Vodafone's response to Ofcom's consultation

Directions for Regulatory Financial Reporting

January 2015

VODAFONE

Headquartered in the UK, Vodafone is a truly global business investing and innovating in all the markets we serve to deliver for our customers. Our home market is no exception and Vodafone provides both mobile and fixed communication services to a wide customer demographic, from individual pay-as-you-go consumers to large multi-national enterprises. With £2.5M being invested each day in our UK network, we remain committed to delivering the very best for our customers.

INTRODUCTION

We welcome this opportunity to respond to Ofcom's proposals which take the first steps towards implementing a new approach to regulatory accounting in the UK. We appreciate the work already undertaken by Ofcom in this complex area of regulation and the progress made in getting to this point. We regard Regulatory Accounting as one of the most crucial aspect of the regulatory regime. It is not simply a hygiene factor that must be met, rather it is a fundamental anchor of the entire regulatory framework, helping to ensure that the economic and market remedies, imposed to combat the adverse consequences of varying degrees of market failure, are soundly based and are working for the benefit of end customers. This ensures that Ofcom, in so far as is possible, can replicate the outcomes achievable in a competitive market.

Although Ofcom has retreated from imposing cost orientation obligations, the requirement for robust regulatory accounting information has never been greater and it remains a vital part of being able to understand whether the prices charged in SMP markets have been fairly, reasonably & efficiently derived, absent the normal incentivising impact that competition would bring. It goes some way to allowing stakeholders to both understand and critique current and proposed charge controls. A sound regulatory accounting approach is especially important in newer markets, such as VULA, which are expected to grow substantially in the years ahead. Given the nature of the VULA product and the reliance of other providers on BT owned infrastructure, it is imperative that Ofcom gets VULA reporting right early on. Given the extent of common infrastructure VULA shares with other services (duct, copper etc.) and the fact that it has been laid down in part with a public subsidy, it is imperative that stakeholders and taxpayers are provided with the right level of transparency over the underlying costs of the service.

We have made our support clear in the past for Ofcom's more hands on approach to regulatory accounting and the steps to overhaul the regime to remove as much bias as possible from the output, scrutinising areas where BT previously had discretion that can and has been used to distort outcomes. We must not fall back into an approach that affords BT too much discretion, enabling it to shape its regulatory accounting output to fit its own commercial objectives, shifting common costs between products to suit its own business position in charge control setting and disputes, thus falling well short of the unbiased and matter of fact reference material that it was intended to be.

We continue to believe that more needs to be done to ensure that there is transparency around BT's profitability in individual SMP markets and in aggregate, across all parts of its regulated business. It is important for all stakeholders to know how much return is being made by the dominant provider where there is market failure. In the past we've seen BT enjoy levels of profitability in regulated services that would be unachievable in a competitive market setting. With returns well in excess of BT's cost of capital, much of this excess has been generated not through efficiency improvements, but rather as a result of volume forecasting errors in charge control setting, or mitigation measures that have been included within the charge control design for policy reasons. In all cases stakeholders need to be clear about past profitability to ensure that informed decisions are made and the wider consumer interest is being safeguarded.

We would like to see Ofcom place new reporting remedies on a range of smaller volume, but critically important, services where the entire industry is reliant upon BT for service. The cost of services like 112/999 Emergency call handling, Text relay and the Payphone Access Charge are all designed for public benefit, not being provided to consumers on a commercial basis, yet BT's costs to provide them aren't transparent and BT is receiving large sums at the wholesale level as it is only provider with the critical mass of traffic able to run such services. We need additional scrutiny over costs in these areas and the regulatory accounts should reflect that, providing badly needed transparency.

We recognise that reform of the regime will take time and that progress will be achieved on a market by market basis. It is vital that Ofcom, over the next two years, undertakes a project to scrutinise the appropriateness of all material attribution decisions, ensuring that they are fit for purpose and don't inflate or deflate costs to suit BT's commercial strategy. We know a balance must be struck between publishing information and not publishing it, however we believe that in each case where information is not disclosed, that there should be a very real reason as to why it was withheld from wider scrutiny. After all the industry, who face the real cost consequences of any overcharging (or undercharging), have both the motivation and the track record of exposing it and holding BT to account, where such information can be made available. Ofcom on its own doesn't have the resource or the commercial imperative to ensure that all overcharging has been eliminated.

To that end we very much welcome Ofcom's plans to publish a wider consultation around attribution rules later in 2015. We believe it is important that these key decisions, which dictate the prices paid by consumers and businesses for a range of services, are transparent and subject to robust scrutiny.

In the remainder of this response we will focus upon the four areas considered by Ofcom in this consultation.

PROVIDING A BETTER UNDERSTANDING OF BT'S FINANCIAL PERFORMANCE

We welcome the general principle that BT's regulatory accounting output should reflect past regulatory decisions. Part of the problem with the current accounting output is that it doesn't reflect past regulatory decisions and a series of adjustments are needed in order to understand the true costs & profitability of a particular service. We do however recognise that there are instances where, for legitimate policy reasons, decisions within charge controls have been taken to reflect other factors, such as ensuring that alternative infrastructure providers can continue to participate in the market, for example in the ISDN30 market or when a hypothetical efficient network model has been used as a basis for calculating charges.

In such cases it is important that the regulatory accounts provide accurate information around the dominant provider's costs and profitability and that this detail isn't obscured by any mitigation measures. We therefore support the view that the default position should be that the accounts reflect regulatory decisions, with case by case exceptions made where it is appropriate to do so, with Ofcom consulting upon each set of circumstances where a departure from the default position is made.

We support the production of the new schedules (the 'Adjusted Financial Performance Schedules') focusing on returns, MCE and ROCE. These will support stakeholders in understanding the costs and returns in regulated markets. In the case of schedule 2 (which we understand is a more detailed version of schedule 1), we hope that while Ofcom wishes not to make this public, that relevant details of its contents will be disclosed if legitimate questions are raised that require answers. Likewise, when consulting on new charge control measures we hope that such details will not be withheld; ensuring stakeholders have the necessary understanding to make informed contributions to the charge control discussions.

PROPOSALS IN THE RELATION TO THE ADJUSTMENTS TO BE MADE TO BT'S DATA FOR INCLUSION IN THE REGULATORY FINANCIAL STATEMENTS

We wholeheartedly agree with Ofcom that's BT 2012/13 RFS changes did not represent a balanced approach to the review of allocations, leading Ofcom to use the 2011/12 Regulatory Financial Statements (or 2012/13 data restated using 2011/12 allocations) for the fixed access market review charge controls. We recognise the practical challenges that maintaining such an approach would have in future controls, especially when a full review of allocation bases is planned for 2016.

Below we briefly review each of the adjustment proposals, setting out our view on each:

1. **SMPF**
   We are supportive of Ofcom's decision to require that all internal costs and volumes relating to the consumption of SMPF are disclosed in the WLR market statements. Given the extent of internal supply it is important that these costs are subject to the proper level of external scrutiny.

2. **Directories**
   We support the exclusion of these costs from WLR rentals, believing there was never any justification for their original inclusion.

3. **DSLAM Capital Maintenance**
   Based on the information available we are supportive of this adjustment being reflected within the accounts.

4. **Group Overheads**
   Where group Overhead costs cannot be truly associated with one business unit or another (e.g. Investor Relations), then we support Ofcom's proposal to allocate these costs in proportion to the total average employees employed by each respective BT subsidiary. Where functions sit in Group but really work on behalf of one or more operating unit, then these costs should be assigned to those units

5. **Deafness Provision**
   We support the exclusion of any backward looking costs from the WLR market statements in the RFS.

6. **Cumulo Rates**

It is imperative that all services, including NGA services take an appropriate allocation of BT's rates costs. We therefore are supportive of adjustments to the RFS that ensure this occurs.

7. **Test Access Matrix (TAMs) Costs & Evolutionary Test Access Matrix (EvoTams)**

Based on the information available, we believe the adjustments required by Ofcom are reasonable and should be reflected with the RFS.

8. **Simultaneously Provided Services**

We support the requirement for BT to disclose information for simultaneously provided services and separately attribute these costs.

9. **Combined fault and Service Allocations**

We support the inclusion of these adjustments within BT's RFS output.

10. **TAMs mark-up & LRIC Differential**

It is important that the accounts are prepared on a consistent basis and using LRIC and FAC reporting simultaneously would thwart transparency.

11. **Line cards & Caller Display**

We consider Ofcom's approach as reasonable, recognising that in these circumstances the decisions in the charge controls need not be reflected within the RFS.

12. **IPStream Market A and B cost allocations & size adjustments**

We support the decision to include these within the RFS.

13. **21CN Costs & Future Benefits**

We view 21CN costs as largely historic, belonging to a technology program that largely failed to deliver its overall objectives. We therefore consider these as legacy costs that should be removed from regulatory reporting in as far as is possible.

14. **Hypothetical ongoing network & other CCA adjustments**

We believe it is important for stakeholders to understand this adjustment through additional reporting requirements, but recognise that it would not be appropriate to include it within the RFS output.

In the case of Migrations and WLR transfer, LRIC adjustment & recovery of common costs and the SMPF allocation we recognise the reasons for excluding these from the RFS and where appropriate the need for them to be captured within the additional reporting requirements. In the case of the Absolute valuation of copper, ISDN30 & ISND2 we recognise the policy rationale for the charge control adjustments and reasons for excluding them from any RFS output.

VULA REPORTING

We have ongoing concerns around the reporting of VULA costs in the regulatory financial statements. While VULA is a relatively new product, demand is rising fast through the take up of superfast broadband. Given that it competes head to head with LLU based services, and that wholesale providers purchasing it are more reliant on BT infrastructure than their own LLU capabilities, it is imperative that communication providers have transparency around its cost of provision. It shares a significant amount of common infrastructure with other services (duct, copper etc.) and has been laid down in part with a significant public subsidy. There are also elements of the costs that aren't properly understood by stakeholders, including the contribution to local exchange costs, where additional fibre costs fall (when additional fibres have been laid) and the treatment of the redundant copper that has been bypassed between the exchange and cabinet.

To this end we welcome the publication of revenue, volume, average price and FAC of each VULA service & VULA migration, based on the component information and usage factors for the WLA market. We also believe the CCA based information should be disclosed as well as details of the government grants from BDUK and other sources to enable roll out. Keeping this information private is not in the public interest as disclosure will not lead to any adverse consequences and will promote transparency around a critical and evolving product. The consultation fails to articulate why CCA information and details of state aid should not be disclosed. Stakeholders as taxpayers have a legitimate interest in understanding how their taxes have been used to help fund the roll out of superfast broadband.

We believe Ofcom need to do more help stakeholders understand the costs involved in providing VULA and the consequences of any such allocation decision on products that utilise the same common costs. To this end we believe a focus workshop on VULA costings and reporting would be welcomed by stakeholders to ensure that right level of transparency was obtained.

ELECTRICITY REPORTING

We welcome Ofcom's efforts to improve transparency in this area. Vodafone spends considerable sums on BT sourced electricity and we need confidence that we are paying a fair rate for our consumption based on the underlying cost to provide it. It must be recognised that as BT is effectively purchasing electricity on behalf of a number of CPs who are co-located in exchange buildings, with its own business also benefiting from this larger pool of consumption with contract savings possible as a result. To this end we would expect BT to divulge more detail, at the very least to those CPs that are purchasing electricity from them and while some additional information should be published in the RFS, a more detail breakdown should be made available to communication provider consumers of BT electricity on a confidential basis.

Safeguards are needed to ensure that all the benefits derived from purchasing bulk electricity are captured in the accounting of it and the only way to achieve that is to provide a more detailed disclosure. If BT has genuine concerns about this being made publically, then a non-disclosure arrangement should be implemented, giving purchasers more detail at the point of purchase.

Vodafone Limited
January 2015