

BRITISH TELECOMMUNICATIONS PLC V OFCOM (ETHERNET DETERMINATIONS) [2014] CAT 14

Ligia Osepciu Monckton Chambers
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On 1 August 2014, the Competition Appeal Tribunal (“**the Tribunal**”) delivered its judgment in five related appeals from Ofcom’s Ethernet Determination of 20 December 2012. The Determination itself resolved a number of regulatory disputes between BT and various communications providers that purchase wholesale Ethernet services from it by (i) finding that BT had breached an SMP Condition requiring it to charge cost orientated prices for the relevant wholesale Ethernet services and (ii) requiring BT to repay the resultant overcharge to its wholesale customers without interest.

The Tribunal’s detailed judgment addresses three important issues: (i) the correct approach to the assessment of cost orientation, (ii) Ofcom’s jurisdiction to order repayment of overcharges levied prior to a dispute being brought and (iii) the scope of Ofcom’s discretion to order interest on repayment in circumstances where there is a contractual term providing for no interest to be awarded.

Background to the disputes

The case concerned BT’s provision of a particular subset of Ethernet¹ services known as alternative interface symmetric broadband origination (“**AISBO**”) services². In the context of its 2004 Leased Lines Market Review (“**LLMR**”)³ Ofcom determined that BT held significant market power (“**SMP**”) on the market for wholesale AISBO services at all bandwidths in the UK (excluding the Kingston-upon-Hull area). Ofcom reviewed that determination in the context of its 2008 Business Connectivity Market

1. Ethernet is an international standard for the transmission of data.

2. AISBO services can be used by communications providers to supply their customers with high bandwidth data connectivity. AISBO services provided dedicated capacity between two points and are referred to as ‘symmetric’ because they allow data traffic to be carried in both directions along the circuit at the same rate.

3. See Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets: Final Statement and Notification, 24 June 2004.

Review (“**BCMR**”)⁴ and found that BT had SMP in the wholesale market for low bandwidth AISBO services in the United Kingdom excluding Hull – but neither BT nor any other provider had SMP on the wholesale market for high bandwidth AISBO services in the United Kingdom.

Following each of the aforementioned findings of SMP in a relevant wholesale AISBO market, Ofcom imposed SMP access and cost orientation obligations on BT pursuant to its powers under sections 87-88 of the Communications Act 2003 (“**the 2003 Act**”). In each case, the relevant cost orientation obligation (Condition HH3.1) provided as follows:

“Unless Ofcom directs otherwise from time to time, the Dominant Provider [BT] 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 HH1 [network access condition relating to the relevant AISBO services] 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 including an appropriate return on capital employed.”

On various dates between 2010 to 2012, a number of BT’s wholesale AISBO customers – Sky, TalkTalk, Virgin, Cable & Wireless, Verizon – referred disputes to Ofcom under section 185(3) of the 2003 Act alleging that BT had charged prices in breach of its cost orientation obligation for certain wholesale AISBO services at various bandwidths. The specific AISBO services concerned were:

- i. “**wholesale extension services**” or “**WES**”, which are used to connect the purchasing communication provider’s main network to its retail customer via a BT exchange; and
- ii. “**backhaul extension services**” or “**BES**”, which are used to connect a purchasing communications provider’s equipment in a BT exchange with that communications provider’s main network – the connection between the exchange equipment and the retail customer being made using an unbundled local loop.

On 20 December 2012, Ofcom published its consolidated determination of the various disputes (“**the Ethernet Determination**”)⁵, finding that BT had breached its cost orientation obligation and, therefore, overcharged for a number of WES and BES at various bandwidths over certain periods between 2006 and 2011. In reaching

4. See Business Connectivity Market Review: Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets – Statement and Consultation, 8 December 2008.

5. Disputes between each of Sky, TalkTalk, Virgin Media, Cable & Wireless and Verizon and BT regarding BT’s charges for Ethernet services: Determinations and Explanatory Statement.

this conclusion, Ofcom:

- i. examined whether each individual connection and rental charge levied by BT for each BES and WES service at issue satisfied Condition HH3.1 – i.e. Ofcom did not consider BT’s aggregate costs and charges across the full package of disputed services nor did it consider BT’s aggregate connection and rental costs and charges for any individual disputed service; and
- ii. presumed that BT had complied with Condition HH3.1 where the relevant individual connection or rental charge was less than or equal to the Distributed Stand Alone Cost (explained further below) of the connection/rental⁶.

In light of its finding that BT had been charging in breach of Condition HH3.1, Ofcom ordered BT to repay its wholesale customers the sums overcharged without interest. The decision not to award interest was based on Clause 12.3 of BT’s standard contract for the supply of the relevant AISBO services.

The Determination was appealed to the Tribunal on various grounds by (1) BT, (2) Sky and TalkTalk and (3) Virgin, Cable & Wireless, Verizon (collectively, “the Altnets”).

BT’s appeal

BT advanced six grounds of appeal: by its first four grounds, BT essentially argued that Ofcom had misconstrued and misapplied Condition HH3.1 with the result that it overstated the level by which BT’s charges for the relevant services exceeded its recoverable costs; by its fifth and sixth grounds, BT challenged Ofcom’s jurisdiction and/or the exercise of its discretion to order repayment of sums “paid without dispute”.

Application of Condition HH3.1

By its first ground of appeal, BT argued that Ofcom should not have examined the cost orientation of *each individual* BT connection and rental charge for each WES or BES of a particular bandwidth, but instead ought to have assessed the cost orientation of the *aggregate BT charges* (connection, rental, any other incidental charges) for a given WES or BES of a particular bandwidth. The Tribunal rejected this argument, holding that the plain wording of Condition HH3.1 required “**each and every charge offered, payable or proposed for Network Access**” to be cost orientated and that there was, accordingly, no basis for aggregation of connection, rental and other incidental charges: § 89. The fact that BT could arguably have imposed a single overall charge

6. Ofcom did not presume that charges in excess of Distributed Stand Alone Cost breached Condition HH3.1, but went on to consider whether other factors brought the relevant charge into compliance with the cost orientation obligation.

for each individual WES and BES in question was irrelevant in circumstances where BT has chosen to charge separately for connection, rental and other components of the relevant service: §93.

BT's second ground of appeal – further or in the alternative to its first ground – was that economic and commercial reality compelled a construction of Condition HH3.1 whereby the cost orientation of connection and rental charges for a given WES or BES fall be assessed in aggregate. BT's main argument⁷ in this regard was that there was no single "correct" way of allocating common costs between the connection and rental components of a service and, therefore, assessing cost orientation on a disaggregated basis could lead to arbitrary results: § 107. The Tribunal accepted, in principle, that economic and commercial considerations could require SMP condition to be construed in a way that departed from the plain meaning of that condition, but it was not persuaded by BT's specific arguments in this case: §106. In particular, it considered that there was no unfairness to BT in assessing cost orientation on a disaggregated basis as (i) BT has significant flexibility to allocate its common costs between connection and rental *ex ante* in its regulatory accounts and (ii) Ofcom's cost orientation assessment simply adopted that allocation: §§108-112.

By its third ground of appeal, BT argued that Ofcom's application of Condition HH3.1 was contrary to the principle of legal certainty as Ofcom has not specified in advance how the Condition would be applied and had allegedly made prior statements inconsistent with the approach taken in the Ethernet Determination. The Tribunal rejected this argument noting that BT had not appealed the imposition of Condition HH3.1 as "*inherently uncertain*" at the time that it was imposed, nor had it since sought guidance from Ofcom on the way in which the Condition would be applied. BT, accordingly, had no legitimate expectation that the Condition would be applied in a particular way (e.g. by assessment of the cost orientation of connection and rental charges in aggregate). In those circumstances, the question for the Tribunal was whether Ofcom has applied the Condition correctly in the Determination – not whether it had applied the Condition in accordance with certain past statements: §129. The Tribunal also addressed and rejected BT's detailed arguments under this ground relating to 2006/07 charges and Ofcom's "rigid and mechanistic" approach to the application of Condition HH3.1: §§132-148.

7. BT also argued that an aggregate consideration of cost orientation is in line with the decision-making practice of communications providers that purchase WES and BES from BT, which typically consider the "whole life cost" (covering both connection and rental) of the relevant service: §113. The Tribunal rejected that factual contention in light of factual evidence from Ofcom and purchasers of the relevant services: §§114-118.

BT's fourth ground of appeal alleged that Ofcom should have made a number of adjustments to BT's Regulatory Financial Statements ("RFS") - which Ofcom had used in calculating BT's costs of providing the relevant services - that would have had the effect of reducing the overall level of overcharge found. The Tribunal considered these proposed adjustments in detail at §§ 207-238, allowing some and rejecting others.

Repayment of "sums paid without dispute"

By its fifth ground, BT argued that Ofcom's jurisdiction under section 190(2)(d) of the 2003 Act to order repayment of sums charged in breach of an SMP condition "is limited to the period from when the disputing communications provider that has negotiated in good faith, but failed to reach agreement, calls on Ofcom to resolve the dispute": §248. Ofcom supported this argument with detailed reference to the Common Regulatory Framework, the package of European Directives harmonising the regulation of communications across Member States – and, in particular, Articles 3(2), 6(2) and 10 of the Authorisation Directive.⁸ The Tribunal considered and rejected the argument at §§246-270, relying in part on its previous judgment in Partial Private Circuits [2011] CAT 5.

The Tribunal also rejected BT's sixth ground of appeal to the effect that Ofcom erred in exercising its discretion to order the repayment of overcharges levied prior to the submission of the relevant disputes to Ofcom: §§271-279.

Sky/TalkTalk's appeal – Cost standard

Sky and TalkTalk appealed the Determination on three grounds. By their first ground, they argued that Ofcom had wrongly presumed BT's charges to comply with Condition HH3.1 if they fell below Distributed Stand Alone Cost ("DSAC") of providing the relevant service; whereas it should also have tested the charges against a Fully Allocated Cost ("FAC") measure (which would have resulted in its finding a higher overcharge for the relevant services for certain periods). The Tribunal's findings on the first ground are considered in further detail in this section.

Sky and TalkTalk's second ground mirrored BT's fourth ground in arguing for certain adjustments to the RFS that would have the effect of *increasing* the overall level of overcharge found. The Tribunal considered and rejected this ground at §§239-243.

The third ground was similar to the Altnet's sole ground of appeal and related to

8. Directive 2002/20/EC.

the appropriate award of interest on BT's repayment of overcharges. It is considered together with the Altnets' arguments in the next section.

First Ground: The relevant measure of cost

Both DSAC and FAC measures take account of the incremental and the fixed common (overhead) costs of providing a given service. However, whilst the FAC measure distributes the common costs of a firm across all of the services that the firm provides, the DSAC measure distributes those common costs across a *particular group* of related services provided by the firm in a given market: §158. In a diversified firm offering a range of services across multiple markets (such as BT), the DSAC of a service will typically be higher than the FAC of the same service.

In the Determination, Ofcom calculated the DSAC for a given WES distributing the BT's common costs for AISBO across all of the WES provided by BT; it calculated the DSAC for a given BES distributing the entirety of BT's common costs for AISBO services across all of the BES provided by BT. As noted above, Ofcom presumed that any charge below the DSAC complied with Condition HH3.1.

First Ground: multiple recovery of common costs

In essence, Sky's and TalkTalk's complaint under their first ground was that Ofcom's reliance on DSAC alone to assess compliance with Condition HH3.1 allowed for multiple recovery of common costs. The Tribunal accepted that Ofcom's approach allowed BT – as a provider of WES, BES and other AISBO services – to over-recover in respect of *its* common costs for AISBO services. However, it noted that the approach would not allow for over-recovery of common costs by a new entrant in one of the WES or the BES sector: §169. The merits of the first ground, accordingly, turned on the meaning of '**appropriate** mark up for the recovery of common costs' in the context of Condition HH3.1: §170.

Adopting the Court of Appeal's approach in *Partial Private Circuits* [2012] EWCA Civ 1051, the Tribunal considered that the "appropriate" mark-up depended on the purpose for which the cost orientation obligation was imposed: §§171-172. The Tribunal noted that:

- a) Ofcom's objectives in imposing the cost orientation obligation included not only an increase in competition on downstream retail markets for Ethernet services but also stimulation of competition (i.e. new entry) in the wholesale AISBO market: §182;
- b) Pricing up to DSAC was consistent with Ofcom's objective of stimulating competition (new entry) on the wholesale market – as DSAC is the measure of

cost that would allow a new entrant providing the same package of either WES or BES as BT to recover its common costs: §177;

c) By contrast, the application of an FAC-based test of cost orientation would only encourage new entry of firms that could replicate the entirety of BT's AISBO offering: §178. Although, presumably an FAC-based test would have led to lower wholesale prices and so would have better stimulated competition on downstream retail markets.

In light of the above, the Tribunal considered that Ofcom was entitled in its approach to Condition HH3.1 to exercise its regulatory judgment to balance the objectives of stimulating wholesale competition on the one hand retail competition on the other. The Tribunal could find no error in Ofcom's decision to use a DSAC measure to assess compliance with the cost orientation obligation in Condition HH3.1.

First Ground: Response to a risk of excessive pricing

Section 88(1) and (3) of the 2003 Act permit Ofcom to impose a cost orientation obligation where it considers that there is a risk of excessive pricing or margin squeeze by the SMP provider. In this case, Ofcom had found a risk of excessive pricing, but no risk of margin squeeze. Against that background, Sky and TalkTalk argued that (i) the cost orientation obligation should be interpreted in a manner that prevents excessive pricing and (ii) the assessment of cost orientation by reference to DSAC alone – as this would allow over-recovery of common costs by BT.

The Tribunal did not accept this submission. It held that section 88, read as a whole “does not require Ofcom, in its response to a risk of excessive pricing, to impose obligations that will immediately produce the lowest price”: §187. Instead, it was open to Ofcom to respond to the risk of excessive pricing by setting a cost orientation obligation that stimulated entry into the wholesale AISBO market on which BT was found to have SMP: §§186-187.

First Ground: Practical problems with FAC-based test of cost orientation

In rejecting Sky's and TalkTalk's first ground of appeal, the Tribunal also had regard to what it considered were the “serious problems of practicality and reliability” in the alternative FAC-based test of cost orientation proposed: §§188-194.

Sky and TalkTalk's appeal and Altnet's appeal - Interest

Sky and TalkTalk's second ground of appeal, and the Altnets' sole ground of appeal,

was that Ofcom ought to have ordered BT to pay interest on its repayments of sums levied in breach of the cost orientation obligation.

Development of the appeals

Ofcom has declined to order interest on the basis of Clause 12.3 BT's standard form contract for wholesale Ethernet services, which provided in relevant part:

"... If any charge is recalculated or adjusted with retrospective effect under an order, direction, determination or requirement of Ofcom, or any other regulatory authority or body of competent jurisdiction, the Purchaser Parties agree that interest will not be payable on any amount due to either party as a result of that recalculation or adjustment."

In the Determination, Ofcom noted that Clause 12.3 had been in place for some years and that its inclusion in the relevant contracts had not previously been disputed. It, therefore, concluded that Sky, TalkTalk and the Altnets had not put forward "strong and compelling evidence that clause 12.3 is not fair and reasonable such that we should intervene in the light of our regulatory objectives to set it aside".

On appeal to the Tribunal, the Altnets and Sky and TalkTalk did put forward evidence concerning the negotiation of contracts for the provision of wholesale AISBO services by BT suggesting that they had been given no option but to accept Clause 12.3. In light of this evidence, Ofcom expressly did seek to defend its Determination on the issue of interest.

BT's position was that (i) Ofcom did not have jurisdiction to award interest in the context of a section 185 dispute and (ii) even if it did have such a discretion, it was right not to award interest in this case.

Jurisdiction to award interest

Section 190 of the 2003 Act sets out the orders that Ofcom can make on determining a dispute under section 185. Section 190(2)(d) empowers Ofcom to give a direction "requiring the payment of sums by way of adjustment of an underpayment or overpayment". The Tribunal considered that the ordinary reading of the language of that section was sufficiently broad to enable Ofcom to order the payment of interest: §288. It did not consider BT's references to other English statutes providing expressly for the award of interest to be relevant: §291.

Exercise of discretion to award interest

The Tribunal held that Ofcom's discretion to award interest in the context of a section 185 dispute should be exercised with a view to (i) ensuring compliance with any SMP Conditions and (ii) facilitating Ofcom's general regulatory duties and objectives as set out in sections 3 and 4 of the 2003 Act: §298. It further accepted Sky's and TalkTalk's submission that the existence of Clause 12.3 is only relevant to the award of interest to the extent that it feeds into the relevant objectives: §298. In so holding, the Tribunal opined that the Supreme Court's judgment in *BT plc v Telefonica O2 UK Ltd (08x numbers)* [2014] UKSC 42 – which emphasises the importance of freely negotiated contractual terms in the context of section 185 dispute resolution on markets where no SMP has been declared – did not give rise to any presumption in favour of the enforcement of Clause 12.3 on a market in which Ofcom had found SMP: §300.

The Tribunal went on to hold that Ofcom should have awarded interest in this case in light of the relevant regulatory objectives.

Comment

The main impact of the case is that orders for interest are likely to be much more common in future telecoms disputes. The Tribunal found that Ofcom has jurisdiction to award interest and indicated that interest should be awarded where that would better promote the regulatory objectives of the 2003 Act. Where a cost orientation obligation has been imposed on an operator with SMP, its incentives to comply with that obligation will be reduced unless interest is awarded.

Meredith Pickford and Julian Gregory acted for Sky and TalkTalk.

The comments made in this case note are wholly personal and do not reflect the views of any other members of Monckton Chambers, its tenants or clients.