the Dispute Resolution Process were insufficient to establish this. The point is very clearly put in the Determination:

> "7.120 The exact combinations of services to be considered by the combinatorial tests are determined by the number of other services which share common costs…
>
> 7.121 As we have explained above, the aim of any such combinatorial analysis is to ensure that common costs are not over-recovered. Where all common costs are not shared by the same services, separate combinatorial tests are required for each of the common costs, as well as for combinations of the common costs. Where firms have numerous products and many types of common costs, as is the case with BT, this can lead to a very large number of combinations being required to satisfy the test. For example, with 10 services sharing common costs, there are over 500 combinations. For 11 services this increases to over 1,000 combinations and for 12 services to over 2,000 combinations.
>
> 7.122 In its Response, BT reported the results from six different combinatorial tests, based on a range of different combinations of PPC trunk and terminating segment services.
>
> [These were then described.]

7.123 …all of the combinatorial tests contained in BT's Response focus exclusively on combinations of services from the three PPC markets regulated in the 2004 LLR Statement (ie trunk and the two terminating service bandwidths). BT did not provide results for any tests that consider services other than PPCs in its Response.

7.124 If all the common costs that are incurred by 2Mbit/s trunk (as the service of interest) were exclusively shared by the combinations tested by BT, the approach to specifying combinations adopted would be sufficient. However, as BT's inclusion percentages tables show, the SAC estimates in all cases include common costs that are shared with non-PPC services…in excess of 75% of BT's SAC estimates in each year consist of trench (effectively duct), optical fibre and transmission equipment common costs, which are shared by numerous other (non-PPC) services."

257. Given the nature of BT's business, inevitably the number of combinatorial tests that would have to be carried out in order to show that BT was only making "an appropriate mark up for the recovery of common costs" would be vast.

258. This was accepted by Mr Budd (Transcript Day 2, pages 61-62):

"Q (Mr Saini) Would you accept that Ofcom made it clear to BT that if there were to be any useful combinatorials there would have to be a huge number of them?

A (Mr Budd) Ofcom did say there was a huge number that could – and the theory, the abstract theory, does mean you need to do a huge number of combinatorials.

Q (Mr Saini) Could I ask you, please, to go to your second statement, para 46, at p359 of the core bundle. Could you read that to yourself please? (After a pause) Have you read that?

A (Mr Budd) Yes.

Q (Mr Saini) There you appear to be suggesting that the problem in respect of combinatorials, or, in fact, the number of services across which the combinatorials would have to be conducted, that point had been made for the first time by Ofcom in the course of these proceedings?

A (Mr Budd) No, I think that the point Ofcom made for the first time is the idea that we should have drawn a broader combinatorial than the core combinatorial which we did. That, I think, was the access network combinatorial.

Q (Mr Saini) Would you agree with me that Ofcom had made it clear that if any combinatorial process was to be undertaken, it had to include many more services than those services currently included in your combinatorials?

A (Mr Budd) And that's why we did the core combinatorial which the DSAC comes from, which spans the whole of the core network, the inland conveyance network.

Q (Mr Saini) And it does not include the many other services of BT which share common costs with trunk – do you accept that?

A (Mr Budd) If you do that you are starting to test for the whole of BT's business.

Q (Mr Saini) I do not want to know about the consequence, I just want to see if you agree with me. You did not do that test, did you?

A (Mr Budd) We did no broader test than the core combinatorial test.

Q (Mr Saini) Would you agree with me that Ofcom suggested to you prior to the determination that any test had to be wider than those which you had hitherto done?

A (Mr Budd)	I'm sorry, could you repeat that question?
Q (Mr Saini)	Do you accept that Ofcom suggested to you prior to the determination that the combinatorial tests that you needed to do would be wider than those which you had hitherto done?
A (Mr Budd)	Well, we met Ofcom and we wrote to Ofcom and asked them which tests they would like us to do in July 2009.
Q (Mr Saini)	And they told you, did they not – this in a confidential letter but I will explain it in broad terms – did they not say to you in clear terms that any useful test would have to include every combination of services that shared common costs with 2 Mbit/s? That would be a vast exercise?
A (Mr Budd)	It would be a vast exercise, and it would get you back to rate of return regulation, a point Ofcom also made to us.
Q (Mr Saini)	But they made that point to you clearly before the final determination – is that not the case?
A (Mr Budd)	They did say that the theory required a vast number of tests to be done.
Q (Mr Saini)	Prior to the determination?
A (Mr Budd)	Yes, but we explained why we considered that the combinatorials we had done were the appropriate relevant ones."

259. It is right to say that, during the course of the Dispute Resolution Process, BT did ask OFCOM what combinatorials it might undertake in order to satisfy OFCOM as to BT's cost orientation. The problem is that – in this context – this was an impossible question to answer, save to say that a very large number of tests would have to be carried out.

260. Ultimately, as we have noted, and as Mr Pigott recognised (Transcript Day 3, pages 18-19), it was BT's responsibility to carry out appropriate combinatorial tests if this could feasibly be done, or (if, as we find, it could not be done) find some other way to demonstrate that 2 Mbit/s trunk charges were cost orientated.

261. The limited combinatorial tests carried out by BT were insufficient to demonstrate that BT had complied with its cost orientation obligation under Condition H3.1.

<u>The circuit analysis</u>

262. BT's circuit analysis was an analysis of the charges for the individual circuits actually purchased by each of the Altnets (paragraph 26 of Mr Budd's statement). As Mr Budd noted in paragraph 27:

> "This approach also permits analysis which avoids simple aggregation across two separate markets, because termination can be combined with trunk only where the two are actually bought together. Aggregation across markets would not involve this limitation but would

simply combine all trunk and terminating services when the latter is sometimes provided on its own."

263. As such, it may be said that BT's circuit analysis is more sophisticated than a simple aggregation of trunk and terminating segments, because it looks to the circuits in fact sold by BT. Nevertheless – as Mr Budd readily acknowledged – the circuit analysis depends upon aggregating trunk and terminating segments (Transcript Day 2, page 57).

264. For the reasons we have given at paragraph 228 above, Condition H3.1 requires the prices for trunk segments at each bandwidth sold to be cost orientated. The fact that the analysis of prices charged in respect of *PPCs* actually sold may be cost orientated (this was in any event controverted by OFCOM) is irrelevant. For this reason, we consider that OFCOM was right, in the Determination, to conclude (in paragraph 7.57 of the Determination) that "BT's circuit analysis is of limited relevance to these Disputes. While it is informative to note that, even on the basis of BT's preferred approach of offsetting trunk charges with terminating charges, it is still possible to conclude that there was overcharging (given that charges exceeded DSAC)…we fundamentally disagree with the aggregation of trunk and terminating charges upon which BT's circuit analysis is based."

International benchmarking/comparisons

265. In his witness statement, Mr Budd said the following about the international comparisons that had been submitted by BT during the course of the Dispute Resolution Process:

> "37. It is generally recognised that international benchmarking can be a valuable means for informing parties, including the National Regulatory Authority ("NRA"), as to one supplier's prices relative to its peers. Across the world, benchmarking is drawn on by governments, regulators and operators alike to inform a range of policy, operational and commercial decisions…
>
> 38. In BT's 14 October 2008 submission to Ofcom, BT therefore included a report by Deloitte on benchmarking comparisons between the price for PPCs provided by BT and the prices from a range of other European operators. This showed that BT's prices for PPCs that only include terminating segments are consistently below the average of comparator countries, whilst for PPCs that also include trunk BT's prices are generally in line with, or slightly below the average.
>
> 39. I do not suggest that benchmarking should be taken as determinative in settling prices, although in some jurisdictions prices have been set by the NRA purely based on international benchmarking. The Deloitte data BT provided was not intended to be

> determinative, but to provide yardsticks indicating the relative level of BT's PPC prices."

266. The importance of international comparisons depends upon the issue in question. Here we are considering compliance with a cost orientation obligation that is, so we have found, tightly and clearly drawn. BT's prices must be orientated to *BT's* LRIC, with a mark-up for *BT's* common costs, and taking into account *BT's* cost of capital. It seems to us that in this context, even if it comprised very detailed and clear information as to the charges of other operators, an international comparison can say very little about BT's compliance with Condition H3.1.

267. BT's international comparisons were contained in a report by Deloitte entitled "A Review of Proposed Adjustments to BT's PPC Revenues and Costs". It is a long report of some 69 pages. However, as Mr Myers pointed out in his statement, the data in the Deloitte report is – for perfectly comprehensible reasons – actually far from perfect. The analysis does not consider cost differences between the various countries reviewed (paragraph 269 of Mr Myers' statement, accepted by Mr Budd at Transcript Day 2, page 44), and has considerable gaps in information even so far as pricing for trunk segments is concerned. In many cases trunk prices were not known, and a proxy was used in place. Whilst Deloitte and BT no doubt did the best they could in terms of international comparison, the information in the report can hardly be said to be particularly compelling.

268. In the Determination, OFCOM reached the following conclusion in respect of international benchmarking:

> "7.10 In the Draft Determinations we identified that, taken at face value, the benchmarking data compiled by Deloitte suggested that BT's PPC charges are lower than the EU averages for both PPC terminating segments and trunk/terminating segments in aggregate, at each of the bandwidths considered (64kbit/s, 2Mbit/s and 34Mbit/s).
>
> 7.11 A more detailed examination of the benchmarking data, however, led us to identify a number of issues that causes us to question the extent to which the comparisons could be relied upon…As a consequence, we proposed to conclude that the lack of comparable pricing information for trunk services and the differences in the competitiveness and level of regulation in the trunk markets meant that it was not possible to draw any reliable inferences from Deloitte's benchmarking work with respect to BT's trunk charges."

269. After reviewing the Deloitte report in greater detail in paragraphs 7.136 to 7.149 of the Determination, OFCOM concluded in paragraph 7.150:

> "The fundamental point, however, is that faced with the actual cost data that indicates that BT has overcharged for 2Mbit/s trunk services and financial data that shows that BT has earned very high rates of return on these services, we do not consider that significant weight can be given to BT's international benchmarking data."

At the conclusion of his cross-examination on this point, Mr Budd essentially accepted that OFCOM's conclusion was at least justifiable (Transcript Day 2, page 49).

270. In his report, Professor Yarrow criticised OFCOM for dismissing "the international benchmarking evidence presented by Deloitte, for no very good reason", quoting paragraph 7.150 of the Determination (paragraph 71 of Professor Yarrow's first report). This statement suggests that the Deloitte report contained material of significance, which should have been, but was not, taken into account by OFCOM.

271. However, Professor Yarrow's oral evidence put matters in a rather different light (Transcript Day 4, pages 68, 69 and 71):

"Q (Mr Saini)	Let us look at another document. Did you look at the Deloitte's report which concerns benchmarking?
A (Prof Yarrow)	Briefly, yes.
Q (Mr Saini)	Sorry, what do you mean by "briefly"?
A (Prof Yarrow)	Just turned the pages, because we have not relied upon that. What we have relied upon is the Ofcom treatment of that report and the issue we are raising was the dismissal of relevant evidence by Ofcom.
	…
Q (Mr Saini)	When you say "briefly" would it be fair to say that having looked at it briefly you were not really able to form a view as to the quality of the evidence of benchmarking?
A (Prof Yarrow)	We didn't, no, that was not something we have done. We are critical of the way in which that evidence is dealt with by Ofcom, and that is the point we make. As for the actual evidence itself, as you know, international comparison evidence always has to be treated with caution. We use it because it is the best evidence we have got usually in many cases, and therefore even though it is highly imperfect evidence, being the best evidence it should always, as a matter of good practice, be considered carefully. Our reading of the Ofcom documents and the Ofcom arguments was that Ofcom was very keen to dismiss this evidence without good ground, and that was plain on the face of the decision and did not need any detail. I took the fact that it is a Deloitte's report, Deloitte had lent its brand name to it so I will count that as a factor.
	…

Q (Mr Saini)	Professor Yarrow, you yourself, have said that you formed no view as to the quality of the information that Deloittes have put forward. That was your evidence, was it not?
A (Prof Yarrow)	Other than the fact that it is a Deloitte's report and therefore I make the normal assumption that that's a sign, it's an indicator."

272. With great respect to Professor Yarrow, this was not satisfactory evidence. OFCOM did, on the face of the Determination, consider the Deloitte report and, after doing so, dismissed it as being of very limited relevance. Professor Yarrow's report suggests that this dismissal was for no good reason: to make such an assertion, it is necessary to be able to articulate what, in the report, OFCOM had disregarded for "no very good reason".

273. We do not wish to understate the general importance of international comparisons and benchmarking. But we consider that OFCOM was right, in this case, to regard the Deloitte report as having really very little relevance to the question of whether *BT's* common costs had been appropriately allocated in compliance with Condition H3.1. We consider that the answer to this question was firmly rooted in BT's own costs and prices.

Conclusion

274. Our conclusion is that none of the material adduced by BT to OFCOM, whether before or during the Dispute Resolution Process was sufficient to discharge the onus, which was on BT, to show that its prices for 2 Mbit/s trunk segments were compliant with the requirements of Condition H3.1. In particular:

    (1) The data on which BT relied – which we have summarised in paragraphs 132 to 135 above – looked at the prices for PPCs on an aggregated basis, which is not what Condition H3.1 calls for.

    (2) The same objection can be made in respect of BT's circuit analysis, which is also an aggregated assessment, albeit one done by reference to the actual circuits purchased by the Altnets.

    (3) BT's international benchmarking and combinatorial tests were inconclusive and essentially irrelevant, for the reasons we have given.

275. Accordingly, BT was in breach of Condition H3.1 in that it could not demonstrate to the satisfaction of OFCOM that Condition H3.1 was satisfied.

Given the dispute between BT and the Altnets that OFCOM had accepted, it then became incumbent upon OFCOM to determine whether BT's prices for 2 Mbit/s trunk segments were cost orientated or not, and if not, then by how much. It is to that question that we now turn.

(d) OFCOM's assessment of compliance with Condition H3

276. OFCOM used DSAC as a "first order" test to determine BT's compliance with Condition H3.1. Two issues fall to be considered:

(1) Is DSAC an appropriate test for cost orientation purposes *at all*?

(2) If so, what emphasis can properly be placed on DSAC? Or, put another way, what does "first order" test mean?

We consider these issues in turn below.

DSAC as an appropriate test for cost orientation purposes

277. There are a number of points that can be made about DSAC as a test for cost orientation purposes.

278. DSAC is not a generally well-known test. Mr Bolt gave evidence of its use in other regulated industries, but even he did not seek to go so far as to assert that DSAC was as well-known as combinatorial tests or FAC. Mr Myers was not aware of other regulators using DSAC (Transcript Day 3, page 38). That said, DSAC *was* reasonably well-known in the context of communications regulation generally, and to BT in particular:

(1) Oftel's "Guidelines on the operation of Network Charge Controls", dated October 1997 ("the Oftel 1997 Guidelines"), provided in paragraph C.1 of Annex C:

> "In general, Oftel would consider a good first order test of whether a charge is unreasonable or otherwise anti-competitive to be whether the charge in question falls within a floor of long run incremental cost and a ceiling of stand-alone cost (paragraphs C3-C5 below explain Oftel's methodology for deriving floors as the incremental cost of conveyance broken down into component costs, and ceilings as stand-alone efficient operator cost of conveyance broken down into component costs). A charge set below the floor could mean that BT was not recovering sufficient of the incremental cost of conveyance from the service and might indicate the possibility of anti-competitive behaviour. A charge set above the ceiling might mean that BT was recovering more than an appropriate share of the full (or stand-alone) costs in providing conveyance, which would indicate possible abuse of a dominant position in the market for the service."

The same wording is to be found in Oftel's December 2001 Guidelines (at Annex B, paragraph B.1). The Oftel 1997 Guidelines appear to be the source of the phrase "first order test", a matter that we consider in paragraphs 290 to 305 below. For present purposes, the point to note is that whilst paragraph C.1 could be more clearly worded (in that there is no reference to distributed long run incremental cost or distributed stand alone cost), it is tolerably clear when paragraph C.1 is considered as a whole, and absolutely clear from the overall context (eg paragraph C.15) that DLRIC and DSAC are what is meant. Even Professor Yarrow, who was very critical of the omission of the "distributed" in paragraphs C.1 and B.1 (Transcript Day 4, pages 89-90), accepted that these paragraphs were referring to DLRIC and DSAC.

(2) BT's Primary Accounting Documents demonstrated great familiarity with DLRIC and DSAC, as the passages quoted in paragraph 104 above demonstrate.

(3) BT's regulatory financial statements reported DSAC "ceilings" (and DLRIC "floors"). Although the granularity of the reporting varied, DSAC ceilings for 2 Mbit/s trunk as a distinct service were reported from 2006 onwards. BT's regulatory financial statements are described in paragraphs 59 to 63 above; Annex C sets out the detailed figures that these regulatory financial statements disclose.

(4) On 3 May 2006, OFCOM published a consultation document in relation to regulatory financial reporting. BT responded in a document entitled "Regulatory financial reporting obligations on BT", dated 12 July 2006. This stated, amongst other things:

(i) At page 3:

> "Note that the terms "cost orientated" and "cost orientation", which are used both in Ofcom's consultation document and in this response, are effectively shorthand for the phraseology used in the formal Conditions imposed upon BT by Ofcom in relation to SMP markets. For example, SMP Condition I1 (retail leased lines of a bandwidth capacity of eight megabits per second or for analogue retail leased lines) says: "[…] each and every charge offered, payable or proposed […] is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs and an appropriate return on capital employed". It is this that the term "cost orientation" is used to indicate."

(ii) At page 4:

> "In relation to SMP markets the main objective [of published financial information] is to provide sufficient assurance that the firm with SMP has complied with key regulatory accounting and reporting obligations. These may include providing first order evidence of non-discrimination, cost-orientation of prices for key products and compliance with *ex ante* price controls."

(iii) At page 6:

> "**Cost orientation of prices for products in SMP markets:** For products subject to periodic price controls this test is, in broad terms, satisfied by the fact that prices are being controlled *ex ante* by the regulator. Comparison of average charges with costs is a good first-order test of cost-orientation. Although the accounts cannot show anything more than a first order test, this approach has been in place for ten years and is widely accepted as an appropriate measure."

279. Unsurprisingly, a number of BT's witnesses showed a clear awareness of DSAC as a test for common cost allocation. On Day 2 (Transcript Day 2, page 59), Mr Budd (when being asked about BT's Primary Accounting Documents) stated: "The DSAC is the first order consideration for considering possible non-cost orientation".

280. Mr Morden, too, was aware of the floors and ceilings (Transcript Day 3/page 8):

"Q (Mr Saini)	…did you know about the existence of these measures as published in your primary accounting documents in your day to day role as the product manager?
Q (Mr Morden)	Ever since 2001, we have put floors and ceilings in the accounts.
Q (Mr Saini)	But there has never been any doubt in BT's mind that Ofcom regarded these floors and ceilings as important?
Q (Mr Morden)	Important, yes."

281. Although there was some suggestion to the contrary in the draft determination, DSAC is not a proxy for combinatorial tests. It operates in a very different way. Whereas combinatorial tests seek to assess cost orientation by what is in effect a properly representative sampling of the prices for multiple products sharing common costs, DSAC distributes the SAC of a broad increment of services *pro rata* amongst each of the services within that increment. It is very different from

combinatorial testing. In particular, it avoids the practical difficulties of combinatorial testing that arise when many products share common costs.

282. One of the points about cost orientation provisions is that whilst prices so regulated are intended to be *orientated* to cost, the price is not dictated. The firm that is subject to the orientation obligation has a degree of flexibility in how it charges. This is important for the reasons given in paragraph 18 of Mr Myers' statement:

> "The overarching economic context is the regulatory balance to be struck between:
>
> a. providing the regulated firm with enough pricing flexibility to recover its costs, including its common costs, in an economically efficient manner; and
>
> b. ensuring that this flexibility is sufficiently bounded to prevent the regulated firm from exploiting its market power to set anti-competitive, exploitative or otherwise unreasonable charges."

283. DSAC achieved this in the following way, as described by Mr Myers:

> "35. OFCOM viewed DSAC as striking a reasonable balance between providing BT with flexibility to price individual services to recover its common costs efficiently and ensuring that this flexibility is sufficiently bounded so as not to allow BT to price in an anti-competitive, exploitative manner or otherwise unreasonable manner.
>
> 36. In general, DSAC lies between fully allocated costs ("FAC") and SAC. FAC provides a useful benchmark, but using it to set all prices can be too restrictive on the pattern of common cost recovery. A key difference from DSAC is that FAC represents one specific view of cost allocation and allows the regulated firm no flexibility if it wishes to recover all its costs. If any price is below FAC, then another price needs to be above FAC – otherwise the firm fails to recover its costs. But there may be other reasonable patterns of cost recovery. In contrast, charges can be below DSAC and still allow for full cost recovery. This is because the sum of all the DSACs exceeds BT's total costs (by including the common costs between two broad increments in the DSACs of both sets of services in these increments). The firm could therefore comply with the DSAC tests and allocate common costs in a myriad of different ways."

284. In paragraph 37(a) of his statement, Mr Myers assessed the flexibility in pricing between DSAC and FAC for 2 Mbit/s trunk, and concluded that DSACs for 2Mbit/s trunk could be 75% to 120% higher than FAC.

285. No-one suggested that DSAC was a conclusive indicator that common costs have been appropriately allocated. It was common ground that a charge for a service could be cost orientated even though it was in excess of the DSAC ceiling, and equally a charge below DSAC might not be cost orientated (see, in each case, Mr Read's cross-examination of Mr Myers on Transcript Day 3/page 32).

286. By the conclusion of the hearing, it appeared that BT did not dispute that DSAC could be an appropriate test for cost orientation. To the extent that BT maintained its contention (made in paragraph 135 of its Notice of Appeal) that DSAC "is fundamentally flawed from an economic and regulatory viewpoint", we reject it. In actual fact, as a method for dealing with the allocation of common costs, DSAC was, in the case of PPCs, the most practicable option:

(1) Combinatorial testing, as we have described in paragraphs 253 to 261 above, was simply not practicable.

(2) FAC could have been used as a means of fully allocating common costs, but would have effectively imposed a single price on BT for its PPC services. Had BT decided to meet its cost orientation obligations under Condition H3.1 by using FAC, then we consider that this would have been an appropriate approach for BT to adopt, and one that OFCOM would not have been able to challenge had it been adopted. But, of course, its very inflexibility is the reason why BT would not have adopted it. Had OFCOM sought to use FAC as the test for BT's compliance with Condition H3.1, then we consider that this would not have been an appropriate course, for precisely the same reason. (We stress that there was never any suggestion that OFCOM would take this course.)

287. In short, we find that the use of DSAC as a test for cost orientation was not only entirely appropriate, but actually the only satisfactory available course open both to BT (in seeking to comply and show compliance with Condition H3.1) and to OFCOM (in seeking to monitor that compliance). Of course, OFCOM would, no doubt, be open to considering fresh alternatives to DSAC, were such to emerge. This was put to Mr Myers (Transcript Day 3, page 40):

"**Q (Mr Read)**	…Is it fair to say, Mr Myers, that DSAC is really, you are the primary person responsible for that test?
A (Mr Myers)	No, that wouldn't be correct. Clearly there were other people who at the time were significantly more senior to me in Oftel, who also participated in and guided that process of deciding that DSAC was a sensible first order test.
Q (Mr Read)	But in any event, you are one of the key people who has been involved in this development over the years.
A (Mr Myers)	Yes. Yes, that's true.
Q (Mr Read)	So, in a sense, this is a bit of your "baby", is it not? DSAC is the test that

you have developed and implemented over the years. Is that right?

A (Mr Myers) Well, yes, I contributed to the development of DSAC as the first order test.

Q (Mr Read) And so the last thing you would like to see is that test being knocked down in any way.

A (Mr Myers) No, that's not true. If there were sound reasons to suggest that things had moved on, that there was a better way of assessing cost orientation, a better way of judging those questions, then I would be perfectly open to that and don't hang on to things in the past just because I was involved in them at the time."

288. We accept this evidence. The fact is that no satisfactory alternative to DSAC was demonstrated by BT: we have explained in paragraphs 252 to 275 above why BT's suggestions for testing compliance with Condition H3.1 (the circuit analysis, international benchmarking and combinatorial tests) were unsatisfactory and rightly rejected by OFCOM in the Determination.

289. As we have noted, BT did not appear to be contending (at least by the end of the hearing) that DSAC was entirely inappropriate. Rather, BT's contention was that OFCOM placed too much weight on DSAC, and that DSAC could and should be no more than a "screening test", which would then trigger a more detailed investigation into BT's pricing. Essentially, BT contended that DSAC was not used by OFCOM as a "first order" test, but as a "pass/fail" test which effectively determined whether or not BT had complied with Condition H3. It is to this point that we now turn.

DSAC as a "first order" test

290. The term "first order" test in the context of cost orientation appears to emanate from the Oftel 1997 Guidelines. Paragraph C.1 of Annex C of this document was quoted in paragraph 278 above. Paragraph C.2 went on to state:

> "In investigating complaints about charges, Oftel would not apply the floors and ceilings test mechanistically. Floors and ceilings are an effective first order test for the likelihood of anti-competitive or exploitative charging. However, there may be circumstances in which charges set outside the band of floors and ceilings are not abusive, or charges set within the band are abusive… If asked to investigate charges, Oftel will seek to analyse the effect of the charge in the relevant market and will take a view on this based on the individual circumstances of each case."

291. "First order" is nowhere defined. The difference between the parties as to what it meant was well-articulated in the evidence of Professor Yarrow and Mr Bolt. Professor Yarrow's evidence was as follows (Transcript Day 4, pages 85-86):

> "**Q (Mr Saini)** Professor Yarrow, I understand that there is not a dispute between yourself and Mr Bolt in relation to the use of DSAC. Your view is that it should be an initial screening test, is that right?
>
> **A (Prof Yarrow)** My strong view is that it can only sensibly be an initial screening test, because it is a concept with no pedigree in economics…
>
> …
>
> **Q (Mr Saini)** You accept that DSAC can be used as a screening test?
>
> **A (Prof Yarrow)** Yes, anything can be used as a screening test.
>
> **Q (Mr Saini)** At the end of it – let us assume you have used it as a screening test and DSAC has been failed?
>
> **A (Prof Yarrow)** Yes.
>
> **Q (Mr Saini)** What consequence does that have?
>
> **A (Prof Yarrow)** You don't use DSAC. Presumably the question is, do these prices conform to the cost orientation condition? If you find prices above DSAC, you have got the screening test. You do the further investigation. Then, as a result of that investigation, if you find that the prices are cost orientated then that's it, that's the conclusion."

292. Mr Bolt's evidence was as follows (Transcript Day 5, page 39):

> "…to be clear, I have no problem with the use of "first order" in a sense of establishing a rebuttable presumption. It is much stronger than a mere screening test, and my experience of regulation in a number of regulatory offices and in a regulated company is that if you don't have something which establishes a reasonable presumption of that sort regulation is so uncertain in its application that it neither achieves the objectives which regulators are looking to achieve, nor is it a practical basis for a regulated company to operate on."

293. We consider that there is a great deal of force in what Mr Bolt said. The problem with Professor Yarrow's approach is that it fails to articulate what test is applied *after* the so-called screening test has been breached. Clearly, there would have to be a further investigation of some sort, but precisely what that would entail is unclear.

294. If, and to the extent that, this further investigation would involve a detailed economic or competition investigation into BT's pricing, looking at criteria different from the screening test itself, then this is plainly not what Condition H3.1 envisages. As we have noted (see paragraph 243 above), Condition H3.1 seeks to ensure that prices are orientated to cost by way of a three stage process. Prices must be in line with LRIC (Stage 1), and thereafter there must be an

appropriate mark up for the recovery of common costs (Stage 2). There is then the return on capital check at Stage 3. The role of DSAC is at Stage 2, as a test for ascertaining whether there has, or has not, been an appropriate recovery (but not over-recovery) of common costs. The suggestion that DSAC is simply a "screening test", triggering a further investigation, understates its significance in monitoring compliance with Condition H3.1.

295. Treating DSAC as a "rebuttable presumption" in relation to the appropriateness of common cost allocation is a better description of the role that DSAC plays, but even this does not fully articulate the true effect of Condition H3.1. Treating DSAC as a rebuttable presumption also suggests that – if that presumption is rebutted – there can be an investigation into the orientation of BT's prices that carries on without reference to DSAC itself.

296. We return to the wording of Condition H3.1. Significantly, it does not use the phrase "first order test" at all. Whereas the Guidelines focus on the negative question of whether charges are abusive (abuse being assessed by reference to cost floors and cost ceilings), and suggest that mechanistic tests should not be used as a pass/fail test as to whether prices are abusive, Condition H3.1 is *permissive*. It allows an "appropriate" mark up for the recovery of common costs.

297. In conclusion, we do not consider the designation "first order test" to be at all a helpful one in the context of Condition H3.1. Our conclusion is based upon our construction of Condition H3.1. As we have found, in the first instance it is for BT to decide how to allocate common costs, provided always that it does so appropriately, and can demonstrate this to OFCOM's satisfaction. It is only if BT is unable to do so (which is the case here) that OFCOM must test compliance, and it is then for OFCOM to consider how compliance must be tested.

298. In assessing compliance, we do consider that OFCOM must have regard to the fact that the firm subject to Condition H3.1 is allowed an "appropriate" mark up from the recovery of common costs. In particular, OFCOM must have regard to the fact that whereas the regulated company is *prospectively* seeking to comply

with the condition, OFCOM is *retrospectively* assessing whether there has been compliance.

299. It may be quite difficult for a regulated firm in the position of BT to ensure that its prices meet its cost orientation obligation, even if it has the firmest of intentions of doing so. This is for a number of reasons. Ensuring that common costs are allocated in a manner that meets regulatory requirements is not straightforward. The cost accounting – particularly in the case of a product like PPCs in a business with so many products and services like BT – is extremely complex and difficult. What is more, whilst no doubt a regulated firm can keep a month-by-month track of its costs and its prices, at the end of the day the conclusive figures (as published in the regulatory financial statements) will be retrospective ones. Equally, costs can and will fluctuate over time, sometimes quickly. Finally, the price may be less easily variable. As BT emphasised, it was not possible for BT to vary its prices for PPC services instantly: notice was required.

300. We are not suggesting that this means that complying with Condition H3.1 is impossible. This point was put to Mr Myers in cross-examination, and he rejected it (Transcript Day 4, page 14):

> "**Q (Mr Read)** If you have that sort of price variation within a year, how is BT to anticipate that in fact the costs for the next year, for the year in 2007/2008, are going to fall so dramatically that its DSAC ceiling is nearly going to halve?
>
> **A (Mr Myers)** Because I would expect BT to have an understanding of its own costs, and it shouldn't be reliant on the publication. It should know what is happening to its own costs before the Financial Regulatory Accounts published at that year end. If we look at Table 2 in my witness statement on p502, and in particular if we look at the bottom row which shows DSAC as a proportion of fully allocated costs – fully allocated costs being a figure that BT might more normally track as part of its normal accounting – we can see that actually DSAC as a proportion of fully allocated costs is a relatively consistent ratio apart from 2006/2007. So I can see that there was perhaps a slight oddity in 2006/2007, but in terms of 2007/2008, the ratio between DSAC and fully allocated costs returns to its more normal level of 175% or thereabouts. So if BT had an understanding of movement in its fully allocated costs and an understanding, as it should have done, of the relationship between Distributed Stand Alone Costs and Fully Allocated Costs, I would expect it to be able to form a reasonable view on what costs movements might look like. I would also expect it, in terms of compliance, to take account of the extent in the prior year by which it had exceeded DSAC. As we can see, for 2007/2008 in 2005/2006 the price was 62 per cent above DSAC and 26 per cent above in 2006/2007. Those would clearly be relevant factors. I would expect BT to take into account in judging how it should vary its trunk prices in order to ensure compliance with cost orientation."

301. Mr Morden – in the evidence we have set out at paragraphs 135 to 137 above – regularly compared revenue against cost. He looked at these matters – and in particular BT's rate of return – on an aggregated basis. He was asked about this at the hearing (Transcript Day 3, pages 11-12):

"**Q (The Chairman)**	Mr Morden, just one question. You said that you looked at the rate of return for PPCs as a whole in terms of assessing price.
A (Mr Morden)	Yes.
Q (The Chairman)	But, presumably you could have calculated rate of return separately for the trunk and terminating parts of the PPC circuit?
A (Mr Morden)	The difficulty is separating of costs. As you see through the history, the difficulty is extracting the cost for trunk, extracting the cost for terminating, because the way we actually provide a PPC is very different from the way that is illustrated in these diagrams. We pointed this out at the start, Oftel made the assumption that we would provide a PPC in the same way we would provide a telephone call. A local exchange goes to a trunk exchange, another trunk exchange. We don't provide it in any way like that. The amount of trunk and terminating in a PPC is loosely bound at best to the underlying costs of provision. It's decided by a formula that comes out that Oftel and Ofcom, sorry Oftel, decided the formula. So you'd have to try and take this formula and then map that on to the actual network provision to try to establish what costs go to which part. So it is difficult to try to say how much ROCE you make on one area and how much ROCE you make on another, because the costs are so intertwined. So, no, I couldn't extract the ROCE in any meaningful way. Consequently, I looked at the overall end to end PPC. Indeed, that is the product that people buy from me. They say, "I want a connection between there and there", and the formula then tells them how much of that is priced at trunk and how much is priced at terminating. I then give it to my engineering department and they route it in the most cost efficient way. The difficulty is matching the two up.
Q (Mr Saini)	Sir, may I just ask a follow up question in relation to that, which is that I find your answer rather puzzling, Mr Morden, because BT has had no difficulty at all in the course of this case and in the course of LLMR Review in putting forward figures to Ofcom indicating its very low rate of return on terminating. Unless I am missing something, by a process of deduction you could work out what your rate of return is on trunk, could you not, surely?
A (Mr Morden)	It depends on the allocation of cost.
Q (Mr Saini)	It is certainly possible, is it not, because it was possible for terminating?
A (Mr Morden)	You can make broad assumptions.
Q (Mr Saini)	And those assumptions were made for terminating showing a very low rate of return, were they not?
A (Mr Morden)	Yes.
Q (Mr Saini)	So equally, one could make assumptions and obtain a rate for trunk, could one not?
A (Mr Morden)	You could make assumptions and do that, yes, absolutely."

302. Mr Morden's point was that considered in paragraphs 25 to 27 above, namely that the distinction between trunk and terminating was essentially a regulatory one, rather than one arising out of the way in which a PPC was provided. However, that regulatory distinction having been drawn, BT and OFCOM had to evolve a method for assessing the respective cost of trunk and terminating segments based upon this distinction. This distinction was, of course, reflected in BT's regulatory financial statements. There is no reason why Mr Morden could not have considered his rates of return on a disaggregated basis, albeit that these would have been calculated on the basis of assumptions that he considered at variance with the true nature of the product he was providing.

303. Nevertheless, we do accept that even a firm doing its level best to comply with Condition H3.1 (by, for example, seeking to apply DSAC) might find that, even so, the DSAC ceiling was on occasion breached. We consider that, in such circumstances, such a firm might well be in compliance with Condition H3.1, in that its mark up for the recovery of common costs would have been "appropriate".

304. Accordingly, when retrospectively seeking to determine compliance with Condition H3.1, it would not be right for OFCOM to apply DSAC (or, no doubt, any test for the allocation of common costs) in a mechanistic way. That would overlook the fact that it is hard in practice for the regulated firm to comply absolutely with whatever test is being used to determine the appropriate allocation of common costs.

305. In other words, when retrospectively assessing compliance with Condition H3.1, OFCOM must guard against the possible injustices of a mechanistic application of a test for the allocation of common costs. Although we do not consider "second order tests" to be a good label, we do consider that OFCOM acted appropriately in looking to other factors in addition to the mere fact that DSAC had been breached by BT's prices. In particular, we consider that OFCOM acted correctly in considering:

    (1) The magnitude and duration of the amounts by which charges exceeded DSAC;

    (2) Whether, and the extent to which, charges exceeded FAC; and finally

(3) The rate of return on capital employed.

This last matter is, of course, expressly mentioned in Condition H3.1.

306. The one matter that we have not mentioned, that OFCOM also took into account, was the potential for economic harm. This is a matter that we consider is an altogether separate question from the issue we are presently determining, namely how it is determined whether prices are orientated to costs. The question of economic harm is considered in Section VII(v) below.

(e) Our conclusions in respect of BT's contentions in its Notice of Appeal

307. We summarised BT's contentions in its Notice of Appeal in paragraph 240 above. Much of what we have said in the preceding paragraphs is directed to these contentions, which we reject for the following reasons:

(1) BT's first contention was that DSAC was fundamentally flawed as a first order test, and that there were or are better tests. For the reasons we have given in paragraphs 277 to 288 above, we do not consider that DSAC is fundamentally flawed; indeed, our conclusion is that in the context of orienting to cost prices like 2 Mbit/s trunk, DSAC was the only practicable test to use.

(2) BT's second contention was that there was a lack of transparency and a lack of legal certainty in OFCOM's use of DSAC. Again, we reject this contention. We have considered precisely how Condition H3.1 operates to orientate prices to costs. We consider the operation of Condition H3.1 to be clear and we are not persuaded that there is any legal uncertainty in the present case. BT had a discretion in how it chose to orientate its prices for individual PPC services, subject to that orientation being appropriate and subject to OFCOM's regulatory scrutiny. For the reasons that we have given, BT failed to orientate its prices as Condition H3.1 required. BT orientated its prices on an aggregated as opposed to a disaggregated basis. As a result, BT could not demonstrate to the satisfaction of OFCOM that its prices were cost orientated. As a consequence of this and of the Altnets' dispute with BT, OFCOM was called upon to assess whether BT's prices were or were not cost orientated, and it was for OFCOM to determine how this assessment should be conducted in order to assess

(retrospectively) whether BT's prices were compliant. In conducting this assessment, OFCOM would have to bear in mind that the regulated firm would be seeking to comply with its cost orientation obligations when setting prices for the future. In the present case, OFCOM's task was relatively straightforward, for two reasons:

(i) First, for the reasons we have given, DSAC was clearly the most appropriate basis for its initial assessment of compliance with Condition H3.1, FAC being too rigid and combinatorial tests being unworkable. As we have noted in paragraph 278 above, DSAC was not unknown in the context of communications regulation, including to BT: given the materials that we have described, we do not consider that BT can have been in any way surprised or taken aback by OFCOM's resort to the DSAC test.

(ii) Secondly, this is a case where BT had orientated its prices by reference to the wrong test. This was not, therefore, a case where a firm subject to Condition H3.1 had attempted to apply the condition, but for reasons of the sort considered in paragraphs 303 to 304 above, had failed to do so.

(3) BT's third contention was that OFCOM treated prices above DSAC as intrinsically excessive and in breach of Condition H3. Our conclusion is that this is precisely what Condition H3.1 requires. As we have set out in paragraph 65 above, Condition H3.1 entitles the regulated firm to mark up prices that have reasonably been derived from LRIC by an appropriate amount to reflect the recovery of common costs and a reasonable return on capital. In this case, DSAC represented the best single measure for assessing whether the condition had been satisfied and so marked the upper limit or ceiling on the permissible mark up of prices.

(f) Legitimate expectation and the section 3(3) point

308. We do not consider that OFCOM made any kind of statement or representation to the effect that Condition H3.1 would be applied in any way other than in accordance with its proper construction. What is more, we consider that Condition H3.1 is a provision that is, in fact, very clearly drafted and whose

meaning is, therefore, correspondingly clear. Accordingly, we consider that BT's section 3(3) point must fail on the facts.

309. Furthermore, we do not consider that BT can have had any legitimate expectation that DSAC would not be used as a test for determining whether common costs had been appropriately allocated. To the contrary, the expectation appears to have been that DSAC *would* be the first port of call in terms of assessing this question.

310. BT did appear to place some reliance on the fact that OFCOM did nothing itself – until it accepted these disputes – to bring home to BT that its pricing for trunk segments was or might be in breach of Condition H3.1. Thus, BT variously referred to the fact that OFCOM closed an "own initiative" investigation into BT's compliance in December 2005 without reaching a final conclusion on the question of compliance, and also to the fact that although it was plain from BT's own regulatory financial statements that DSAC "ceilings" for various PPC services were being breached (as to which, see Annex C), OFCOM did nothing.

311. There are specific answers to these points. OFCOM's "own initiative" investigation expressly reached no conclusion as to BT's compliance with Condition H3.1 and was discontinued because of BT's "inability to provide data on a disaggregated basis". BT was then required to produce data on such a basis (Defence, paragraph 187). In relation to the breaches of the ceilings reported in BT's regulatory financial statements, OFCOM made it clear in the 2004 LLMR Statement that it would only act if in receipt of an evidence-based complaint that the prices set by BT were not cost-orientated. Paragraph 8.58 of the LLMR Statement states:

> "Ofcom considers it premature to carry out a full analysis of the cost to BT of providing trunk and intends only to carry out such an assessment if it receives evidence-based complaints that the trunk prices set by BT are not cost oriented..."

312. There is, however, a more fundamental point. Apart from the fact that none of these matters amounts to an unequivocal statement or representation of any kind, given that Condition H3.1 is clear, what BT needed to demonstrate was an unequivocal statement by OFCOM that Condition H3.1 would not be applied in

accordance with its true construction. BT has, quite simply, not come close to demonstrating such a statement.

(v) Failure to give proper regard to economic harm

(a) BT's contentions

313. In its Notice of Appeal, BT contends that OFCOM failed to give proper regard to economic harm in the Determination. Essentially, BT made two points:

(1) First, BT contended that the question of economic harm was relevant to the question of whether BT had breached Condition H3.1 (paragraphs 72-79 of the Notice of Appeal). It is obviously necessary for BT to make this contention good: unless economic harm is a relevant factor in the operation of Condition H3.1, it will not have to be considered. BT contended that economic harm was legally relevant in three ways:

(i) First, in the imposition of cost orientation obligations (paragraphs 75-77 of the Notice of Appeal).

(ii) Secondly, in the assessment of compliance with cost orientation obligations (paragraph 78 of the Notice of Appeal).

(iii) Thirdly, in the exercise of discretion under section 190(2)(d) of the 2003 Act (paragraph 79 of the Notice of Appeal).

(2) Secondly, BT contended that OFCOM had failed to assess economic harm properly and that OFCOM's application of the DSAC test in fact produced economic harm (paragraphs 80-93 of the Notice of Appeal).

(b) The legal relevance of "economic" harm in Condition H3.1

<u>BT's first point: imposition of cost orientation obligations</u>

314. As we have noted, BT contended that "economic harm" was relevant in three ways. The first was that "[b]efore Ofcom can impose a rule regarding cost recovery and cost orientation pursuant to s87(9) of the Act or modify an existing SMP condition by introducing a new cost orientation methodology, it has to comply with the statutory conditions laid down in ss47(2) and 88 of the Act".

315. So far as it goes, this is unexceptionable. As we have described at paragraph 44 above, before an SMP condition can be imposed or modified, a considerable

number of preconditions need to be met. However, the key question is whether OFCOM's use of DSAC as a test for cost orientation involved the imposition or modification of an SMP condition. We do not consider that it does. As we have noted, Condition H3.1 leaves it to BT to decide how and what to charge for its services, provided always these charges are "reasonably derived from the cost of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed". Condition H3.1 also imposes on BT an obligation "to demonstrate to the satisfaction of Ofcom" that this obligation has been complied with.

316. OFCOM used DSAC as a first order test of BT's compliance with Condition H3.1. That is not the same as Condition H3.1 imposing DSAC on BT as a price control or as imposing a new, or modifying an existing, SMP condition. Either OFCOM used an appropriate methodology for the purposes of assessing BT's obligations – in which case, all OFCOM did was monitor compliance with a pre-existing obligation; or OFCOM used an inappropriate methodology in order to monitor compliance, in which case that is a matter that would be corrected on appeal.

317. Here of course, we have found that OFCOM's approach was appropriate: but, whichever way this decision had gone, OFCOM's application of DSAC would not have involved either the imposition of a new, or the modification of an existing, SMP condition.

318. Accordingly, we reject BT's first point.

319. This point is identical to BT's third "legitimate expectation" point, which we described in paragraph 206(3) above. Since we do not consider that the Determination involved any modification to the SMP conditions that were imposed on BT by the 2004 LLMR Statement, this point must fail.

<u>BT's second point: assessment of compliance with cost orientation obligations</u>

320. Paragraph 78 of the Notice of Appeal states:

> "A cost orientation obligation is designed to mitigate the risk of "adverse effects arising from price distortion" for end users and, to that end, provides that charges are "reasonably derived from the costs of provision" with an "appropriate mark-up". The assessment of "reasonableness" and "appropriateness" necessarily entails an assessment of the risks of

excessive pricing posed by the charges in question as well as the effects of the alleged breach on competition and consumers, by reference to the wider economic context…"

321. We consider that this point confuses the *purpose* of Condition H3.1 with its *legal meaning*. As we noted at paragraph 44 above, the 2003 Act sets out a series of requirements that must be satisfied before a cost orientation provision can be imposed. As OFCOM noted in paragraph 15 of its written closing submissions:

"Condition H3 was the result of a detailed and lengthy analysis by Ofcom, in the LLMR Statement, which is critical to this appeal. In particular, in the LLMR Statement, Ofcom:

(i) identified distinct markets in respect of: (1) high bandwidth PPC terminating segments, (2) low bandwidth PPC terminating segments, and (3) trunk segments at all bandwidths…;

(ii) concluded that BT had SMP in each of those three distinct markets…;

(iii) concluded in respect of each of those three distinct markets…:

(a) that there was a risk that BT might so fix and maintain some or all of its prices at an excessively high level, or impose a price squeeze, as to have adverse consequences for end-users of public electronic communications services (sections 88(1)(a) and 88(3) of the 2003 Act); and

(b) that the setting of the relevant SMP condition…was appropriate for the purposes of promoting efficiency, promoting sustainable competition, and conferring the greatest possible benefits on the end-users of public electronic communications services (section 88(1)(b) of the 2003 Act;…"

322. In short, the purpose of Condition H3.1 was to prevent BT from raising its prices unduly away from its costs in respect of (amongst other things) 2 Mbit/s trunk segments because BT had significant market power in this market and so would be able (absent the condition) to maintain prices for this service at an excessively high level so as to have adverse consequences for end users. This analysis of economic harm was carried out when Condition H3.1 was imposed (and could, as we have noted, have been challenged on appeal by BT at that time).

323. It is clear, therefore, that there was an implicit expectation that *if* Condition H3.1 were to be breached by BT, adverse economic consequences would follow. If BT's prices breach the constraints of Condition H3.1, then it follows that BT's customers – here the Altnets – are paying more than they should for the services they are purchasing from BT and may well pass these on to the ultimate consumers. This is because of BT's SMP: other communications providers like the Altnets are limited in their purchasing options regarding such

services – it is difficult for them simply to go to another supplier. As we noted in the preceding paragraph, the whole point of Condition H3.1 was to prevent BT from using its significant market power to maintain prices at an excessively high level.

324. When he opened OFCOM's case orally, Mr Saini stated (at Transcript Day 2, page 18) that "there is no doubt that the individual price charged for a trunk segment will have an effect on a communication provider's purchasing decisions. It is clearly a significant factor and in particular those who buy a higher proportion of trunk segments, which we know some communications providers do, will be significantly worse off that those who do not, who rely for example on self supply".

325. In the Determination, OFCOM stated at paragraph 7.34:

> "We accept the arguments of the [Altnets] that economic harm is not a pre-requisite to Ofcom's determination of the Disputes. We agree that it is not essential to demonstrate that economic harm has in fact occurred in order to determine whether there has been overcharging. It is sufficient to establish that over-charging could potentially cause economic harm."

326. We agree with the statement contained in the first sentence of paragraph 7.34. Indeed, it is for this reason that Condition H3.1 contains no separate requirement that "economic harm" be established. BT is not permitted to raise prices beyond those that are cost orientated, *because* this would be likely to cause economic harm: this was established by the anterior finding of SMP made at the time the condition was imposed. Economic harm and breach of the cost orientation obligation are, therefore, two sides of the same coin. If prices are not orientated, then potential purchasers of PPCs are very likely to be damaged.

327. It may be that the last sentence of paragraph 7.34 intends to make this point – namely that there is a nexus between a breach of Condition H3.1 and economic harm. Our conclusion, however, is that the need to show economic harm – of any sort – is not a pre-requisite for a finding that Condition H3.1 has been breached. Accordingly, we reject BT's second point. OFCOM, for its part, appeared to concede (indeed, contend) that economic harm did play a limited role in the operation of Condition H3.1 as one of several "second order"

controls to ensure that DSAC is not applied "mechanistically". We are not persuaded that this is correct on a proper construction of Condition H3.1.

BT's third point: exercise of discretion under section 190(2)(d) of the 2003 Act

328. BT's third point (made in paragraph 79 of the Notice of Appeal) was that when exercising its powers under section 190(2)(d) of the 2003 Act, BT must take the utmost account of the effects of its determination on competition in the market and on consumers. We consider this point in the context of section 190 itself (see paragraphs 336 to 338 below).

(b) Was economic harm established?

329. For the reasons given in paragraphs 320 to 327 above, we do not consider there to be a role for an economic harm test when OFCOM is seeking to assess whether BT has breached Condition H3.1. In case we are wrong on this point, we nevertheless consider whether, in this case, economic harm was established.

330. In the Determination, OFCOM considered in some detail whether BT's overcharging in respect of 2 Mbit/s trunk segments could potentially cause economic harm (see paragraphs 7.36 to 7.72 of the Determination). OFCOM's conclusion was that "not only did BT's charges for 2Mbit/s trunk services have the potential for causing economic harm, but…it seems likely that such harm would have occurred" (paragraph 7.35 of the Determination).

331. The basis for this conclusion was summarised in paragraph 7.36 of the Determination:

> "BT's 2 Mbit/s trunk charges have resulted in the [Altnets] and/or their retail customers paying BT too much for these services, and therefore generating financial loss or harm to them. Moreover, we also consider that the charges are likely to have given rise to a number of economic distortions, and therefore to economic harm. We consider that the main sources of this harm are likely to have been:
>
> i) reducing the overall demand for retail leased lines through increasing retail prices;
>
> ii) distorting competition between [communications providers] at the retail level by favouring those able to self-supply trunk services; and
>
> iii) distorting the investment decisions of [communications providers] in terms of whether to build or buy trunk services."

332. We consider all these points to be correct and – with all due respect to OFCOM's analysis in the Determination – virtually self-evident:

(1) Plainly, if, according to Condition H3.1 properly applied, there has been overcharging, then the Altnets will have suffered economic harm (and BT will have had a corresponding economic benefit). The likelihood is that the increased costs borne by the Altnets (in the form of unduly high charges for 2 Mbit/s trunk segments) will (in some way) be passed on to the Altnets' retail customers.

(2) In paragraph 33 to 35 above, we described the various different networks of the Altnets and – in particular – their varying needs to purchase trunk segments. We noted that these variations were considerable. It is, again, logically inevitable that if the price for trunk segments is improperly high then those communications providers needing to purchase more trunk will be disadvantaged as against those whose networks mean that they can buy less.

(3) Equally clearly, if a communications provider has a network that may require the considerable purchase of trunk segments, because the communications provider does not itself have such trunk connections, then such a communications provider – if it needs to have trunk segments – will either have to purchase them or self-supply. If the price for trunk is improperly high, then the economics of this decision (buy-in or self-supply) are distorted.

333. Mr Harding gave some hard practical examples of the foregoing points, and Mr Tickel – when cross-examined by Miss Rose – certainly conceded the point at paragraph 332(2) above (Transcript Day 3 (confidential), pages 11-12). He also conceded in abstract terms the point at paragraph 332(3) (Transcript Day 3 (confidential), pages 17-21), but was (quite rightly) cautious about conceding the specific factual example that Miss Rose was putting to him regarding Cable & Wireless' network in the South West of England, and the nature of Cable & Wireless' investment decisions in this particular context.

334. We conclude that BT's overcharging in respect of 2 Mbit/s trunk certainly had the potential to cause economic harm, and very likely did so. But, as we noted in paragraph 326 above, we consider these consequences to be inherent in a failure to comply with Condition H3.1.

VIII. APPLICATION OF CONDITION H3.1

335. Accordingly, it is our conclusion that BT's challenges to OFCOM's application of Condition H3.1 fail. Accordingly, the data that is relevant to assessing whether BT has failed to comply with this Condition and has overcharged the Altnets (and, if so, by how much) falls to be considered by reference to the data set out in paragraphs 120 to 131 above, which is precisely the data that OFCOM relied upon in the Determination.

IX. HAS OFCOM MISUSED ITS POWERS UNDER SECTION 190(2)(d) OF THE 2003 ACT?

336. The relevant parts of section 190 of the 2003 Act provide as follows:

> "(1) Where OFCOM makes a determination for resolving a dispute referred to them under this Chapter, their only powers are those conferred by this section.
>
> (2) Their main power…is to do one or more of the following –
>
> …
>
> (d) for the purpose of giving effect to a determination by OFCOM of the proper amount of a charge in respect of which amounts have been paid by one of the parties of the dispute to the other, to give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums by way of an adjustment of an underpayment or overpayment."

337. Pursuant to this provision, OFCOM determined that BT should pay to the Altnets the sums that they had overpaid, this being the difference between what BT in fact charged the Altnets and what the Altnets should have been charged had BT orientated its prices for 2 Mbit/s trunk by reference to a DSAC ceiling. OFCOM's reasoning in this regard is set out in paragraphs 8.27 to 8.46 of the Determination.

338. We consider that OFCOM exercised its discretion properly under section 190(2)(d) for the following reasons:

(1) As we have noted, such discretion as OFCOM has under section 190(2)(d) is a "hard" discretion confined to requiring OFCOM to follow through on the conclusions it has drawn pursuant to the Dispute Resolution Process. Here, OFCOM concluded that there had been overcharging by BT in that its prices for 2 Mbit/s trunk were not cost orientated.

(2) Given this conclusion, it is plain that the Altnets have overpaid in respect of 2 Mbit/s trunk, and that BT has had the benefit of such overpayments. Repayment is simply putting the parties in the position they would have been in had Condition H3.1 been complied with. Failure to do so would undoubtedly signal that compliance with SMP conditions is not rigorously policed and that – we consider – is an inappropriate signal to send. Had BT carefully sought to apply Condition H3.1, but failed, then we consider that that should have been taken into account, and the amount BT would have to pay reduced. But that is not so in this case. This is a case where BT has comprehensively misconstrued the obligation on it, and overcharged as a result. Any shift away from the restitutionary approach that we have described would, so we conclude, be unjustifiable.

(3) BT, on a number of occasions sought to characterise OFCOM's direction as the imposition of a penalty (Notice of Appeal, paragraphs 34, 63(d), 218; Mr Read also referred to it as a "punitive measure" (Transcript, Day one, page 3)). We reject this characterisation. OFCOM's direction, as we have noted, was not intended (and did not) penalise BT, but sought to rectify some (but probably not all) of the adverse effects of BT's failure to comply with Condition H3.1. In so acting, OFCOM was acting consistently with a number of cases stating that where a person is given the power to levy charges, if that person charges excessively, then the excess is recoverable at the instance of the person who has overpaid: see, for instance, *Corporation of Stamford v Pawlett* (1830) 1 C & J 57 at 80-81, 148 ER 1334.

(4) In these circumstances, we fail to understand BT's contention that economic harm needs to be taken into account. This contention was summarised in paragraph 313(1) above. As we have concluded, we consider that establishing economic harm is not a pre-requisite for showing a breach of Condition H3.1, simply because Condition H3.1 is itself based on a strong assumption that SMP would be very likely to cause economic harm if the condition is not complied with.

(5) The effect of OFCOM's Determination is that BT must pay a considerable sum of money to the Altnets – with the likelihood of further payments to

other communications providers. We consider that to be a consequence of BT's failure to comply with Condition H3.1. OFCOM, however, did take a further factor into account, namely the impact on BT of repaying the overcharged revenue to external customers on BT's rate of return for PPCs in aggregate for the period of overcharging. Essentially, OFCOM wanted to be satisfied that BT's rate of return on capital remained at around 12%. Although, given the conclusions we have stated in the preceding sub-paragraphs, we have some misgivings about this approach, we consider that it was an approach that was open to OFCOM to take. Accordingly, it is necessary to consider the dispute between BT and OFCOM as to what BT's overall rate of return on PPCs was. We have described the nature of the disagreement between BT and OFCOM in paragraphs 142 to 152 above. There were two points:

(i) First, whether – for the purposes of this particular assessment – BT's internal sales should be taken into account or whether only external sales were relevant. On this question, Mr Myers is obviously right. Given that the repayment ordered by OFCOM applies only to overpayments by the Altnets, it is self-evident that only external sales (and not internal sales within BT) are relevant.

(ii) Second, whether – again for the purposes of this particular assessment – the period of assessment should be the period of overcharging or should include a year (2004/2005) where there was no overcharging. Put like this, the answer is obvious: the only relevant years for the purposes of this calculation are the years in which OFCOM has determined that BT was overcharging.

On this basis, taking account of the repayment ordered by OFCOM pursuant to section 190(2)(d) of the 2003 Act, BT's return on capital on PPCs as a whole was at a rate above the cost of capital (at 14.2%).

X. ORDER

339. BT's challenges to the Determination, which we summarised in broad terms in paragraph 7 above, all fail, for the reasons we have given. We find that:

(1) OFCOM's use of the Dispute Resolution Process in this case was unimpeachable.

(2) OFCOM applied the cost orientation obligation contained in Condition H3.1 in accordance with its true construction, and that BT had no right to expect that Condition H3.1 would be applied in any other way.

(3) OFCOM correctly applied its powers under section 190(2)(d) of the 2003 Act by ordering that the entire amount of BT's overcharge should be repaid by BT to the Altnets.

340. For the reasons given in this judgment, we unanimously order that BT's appeal against OFCOM's Determination be dismissed.

Marcus Smith QC Professor Peter Grinyer Richard Prosser OBE

Charles Dhanowa
Registrar Date: 22 March 2011