



New Pricing Framework for Openreach
Response by Vodafone to Ofcom's Second Consultation

6 March 2009

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1. Introduction

Vodafone welcomes the opportunity to respond to Ofcom's second consultation on a new pricing framework for Openreach (the Consultation Document).

In summary, Vodafone's believes that Ofcom is over-estimating Core Service line costs for the following reasons:

- The downward trend in the total number of BT fixed lines will level out faster than forecast by Ofcom:
 - the emergence of mobile-only households has stabilised at around 10% (with 90% of households retaining fixed lines for data services at least), and will be replaced by the underlying demographic trend of rising household numbers at the rate of 0.7% pa.;
 - the ability of BT to compete against cable TV services has increased, especially with the development of the NGN and the availability of more wholesale content;
 - demand for second lines has now largely unwound as broadband penetration amongst households previously requiring second lines is now complete, and so this factor will not further reduce the number of BT lines.

Therefore, none of the factors listed in the Consultation Document will contribute significantly to further falls in the total number of BT lines. We suggest, therefore, that the overall number of BT analogue lines is held constant at 2008/9 levels;

- Ofcom has seriously under-estimated the potential for efficiency improvements by Openreach for two reasons:
 - Vodafone does not believe in "non-compressible" costs. All costs are compressible over a sufficiently long time frame, and will be compressible to some degree over a 4 year period (e.g. rolling contracts for accommodation). This issue needs to be considered further by Ofcom;
 - The KPMG report of November 2008 "BT Openreach Efficiency Review" excluded any study of labour productivity. Ofcom should assume that Openreach should aim to equal the labour productivity of the UK economy, and achieve a labour force reduction of 1.8% p.a. This corresponds to a cumulative reduction of 9.3% over the 5 year period studied by KPMG, and so also corresponds closely to KPMG's 10% cumulative reduction scenario, giving an overall revised efficiency gain of 3.7-4.0% on total costs (equivalent to 5.3-5.7% on "controllable" costs);
- All costs of the Light User Scheme (LUS), both revenue reductions and administration costs, should be excluded from Openreach's cost base. This is because responsibility for the LUS should rest with BT Retail (since the LUS provides for lower retail prices). If the net costs of universal service provision were significant we would expect BT Retail to receive contributions from a universal service fund, but these contributions would be paid to BT retail (the entity providing the subsidised prices), not Openreach. It follows that inclusion of LUS costs in the Openreach cost base would result in BT being "doubly compensated" for a proportion of LUS costs - once through the universal service fund, and once through Core Rental Service revenues. Since, in Vodafone's view, there is no doubt that all LUS costs should be excluded, the exclusion should apply in all scenarios (not just the low scenario as applied by Ofcom);
- All dropwire costs should be excluded from the Core Rental Service costs where the cost can reasonably be assumed to have already been recovered through a line connection charge or other retail tariff (whether a regulated charge control or not). We believe that this goes beyond

the adjustment already made by Ofcom, which excludes only a proportion of these costs insofar as they relate to price cap regulated tariffs over the period 2001/1 to 2004/5. The risk of BT being doubly reimbursed for these costs is the same whether through regulated or unregulated prices;

- Vodafone remains concerned of an over-allocation of corporate overheads to Openreach (4.9% of Openreach's total operational expenditure.). Openreach is a simpler operation compared to the other BT units (and especially compared to BT Global Services), providing for the most part passive connectivity, analogous to other utility network distribution industries such as water, electricity and gas. Activities such as capacity management and fault repair are similar to those in other utility industries. Allocating costs on the basis of FTEs (resulting in the 4.9% mark-up) significantly over-estimates the amount of corporate resource dedicated to Openreach. Over-estimation is evident by comparison to data from electricity distribution networks presented in the KPMG reports, showing a relatively small corporate overhead mark-up of about 1-2% for these companies. Vodafone believes that this discrepancy between Openreach and other utility distribution networks is more likely to be an allocation problem, rather than inefficiency – and so should be treated as such. Vodafone proposes an allocation of corporate overhead equivalent to 1.5% of Openreach's operating costs (the mid point of the utility benchmarks);
- Vodafone is perplexed by the impact of inflation on depreciation and holding gains. Whilst the overall per-line unit cost of Core Rental services is projected to rise by an average of 4-5% p.a., depreciation and holding gains rise at a massive annual rate of 18-20% p.a. per line. Under FCM asset specific inflation will increase asset values and depreciation, but over a period of years will be offset by holding gain deductions due to asset specific inflation (such as capitalised labour with wages assumed to run at 1% above inflation). Thus, over the 6-year period to 2012/13, the offsetting impact of holding gains should be evident. Ofcom should have a clear explanation of the increases in depreciation and holding gain costs since the projected trend would appear to lead to an over-recovery of incurred capital costs;
- Vodafone would also like to confirm that the correct consistency has been given to the use of either:
 - a nominal WACC applied to an asset base that has not been re-valued to reflect general inflation; or
 - a real WACC applied to an asset base that has been re-valued to reflect general inflation

Either of the above two approaches could in principle be used. However the Consultation Document gives the impression that a nominal WACC has been applied to an asset base re-valued for general inflation. If this were the case, the general inflation effect would be double counted.

Vodafone supports Ofcom in the following:

- Ofcom is correct to be cautious over the extent of migration from WLR to MPF lines. Relative rental prices between WLR and MPF will be a key determining factor, and higher MPF prices will slow this migration by making it less economic for CPs to migrate customers to MPF. There is a danger of assuming a rate of migration that results in higher MPF prices that make it likely that migration will not happen – an inconsistent scenario;
- Vodafone fully supports Ofcom's assumptions on fault rates (further reductions of 4-6% pa.). BT's view that fault rate improvements will suddenly cease, and remain at 2007/8 levels is implausible;
- Vodafone agrees with all the adjustments made by Ofcom in Annex 10.

Finally, Vodafone disagrees with Ofcom's proposal to accelerate the rebalancing of the MPF line rental. The high end of the MPF rental range for 1 April 2009 has been set so as to accelerate rebalancing in order to avoid inefficient decisions by CPs. Vodafone submits, however, that this will not be the case since Ofcom is making quite clear the anticipated end-point of the MPF line rental, and CPs will in any event factor this into their plans. Set against this a step increase in the MPF line rental for 2009/10 (above that given by a smooth glidepath) could be unduly disruptive to the cash flow of CPs, and may result in delay to efficient investment. Vodafone proposes, therefore, that Ofcom sets an MPF line rental for 2009/10 consistent with achieving CCA FAC in 2012/13 via a smooth glidepath.

Further explanation of each of these points is provided in the following section through detailed answers to Ofcom's questions.

2. Responses to Ofcom's detailed questions

Question 2.1: Do you agree with the stated scope of the review in the context of the proposed market reviews for Fixed Narrowband Market Review and Wholesale Line Access?

Yes. Previous consultations have identified the need for this review of BT Openreach pricing to cover the whole of the BT Openreach cost base, even though prices are only being set for Core Rental Services. This is because allocation of common costs within BT Openreach is a very important issue affecting Core Rental Services, as identified by many respondents, including BT.

In general Vodafone supports the use of a 4 year forward looking model to assist in price setting, the primary reasons being the business certainty that follows once prices are set (or at least indicated), and minimisation of short term price fluctuations that may result from year-by-year price setting without any regard to the longer term. The clear weakness of such an approach is its reliance on forecasts, and so Ofcom is correct to devote considerable care to these assumptions, to minimise the risk of over (or under) pricing.

Question 2.2: Do you agree with the proposed objectives of the review?

Yes. The review should be seeking to determine regulated prices that:

- Facilitate efficient and sustainable competition;
- Allow BT Openreach opportunity to recover efficiently incurred costs, and maintain incentives for efficient investment, innovation and service quality improvement (where efficient);
- Provide an environment of regulatory certainty for all companies, so as to minimise this particular element of business risk.

Question 3.1: What do you consider to be the key developments in access service competition?

Question 3.2: How should we take account of these developments and possible future developments when developing our final proposals?

From a regulatory prospective, development of competition based on unbundled local loops has been a key development. However, regulatory frameworks need to remain flexible since market and technological developments can change the nature of competition. In particular, the development of Next Generation Access Networks (NGAN) could radically alter the economics of different competitive models and reverse historical trends.

Question 4.1: To what extent should our assessment of Openreach's financial performance to date inform our final decisions for a new financial framework?

Although Vodafone fully endorses the use of a forward looking financial model, BT Openreach's performance to date (measured on an appropriate CCA basis) must also be relevant for at least two reasons.

Firstly, whilst BT Openreach's rate of return remains above its corresponding WACC at either the level of BT Openreach as a whole, or for the Core Rental Services in particular, the case for real increases in BT Openreach's regulated prices must be treated more critically. In particular, Ofcom should be very sure of the basis on which assumptions are made that lead to a projected fall in the rate of return to below the WACC. Otherwise there is a significant danger that BT Openreach will be permitted to make super-normal profits for an extended period of time – something that would not be possible in a competitive market.

Secondly, the breakdown of BT Openreach's financial performance to date by regulated and unregulated services provides evidence of the appropriateness of cost allocation procedures. If BT Openreach is earning returns on unregulated services which are consistently in excess of its WACC (again something that should not happen in a competitive market) this must be treated as evidence that the allocation of costs is misplaced, with the implication that the return on Core Rental Services both currently, and projected into the future, may be under-stated.

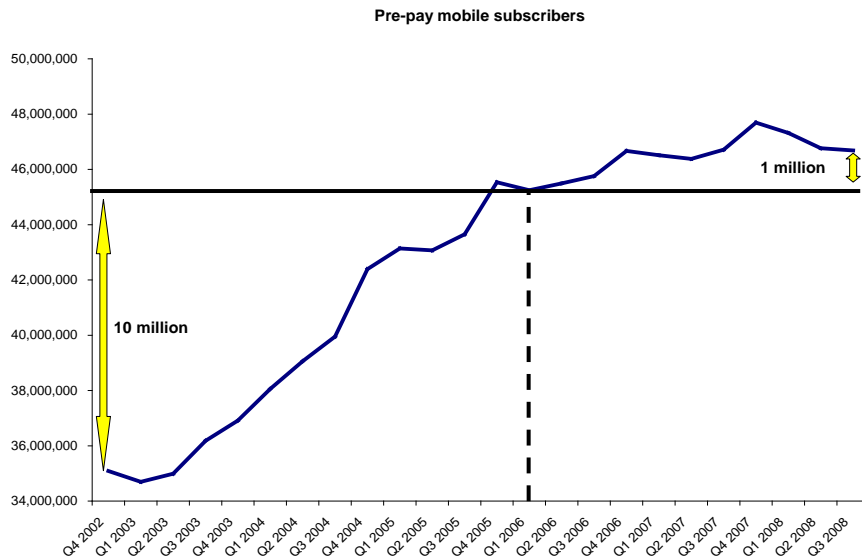
Given the essentially arbitrary nature of many of the cost allocation methods employed by BT Openreach, persistent super-normal returns earned in non-regulated services (assumed competitive) should be an actively monitored "cross-check". If persistent super-normal returns do exist, adjustment to arbitrary cost allocation rules is justified.

Question 5.1: With reference to Annex 11, what are your expectations for future levels of demand for fixed lines and the mix of this demand between MPF and WLR?

The downward trend in the total number of BT fixed lines will level out. The principal reasons for the decline to date have been:

- The emergence of mobile-only households, which, according to data in Chart 11.1 of the Consultation Document, have increased from 7% of the population in 2002 to 10% by 2006, or a loss of approximately 0.8 million fixed lines. This corresponded to the period of growth of low cost pre-pay tariffs allowing a proportion of households to switch to mobile only – see Chart A below. Since 2006, however, this trend has abruptly ceased (again see Chart A below), and Chart 11.1 of Ofcom's Consultation Document confirms that the number of mobile only households has stabilised at around 10%;

Chart A



Source: *Wireless Intelligence*

For the purposes of future projections, therefore, we would expect no further loss of BT lines to mobile only households, with 90% of households retaining fixed lines for broadband data services at least. In the longer term we expect BT's fixed lines to resume an upward trajectory due to long term demographic trends of household growth at the rate of 0.7% pa.¹ (caused by a combination of rising population and shrinking average household size);

- Increased competition from cable. However, with the recent ability of BT to compete against cable TV services, it seems unwise to project further market share loss of lines to cable, especially with the development of the NGN and the availability of more wholesale content²;
- Reduced demand for second lines as a result of broadband take-up. Although this may have been a factor in the past, this segment of the market must by now be saturated and new take-up of broadband is likely to be almost entirely amongst single line households.

For the reasons given above, none of the factors listed in the Consultation Document will contribute significantly to further falls in the total number of BT lines. We suggest, therefore, that the overall number of BT analogue lines is held constant at its 2008/9 level.

Apart from the overall forecast of analogue BT lines, the other critical factor is the mix between MPF and WLR lines. Ofcom is correct to be cautious over the extent of migration. Relative rental prices will be a key determining factor, and higher MPF prices will slow this migration by making it less economic for CPs to migrate customers to MPF. There is a danger of assuming a rate of migration that results in MPF prices that ensure that the migration will not happen. We are not aware that BT Openreach has taken account of this factor in determining its own migration assumptions. Ofcom has, however, considered this effect, and for this and other reasons proposed an alternative migration assumption 25% below that suggested by BT Openreach. Ofcom should, therefore, ignore BT Openreach's projection, and instead adopt its own alternative assumption as the only one appropriate to use.

¹ Source: Office of National Statistics.

² We note that Ofcom is proposing to place a wholesale must-offer obligation on Sky to cover all core premium sports and core premium movie channels supplied by Sky, coupled with appropriate pricing regulation. See "Pay TV second consultation Access to premium content", Ofcom, 30 September 2008.

Question 5.2: With reference to Annex 12, do you agree with our approach to estimating Openreach's cost of capital?

Vodafone agrees with the approach taken by Ofcom in Annex 12. Although individual components of the WACC calculation could be disputed, Vodafone believes that the end result is reasonable for BT Openreach.

Question 5.3: With reference to Annex 14, do you agree with our approach to estimating Openreach's ability to deliver further efficiency gains in the future?

Vodafone fully supports Ofcom's assumptions on fault rates (further reductions of 4-6% pa.). BT's view that fault rate improvements will suddenly cease, and remain at 2007/8 levels, is implausible.

However, Vodafone believes Ofcom has seriously under-estimated the potential for other efficiency improvements by BT Openreach for two reasons:

- Firstly, Vodafone does not believe in "non-compressible" costs. All costs are compressible (meaning subject to reduction under improved efficiency) over a time frame. Examples given in the Consultation Document include accommodation and Cumulo Rates. Both these cost categories are compressible. Accommodation contracts will continually expire on a rolling basis. Evidence for potential saving in accommodation costs is indicated in the KPMG report of November 2008 "Review of Openreach Allocation Methodologies". In this report there is discussion of "empty space" (see Section 3.3.1). Although empty space can't be released immediately, it should be possible to realise savings over a rolling period of time through a process of exchange reconfiguration making possible relinquishment of accommodation space.

Similarly, Cumulo Rates are linked to accommodation and other rateable assets (duct, poles, cabinets, exchanges, etc.) and so should compress over a period of time with network architecture re-design. This should be factored into BT Openreach's efficiency targets.

Ofcom should, therefore, include potential efficiency gains in accommodation and related costs, assuming pro-rata realisation of the potential gains over an appropriate period of average contract duration;

- Secondly, the KPMG report of November 2008 "BT Openreach Efficiency Review" excluded any study of labour productivity. Ofcom bases its efficiency assumption on this report, and finds potential efficiency gains of 3.2-3.5% p.a. across all operating costs. However, this report excluded any study of labour productivity (see, for example, 3rd bullet point on page 3). Labour productivity should be the principal area of concern for a labour intensive organisation such as BT Openreach. Although not studying labour productivity, KPMG did compute a scenario in which field staff were reduced by 10%;

In the absence of better information Ofcom should overlay a labour productivity assumption equivalent to existing labour productivity (output per worker) trends for the whole UK economy averaged over the economic cycle. The ONS index of output per worker for the UK economy has increased at annual rates of 1.4%, 1.6% and 1.8% over the respective 5, 10 and 20 year periods to 2008 Q3.³ Therefore, with a reasonable degree of confidence, Ofcom should assume that BT Openreach can equal labour productivity of the UK economy, and achieve a labour force reduction of 1.8% p.a. (since its output is expected to be virtually flat). This corresponds to a cumulative reduction of 9.3% over the 5 year period from 2008 to 2013 studied by KPMG, and so also corresponds closely to KPMG's 10% cumulative reduction scenario, giving an overall

³ prdy: A4YM: Output per Worker: Whole Economy SA: Index 2003=100: UK.

revised efficiency gain of 3.7-4.0% on total costs (equivalent to 5.3-5.7% on "controllable" costs), plus further adjustments for accommodation costs discussed above.

Question 5.4: Do you have any comments on the absolute levels of costs or cost trends projected in Section 5 and Annexes 9 and 10?

Question 5.5: Please provide any comments and evidence you may have to inform our assessment of the cost projections and key assumptions set out in Section 5 and in Annex 10.

Vodafone agrees with all the adjustments made by Ofcom in Annex 10, particularly:

- Allocation of a fair share of costs to all unregulated services: it is certainly the case that all services provided by BT Openreach should share in cost allocation. Ofcom has identified certain unregulated services that appear not to have been allocated costs, and is proposing to re-allocate costs to these services based on an EBIT margin on revenue of 20%. Vodafone agrees with this approach, but also believes that Ofcom should monitor the overall return on all unregulated services, for evidence that, based on EBIT margin or ROCE, costs may have been under-allocated to other non-regulated services;
- Exclusion of pension scheme shortfalls, since these relates to the provision of services in previous years: a general principle of forward looking price controls is that costs are forecast to set a price cap and the company retains any surplus or suffers any loss – thus providing the incentive to pursue efficiency. Including pension scheme shortfalls, essentially allowing recovery of costs incurred in previous years, would contradict this principle. It should be noted that the risk to BT is symmetric: in the event that there was a pension scheme surplus, BT would be allowed to benefit;
- SLG payments based on bottom-up modelling of efficient costs: although Vodafone sees little reason not to adopt an annual fault rate of 6% (rather than 10%) if this is in indeed best practise in European networks (as suggested by CPW).

In two areas, Vodafone believes that Ofcom's adjustments do not go far enough:

- All costs of the Light User Scheme (LUS), both revenue reductions and administration costs, should be excluded from BT Openreach's cost base. This is because responsibility for the LUS should rest with BT Retail (since the LUS provides for lower retail prices). If the net costs of universal service provision were significant we would expect BT Retail to receive contributions from a universal service fund, but these contributions would be paid to BT retail (the entity providing the subsidised prices), not BT Openreach. It follows that inclusion of LUS costs in the BT Openreach cost base would result in BT being "doubly compensated" for a proportion of LUS costs - once through the universal service fund, and once through Core Rental Service revenues. Since, in Vodafone's view, there is no doubt that all LUS costs should be excluded, the exclusion should apply in all scenarios (not just the low scenario as applied by Ofcom);
- All dropwire costs should be excluded from the Core Rental Services cost base where the cost can be assumed to have already been recovered through a line connection charge or other retail tariff (whether a regulated charge control or not). Vodafone believes that this goes beyond the adjustment already made by Ofcom, which excludes only a proportion of these costs insofar as they relate to price cap regulated tariffs over the period 2000/1 to 2004/5. However, the risk of BT being doubly reimbursed for these costs is the same whether tariffs were regulated or unregulated. It is reasonable to assume that historically both regulated and unregulated connection charges included an allowance for dropwire costs.

Finally, there are two areas where Vodafone believes other adjustments should be made, or at least investigated:

- Vodafone remains concerned of an over-allocation of corporate overheads to BT Openreach. The KPMG report of November 2008 "Review of Openreach Allocation Methodologies" at Section 3.3.4 describes how non-property corporate overheads have been allocated in accordance to FTEs. Further, the KPMG report of November 2008 "BT Openreach Efficiency Review" at Section 4.5.2 reports the benchmarking results that follow from this cost allocation method. BT Openreach's allocated corporate overhead (as a proportion of total operating costs) is 4.90%. This is almost 2.5-4.5 times the level of National Grid (1.10-1.19%) and the average of the electricity distribution companies (1.99%).

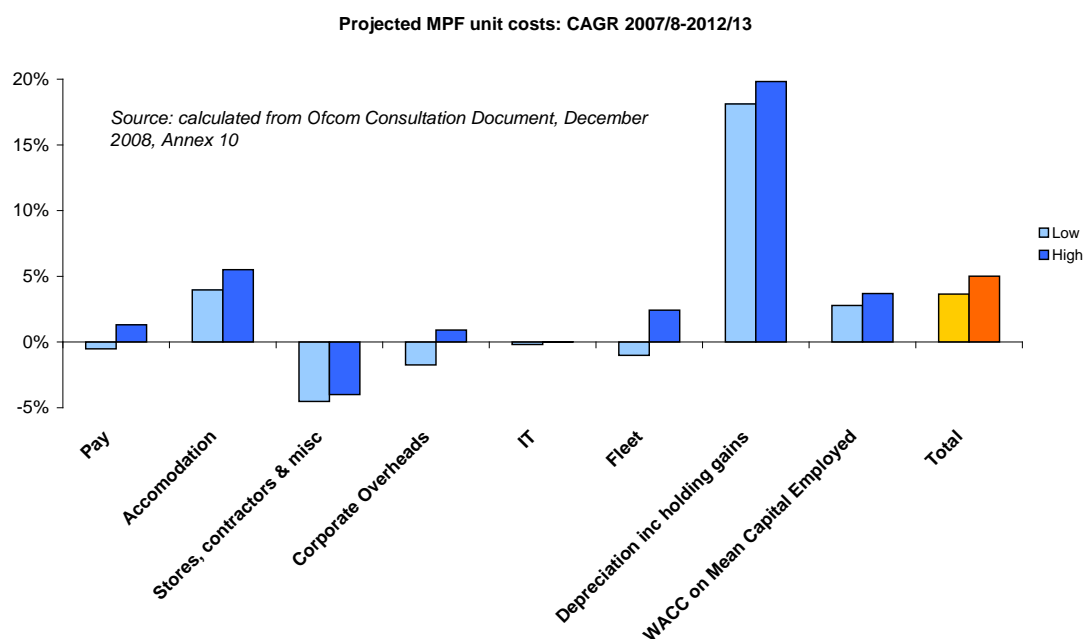
BT Openreach is a simpler operation compared to the other BT units (and especially compared to BT Global Services). Allocating costs equally on the basis of FTEs will significantly over-estimate the amount of corporate resource dedicated to BT Openreach. This over-estimation is evident from the comparison with other similar network utilities that show only a relatively small corporate overhead mark-up is required (about 1-2%).⁴

Vodafone believes that this discrepancy is far more likely to be an allocation problem, rather than inefficiency – and so should be treated as such. Vodafone proposes an allocation of corporate overhead equivalent to 1.5% of BT Openreach's operating costs (the mid point of the utility benchmarks). This most likely provides a much better indication of the corporate effort expended on BT Openreach than the FTE allocation;

- Vodafone is perplexed by the impact of inflation on depreciation and holding gains, discussed by Ofcom in paragraph A9.29 of the Consultation Document. Ofcom believes this is a significant driver of the exceptionally large increases in depreciation and holding gain costs within BT Openreach's Core Rental Services. We illustrate this in Chart B below, calculated from data published in Annex 10 of the Consultation Document. Chart B shows the components of the per line unit costs of MPF. Whilst the total cost is projected to rise by an average of 4-5% pa, depreciation and holding gains rise at an annual rate of 18-20% pa. This is by far the fastest rising cost category and completely out of line with all other categories including pay and accommodation (which also presumably have a high fixed cost component).

⁴ Telecoms and electricity distribution networks are both passive networks requiring fault repair and capacity management activities.

Chart B



Source: Vodafone calculations based on data from A10.116 of Consultation Document

Under FCM (Financial Capital Maintenance)⁵ asset specific inflation will increase asset values and depreciation but, over a period of years, will be offset by holding gain deductions due to asset specific inflation (such as capitalised labour with wages assumed to run at 1% above inflation). Thus, over the 6-year period to 2012/13, the offsetting impact of holding gains should be evident. Ofcom should have a clear explanation of the increases in depreciation and holding gain costs since the projected trend would appear to lead to an over-recovery of incurred capital costs (similar to that which would occur under Operating Capital Maintenance (OCM) with increasing real asset values).

Vodafone would also like to confirm that the correct consistency has been given to the use of either:

- a nominal WACC applied to an asset base that has not been re-valued to reflect general inflation; or
- a real WACC applied to an asset base that has been re-valued to reflect general inflation

Either of the above two approaches could in principle be used. However the Consultation Document gives the impression that a nominal WACC has been applied to an asset base re-valued for general inflation. If this were the case, the general inflation effect would be double counted.

Question 6.1: Do you agree with our assessment that on balance it is appropriate to rebalance MPF charges towards CCA FAC?

Question 6.2: Do you agree with our assessment that a glide path offers the best approach to the introduction of any new charges, subject to an assessment of starting points and the returns in a given year?

Yes, rebalancing over the four year pricing period is the best policy – subject, of course, to correctly calculated CCA FAC (along this lines discussed in this response). This represents best practise in price

⁵ This is the form of CCA employed in BT's accounts.

cap regulation, balancing efficient pricing against disruption costs, and also mimics behaviour of a competitive market, where prices above or below cost will adjust over a period of time as competitive conditions respond.

Question 8.1: Please set out your views on the proposals set out in Section 8, together with the potential implications of those proposals for CPs and for consumers, and the factors you consider we should take into account when determining the final pricing regime.

Subject to the correct regulated price glidepaths being set with reference to the correct CCA FAC estimates (discussed in previous questions), Vodafone has only one further disagreement on the Ofcom proposals. The high end of the MPF rental range for 1 April 2009 has been set so as to accelerate rebalancing. Ofcom's reasoning is given in paragraph 8.20: to avoid inefficient decisions by CPs. Vodafone submits, however, that this will not be the case since Ofcom is making quite clear the anticipated end-point of the MPF line rental, and CPs will in any event factor this into their plans. Set against this a step increase in 2009/10 (above that given by a smooth glidepath) could be unduly disruptive to the cash flow of CPs, and will consequently risk delay to efficient investment.

Vodafone proposes, therefore, that Ofcom sets an MPF line rental for 2009/10 consistent with achieving CCA FAC in 2012/13 via a smooth glidepath.

Question 8.3: Please provide any other comments you may have in response to the proposals set out in this document.

Vodafone's comments are covered in the above.