Vodafone's response to Ofcom's consultation

"Fixed access market review approach to the VULA margin"

September 2014

EXECUTIVE SUMMARY

Vodafone supports the following principles underpinning Ofcom's ex ante margin test approach:

- LRIC plus is the correct cost standard to estimate costs;
- The adoption of the adjusted EEO (equally efficient operator) is appropriate to ensure that competitors are able to compete effectively with BT, although further adjustments are warranted;
    - That the margin of all broadband retail offers, including bundles, are included within the test;
    - The costs and revenues of all services within bundles must be taken into account when assessing margins.

Vodafone does not support the following:

- The proposed method of allocating BT Sports costs. These costs should be distributed solely to users of that service rather than all users;
- The exclusion of business services from the test. Ofcom will also need to carefully assess the cost attribution between consumer and business services;
- The level of aggregation proposed for the margin squeeze test, as Vodafone considers that a product by product test is necessary. Only a product by product approach can address BT's ability to adversely leverage its SMP into neighbouring products.
- Monitoring and enforcement of compliance only in an *ex-post* fashion, as Vodafone considers such a process is inadequate to address competition concerns quickly enough to prevent consumer harm. Pre notification is therefore essential.

Background

The superfast broadband market is an important and growing new market. Ofcom's most recent market data report (published August 2014) shows that 26.7% of broadband connections, including Virgin customers, are now superfast. We can also see from the report the growing importance of fibre based broadband connection with a 97% growth year on year.

Figure showing broadband connections data collected by Ofcom

Table 16
Summary of residential and small business broadband connections at end of quarter (000's)[1]

	Total	Non-LLU ADSL	LLU ADSL	Cable	Other (inc. FTTx)	BT retail share
2012	21,668	7,499	8,777	4,290	1,101	29.5%
2013	22,577	6,580	9,241	4,394	2,362	30.7%
2013 Q1	21,890	7,333	8,850	4,328	1,380	29.8%
2013 Q2	22,090	7,101	8,958	4,325	1,706	30.0%
2013 Q3	22,284	6,878	9,025	4,355	2,027	30.3%
2013 Q4	22,577	6,580	9,241	4,394	2,362	30.7%
2014 Q1	22,808	6,353	9,301	4,435	2,719	31.4%

[1] Figures exclude corporate broadband connections. Connection numbers have been adjusted to exclude corporate broadband based on Ofcom estimates.

Also Ofcom's European Broadband Scorecard 2014 finds that the availability of super-fast broadband has increased in the UK from around 60 per cent at the end of 2011 to 73 per cent.[1] This evidence supports a significant growth in superfast broadband and especially "Other" broadband connections over time.

During this key period of market development BT has been able to gain a disproportionate market share in the SFBB market segment compared to its market share in legacy BB (broadband). BT's last quarter accounts claim that BT achieved 64% share of new broadband additions (presumably across both legacy BB and SFBB). BT's markets share of SFBB (excluding cable) is in the region of 85%[2]. BT is having far greater success than its rivals in attracting SFBB customers. This is at odds with the fact that legacy BB market shares have been more evenly split between BT, TT and Sky. BT's SFBB market share is a clear warning that there is a problem[3].

Analysis by Ofcom, while preparing the margin test, has found that under the current method that BT is very close to the margin boundary. This is similarly a cause for concern.

We are increasingly of the view that the upstream VULA product requires price regulation by Ofcom (but recognise that this is now out of scope until a market review in the future) because:

- Large scale alternative network competition will not occur
  - It is now clear that alternative SFBB networks to BT's are niche developments and therefore a functioning wholesale supply will rely upon the services provided by BT.
- Pricing certainty may be what is impeding NGA competition
  - Absent detailed cost modelling by Ofcom it is impossible to determine whether BT's existing VULA product will vary in price (either up or down) and we have no certainty of the future direction of pricing. Charge control regimes are ideal for regulated services as prediction of service prices is much more achievable.

Clear objectives for the *ex ante* test

The purpose of the margin squeeze test is to protect and promote BB/SFBB competition by ensuring that BT's retail offers can be economically replicated by competitors. The extent to which the VULA test achieves its objective depends on the selection of appropriate assessment criteria as well as an effective monitoring and compliance framework.

Ofcom is seeking to ensure that competition in SFBB is not dampened by BT's SMP. In particular Ofcom wishes to ensure that competition in legacy BB is able to continue into SFBB. Ofcom focusses its attention upon the possible cost disadvantages faced by BB suppliers that today have a significant/ scale presence in the legacy BB market.

It is also necessary to evaluate whether unfair advantage / non replicable advantage is obtained by BT's ability to leverage its SMP from uncompetitive services to competitive services via bundling. For this reason we consider a product by product margin test is necessary. BT's scale and scope if far

[1] *Vide* http://media.ofcom.org.uk/news/2014/european-broadband-scorecard/

[2] 2.3M BT SFBB retail customers at per BT Q1 2014 as a percentage of all SFBB retail connections 2.719M from Ofcom Market data Q1 2014

[3] This odd disparity between the growth in market shares between the existing and established broadband providers presents sufficient concern that something is unduly effecting competition. Whether this is the VULA price[3] or the VULA margin remains unclear and while such doubt exists a higher degree of caution is appropriate

wider than its competitors and therefore a portfolio approach alone cannot address BT's threat to a healthy competitive market.

Adjusted EEO

Generally we support the use of an adjusted EEO for the assessment of the VULA margin, this aligns with the EC Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment. We support the positive steps taken by Ofcom to use an adjusted EEO (in particular adjustments to for lower competitor's Average Customer Lifetimes and unit bandwidth cost). However we consider there is further to go. In particular we identify two areas below:

1. Ofcom is correct to base minimum bandwidth cost on the trends of the adjusted EEO. BT's own bandwidth costs may be susceptible to allocation gaming by BT. Our past understanding has been the BT Design purchases large bandwidth increments on behalf of all BT downstream lines of business therefore achieving the best economies in bandwidth sharing. The allocation of the cost of this shared bandwidth therefore can be reasonably apportioned to a large variety of services and BT business groups. A competitor to BT is unlikely to have a similar opportunity to share bandwidth costs and consequently will face higher bandwidth costs.

2. It is our understanding that BT has an unusual out of bundle call profile compared to its competitors. This is clearly an important adjustment within the adjusted EEO test if competitors to BT have a far lower revenue stream for this cost item. The adjustment must address this issue.

BT Sport

The appropriate cost apportionment of BT Sport has featured within the consultation. We do not agree that the costs of BT Sport should be apportioned to customers that do not take up BT Sport. Spreading the costs of BT Sport more widely than the customers that take up the service, especially across legacy BB customers where margins per customer are at present higher, is economically flawed. We consider the only appropriate analysis of cost apportionment is across customers that have subscribed / make use of the service.

Due to reliance on BT's regulatory accounts, there should be heightened scrutiny by Ofcom and BT's regulated accounts auditors on SFBB costs, allocation of joint and common cost etc. We request that the audit standard for this product to be raised to Fairly Present.

Level of aggregation / relevant retail products:

Ofcom proposes to assess whether BT makes a margin across the entire range of BB/SFBB products. Theoretically therefore BT could make lower, none or negative margin on a proportion of services. We consider that this approach is flawed, subject to gaming by BT and fails to achieve the objective of the margin squeeze test. It is also skewed to favour BT who is likely to have a wider service / portfolio range than its competitors. A case in point is BT's capability to offer mobile services. In contrast to SKY and TT, BT is unique in this capability. For example BT could readily chose the mobile inclusive bundle for higher pricing and higher margins while retailing other more competitive bundles at lower margins. SKY and TT would be unable to replicate this approach, at least in the short term.

As a consequence we consider that the portfolio approach should be complemented by a product by product analysis (or at the very least a lower level of aggregation) as otherwise BT could price very aggressively some products thereby damaging competition from rivals who could not follow this strategy while satisfying the overall no margin squeeze constraint. This is consistent with the EC Recommendation's emphasis on conducting economic replicability analysis of flagship products.

BT's retail offers will not remain static and therefore it is necessary for the model to accommodate all changes that occur over time. Ofcom will therefore continually need to ensure that all relevant costs, revenues and discounts/promotion should be adequately captured in the margin test.

Inclusion of business offers

Ofcom has taken a provisional view that it is not appropriate or proportionate to extend the VULA margin assessment to include SFBB supplied by BT business[4]. It is Ofcom's intention that the VULA margin test applies to consumer broadband only.

We consider that the margin test approach is equally applicable to business services[5] and that such application would be an achievable extension of the current test proposal.

Ofcom does not include business services at this stage due to "slightly different competitive conditions[6]" in particular "the consumer operators are not all present in the business market" and "that a number of smaller operators are only active in the business segment of the market". Ofcom concludes that BT's relevant position in the business segment may differ.

Similarly to our discussion concerning the formation of the consumer broadband market we consider that the structure of competition in the business broadband market currently warrant inclusion in the scope of the test to address BT's SMP. The need to do so will further increase in the event of bundling, and take up of bundles, including mobile service provision within this market. Recently BT has announced the bundling of 4G mobile within its business SFBB offer. Such an offer is of major importance to other mobile business CPs who are likely to have to offer similar bundles in order to remain competitive in the mobile SOHO and SME markets.

Therefore, Vodafone considers Ofcom must extend the VULA margin squeeze test to business broadband.

Gaming

BT has an established history of gaming regulatory cost models. Many of BT's costs are common and arguably may be attributed by multiple methods. Shunting around of reported costs can make the difference between a product being profitable or otherwise. The detail of BT's gaming often does not become transparent until future RFS reporting and charge control cost modelling. We therefore have serious reservations concerning the redactions of cost data and the absence of fully reported costs and cost methodologies in the RFS.

Bundles

Ofcom sets the principle that the margin squeeze test approach proposed will consider the revenues and costs of all of the services within the bundles. Over time and perhaps even during the period of

[4] 5.71
[5] Business are already the poor relative of SFBB having failed to have locations feature in early rollout plans and now having to use in essence a product created for consumers.
[6] 5.69

this FAMR product bundles will evolve. It is likely that mobile will be included within service bundles (indeed as described above, 4G is already included within BT's business SFBB bundles). Naturally the same approach to costs and revenues is easily adaptable to incorporate into new bundle elements offered by BT.

Robust monitoring and compliance framework

Vodafone does not consider Ofcom's monitoring and enforcement proposal sufficiently addresses the competition concerns which have prompted the need to put in place a margin squeeze framework.
The present proposals for monitoring and compliance of the VULA margin unfairly put the onus upon competing CPs to compile the basis of concerns to Ofcom. This is clearly an undue burden upon competing CPs and is somewhat bureaucratic when BT will readily create and hold the information.

Ofcom's market evidence (discussed in the background section) clearly illustrates the importance of this market and the growth occurring each quarter in SFBB. We therefore consider that pre notification is essential to effectively protect competition. BT must be required to supply pre-launch notification of major price changes and the new offers whereby BT would be required to submit information showing compliance with the no margin squeezing rule for review by Ofcom. This is proportionate in so far as BT would be carrying those compliance checks anyway and would contribute to diminish the risk gaming by BT and abuse of its position of SMP. Further Ofcom should carefully review the information submitted as part of BTs ex-post reporting requirements, notably to assess the veracity of BT's cost allocation and act promptly if a margin squeeze is identified.

In addition we consider that information should be supplied on a quarterly basis in order to allow Ofcom to have timely access to information.

Responses to questions

Vodafone has not provided comment on each and every element of the draft guidance. This should not be interpreted as agreement.

Q. 2.1 Do you consider that there has been a material change in circumstances in the WLA market since the 2014 FAMR Statement? Please provide supporting evidence as necessary.

Vodafone submits that the circumstances highlighted in Ofcom's 2014 FAMR largely remain applicable, however, we would like to highlight some points with respect to the superfast broadband market segment.

Ofcom's 2014 telecommunications market table shows growing importance of fibre based broadband connection with a 97% growth year on year. Also Ofcom's European Broadband Scorecard 2014 finds that the availability of super-fast broadband has increased in the UK from around 60 per cent at the end of 2011 to 73 per cent.[7] This evidence supports a significant growth in superfast broadband and especially "Other" broadband connections over time.

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Source: Ofcom Q1 2014, Telecommunications Market Table http://stakeholders.ofcom.org.uk/binaries/research/cmr/telecoms/Q1_2014.pdf

While this is a welcome development, Vodafone is concerned with the effectiveness of competition in the next generation super-fast broadband market (SFBB).

Evidence supports that BT has been able to gain a disproportioned market share in the SFBB market segment compared to its market share in legacy BB (broadband). BT's last quarter accounts claim that BT achieved 64% share of new broadband additions (presumably across both legacy BB and SFBB). BT's markets share of SFBB (excluding cable) is in the region of 85%. This does not only underline BT's dominant position in the SFBB market segment but also gives rise to concerns with regards to the effectiveness of competition in this growing market segment. The VULA margin test analysis and Ofcom's conclusion that BT is very close to the envisaged margin boundaries signify the importance for effective regulation and is a clear warning sign of an emblematic problem in the SFFB market.

Vodafone therefore welcomes Ofcom's consultation on regulating the margin between BT's wholesale and retail superfast broadband prices. While we agree with many elements of Ofcom's proposal, we submit among other points highlighted throughout this response that there are deficiencies with respect to transparent and robust monitoring and overall compliance mechanisms critical to effectively address the risk of gaming. We would therefore and in accordance with the EC recommendation highlight the importance to ensure "a level playing field through the application of

[7] *Vide* http://media.ofcom.org.uk/news/2014/european-broadband-scorecard/

stricter non-discrimination rules" and guarantee "technical replicability of new retail offers before their launch and at all times thereafter". [8]

Q.3.1 Do you agree with our proposed regulatory objective for the VULA margin? Please provide reasons in support of your view

Vodafone agrees with Ofcom's regulatory objective to "to ensure that BT cannot use its SMP in the WLA market to set the VULA margin over the period of the market review such that it causes retail competition in superfast broadband to be distorted."[9]

Further, we agree with Ofcom's conclusion that "Option 2 - ensure that BT does not set the VULA margin such that it prevents an operator that has slightly higher costs than BT (or some other slight commercial drawback relative to BT) being able to profitably match BT's retail superfast broadband offers"[10] constitutes an proportionate regulatory aim for the review period in question.

In this context, it is important to note that Ofcom should consider all relevant costs that constitute the higher cost base of an SFFB provider allowing sufficient recovery of costs in light of substantial disadvantages in terms of economies of scale and scope. Further, it is critical to ensure an appropriate cost base to allow sufficient allocation of costs based on a product-by-product assessment along with a portfolio approach.

Q4.1 Do you agree with the proposed form of the VULA margin requirement and associated compliance monitoring? Please provide reasons in support of your views.
& Q5.1 Do you agree with our proposals for BT to provide information on the VULA margin every six months? Please provide reasons in support of your views.

Vodafone considers that the information requirements suggested by Ofcom do not sufficiently address the competition concerns at hand. Considering the significant quarter on quarter developments in the SFFB market, we therefore propose the introduction of a pre-notification mechanism before the launch of new SFFB products requiring BT to supply Ofcom with analysis of the test in order to ensure pre-launch compliance. In addition, we submit that information should be supplied on a quarterly basis allowing a systematic and timely tracking in case of complaints.
In essence, we are of the view that these requirements will minimise the risk of gaming and abuse of BT's SMP position.

Q5.1 Do you agree with our approach to the VULA margin assessment? In particular, do you agree that we should:

> **(a) adopt an adjusted EEO approach?**
> **(b) assess costs on a LRIC+ basis?**
> **(c) assess costs and revenues at the level of the entire portfolio of superfast broadband packages marketed at residential consumers and taking into account the components of these packages?**

Q.5.1 (a) Equally efficient operator (EEO) approach

Vodafone welcomes Ofcom's principle move towards an adjusted EEO approach. More specifically, we support the adoption of a lower average customer life time and a unit bandwidth approach.

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[8] *Vide* Commission Recommendation 2013/466/EU http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:251:0013:0032:En:PDF
[9] *Vide* OFCOM VULA Margin Consultation, p. 20.
[10] *Vide* OFCOM VULA Margin Consultation, p. 36.

Having said this, we believe the test requires further adjustments considering *inter alia* calibrating consumer usage profiles, acknowledging particularities of BT's customer base e.g. with respect to out-of bundle costs and taking into account the potential costs of an equally efficient new entrant, in particular, in view of the prospective evolution of quad-play offers. In this respect, it may be important to re-assess the adjustment of WACC for a hypothetical efficient entrant.

Q.5.1 (b) LRIC+ basis and inclusion of business services
Vodafone agrees with OFCOM's proposed LRIC+ cost standard.

More generally it is important to ensure that all relevant downstream costs and revenues are sufficiently accounted for and allocated in an appropriate basis.

The exclusion of business services due to "slightly different competitive conditions[11]" therefore needs to be rejected. BT's SMP extend into the business market requiring an all-encompassing approach with respect to the adopted minimum VULA margin.

In fact, it is critical to account for business broadband services as this will have an important bearing on the allocation of common cost relevant to the application of LRIC+.

Q.5.1 (c)
Portfolio approach and levels of aggregation
Ofcom proposes to assess whether BT makes a margin across the entire range of BB/SFBB products. Theoretically therefore BT could make lower, none or negative margin on a proportion of services. We consider that this approach is flawed, subject to gaming by BT and fails to achieve the objective of the margin squeeze test. It is also skewed to favour BT who is likely to have a wider service / portfolio range than its competitors. A case in point is BT's capability to offer mobile services. In contrast to SKY and TT, BT is unique in this capability. For example BT could readily chose the mobile inclusive bundle for higher pricing and higher margins while retailing other more competitive bundles at lower margins. SKY and TT would be unable to replicate this approach, at least in the short term.

As a consequence, Vodafone concludes that the **portfolio approach** needs to be complemented by a **product by product** approach (or at least a lower level of aggregation) as otherwise BT would be incentivised to abuse its dominant position in certain product lines while still satisfying the overall minimum VULA margin obligation as envisaged by OFCOM.

Further, the analysis should be completed for stand-alone offers as well as all relevant bundles which include any components offered on the basis of GEA.

Bundles
Ofcom sets the principle that the margin squeeze test approach proposed will consider the revenues and costs of all of the services within the bundles. Over time and perhaps even during the period of this FAMR product bundles will evolve. It is likely that mobile will be included within service bundles (indeed 4G is already included within BT's business SFBB bundles). Naturally the same approach to costs and revenues is easily adaptable to incorporate into new bundle elements offered by BT.

Q6.1 Do you agree with the details of how we propose to treat costs and revenues? In particular, do you agree:

(a) with our draft guidance, particularly the proposed guidance in relation to BT Sport?
(b) with the adjustment to average customer lifetimes in the proposed SMP condition?
(c) with the floor on unit bandwidth costs in the proposed SMP condition?
(d) that overall our proposals are likely to meet our objective?

[11] Vide OFCOM VULA Margin Consultation 5.69

Q6.1 (a) BT sport

The appropriate cost apportionment of BT Sport has featured within the consultation. We do not agree that the costs of BT Sport should be apportioned to customers that do not take up BT Sport.

Spreading the costs of BT Sport more widely than the customers that take up the service, especially across legacy BB customers where margins per customer are at present higher, is economically flawed. We consider the only appropriate analysis of cost apportionment is across customers that have subscribed / make use of the service.

Due to reliance on BT's regulatory accounts, there should be heightened scrutiny by Ofcom and BT's regulated accounts auditors on SFBB costs, allocation of joint and common cost etc. We request that the audit standard for this product to be raised to Fairly Present.

Q.6.1 (b), (c) Adjustment to average customer lifetime and floor on unit bandwidth costs
While we understand the difficulties of estimating an appropriate ACL and hence accept the adoption of standard broadband churn to estimate the ACL at this point in time, it may be important to define a more forward-looking ACL adjustment method.

With respect to the applicable minimum bandwidth costs, we fully support that these must be based on the costs of the adjusted EEO. Moreover, we propose a consistent methodology with respect to cost allocation and enhanced transparency of the accounting and audit standards applied to BT's regulatory accounts.