# Vodafone's response to Ofcom's May 2008 consultation on a new pricing framework for Openreach

## Introduction

This document contains Vodafone's views relevant to the Ofcom consultation document "A New Pricing Framework for Openreach", 30 May 2008.

Vodafone will not reply to each of the questions raised by Ofcom, but rather will focus its comments on what it considers to be the most pertinent questions at this stage of the consultation process. Vodafone agrees with Ofcom's goals, and believes that the existing framework has generally worked to support these goals (Ofcom's Questions 2.1 and 2.2). In order to continue the development of a competitive broadband market, changes to this framework must be made extremely carefully, and only on the basis of robust analysis of market and costs data (Ofcom's questions 3.1 and 3.2). Consequently, Vodafone will focus on Question 4.1.

***Question 4.1: Do you accept that the evidence presented by BT on movement in costs provide a compelling case for a review of the price controls?***

Ofcom's preliminary analysis[1] indicates that, in the most recent period for which financial information is available, BT Openreach made an underlying return on capital employed of 13% (on a CCA basis), with a slightly lower return of 12% on its regulated core rental services. Both these rates of return are significantly above BT Openreach's cost of capital of 10%.

The argument for reviewing Openreach's regulated prices relies on three premises:

1. That the existing calculated returns made on regulated services are a correct assessment; <u>and</u>

2. That there is a robust case for projecting an increase in Openreach's costs; <u>or</u>

3. There is an imbalance in returns between WLR and MPF services.

Vodafone's view is that none of these justifies a case for changing Openreach's prices at this time.

*1. Are the existing calculated returns made on regulated services a correct assessment?*

[1] See paragraphs 4.17-4.19.

Vodafone fully supports Ofcom's continued scrutiny of the Openreach cost data, described in Annex 7 of the consultation document. Issues such as capitalisation treatment of the drop wire (paragraph A7.44) are important.

However, Vodafone also remains concerned about the allocation of costs between regulated and non-regulated services. Figure A7.9, shows ROCEs for Openreach's non-regulated services ranging from 41-49%. Ofcom explains these high returns as "…to some part due to the low levels of capital employed". Vodafone agrees that this is likely. However, returns of this level (from a relatively light investment) seem unlikely – especially if these services are provided in a competitive market. Vodafone believes Ofcom should continue to study Openreach's cost allocations extremely carefully to ascertain if there is an under allocation to non-regulated services, and whether such high returns to non-regulated services are plausible (which Vodafone doubts).

International comparisons provide additional evidence to suggest that Openreach's costs should be carefully studied. Although international comparisons need to be very carefully interpreted and should never be used as the primary sources of information in a regulated price, they are nevertheless indicative of the need to explore BT's reported costs (and particularly cost allocations). (See Ofcom's Question 6.1.)

*2. Is it reasonable to project Increases in Openreach's costs?*

In respect of the projected increase in Openreach's costs, this projection is dependent on:

- Future volumes: BT forecasts an overall decline in the volume of retail lines between April 2007 and March 2012 (paragraph A9.5), and this in turn appears to feed through to the demand for WLR and MPF lines. Vodafone believes an overall decline is unlikely in the context of a UK population projected by government to grow at an average of 0.7% pa over the period.[2] An efficient operator should, at least, be maintaining market share;

- Cost volume relationships: cost volume relationships are equally important as the volume forecasts themselves, since it is highly unlikely that the Openreach cost base is entirely fixed. In the long term we would expect all Openreach's costs to display constant returns to scale – a feature that explains why small incumbent fixed network operators (including KC) have similar unit costs to large operators. Therefore, even within declines in volumes, unit costs should not decline. Ofcom should carefully study the cost volumes relationships embedded in BT's cost projections. Converting the Openreach cost estimates supplied on pages 67 and 68 of the consultation into costs of each element per unit per year, and then calculating the underlying year on

[2] See http://www.statistics.gov.uk/pdfdir/pproj1007.pdf and http://www.statistics.gov.uk/cci/nugget.asp?id=1352

year unit price changes for each element shows that some unit costs would appear to be rising faster than RPI, both for services where the unit volume increases and for services where the unit volume decreases. Also total operating costs per unit for SMPF and MPF appear to decline over the period 2006/07 to 2008/09 before rising relatively steeply thereafter.

- Future unit cost increases, such as of labour costs;

- Offsetting productivity changes: Ofcom is correct to identify two separate sources of productivity gain: "catch-up" for existing inefficiency, plus overall trends in productivity. In Annex 8, Ofcom present results from a number of different approaches to estimation of potential efficiency gains, and it is important to realise that not all of these approaches capture both elements. In particular, the econometric SFA naturally captures only the former, whereas historic cost trends will also capture the latter. Therefore, Vodafone would support efficiency gains towards the upper end of the range proposed by Ofcom, to ensure inclusion of both "catch-up" and overall trends in long term productivity. (See Ofcom's Question 6.2.)

*3. Imbalance in returns between regulated prices between WLR and MPF services?*

Finally, to the extent that there is a currently perceived imbalance in existing regulated prices between WLR and MPF services, Vodafone's view is that cost allocations within Openreach are not yet sufficiently robust to enable any definite conclusions to be drawn.

Vodafone accepts that the balance of prices between different services is important for allocative efficiency and so, in the medium term, it is important the correct balance is achieved. Changes in regulated prices risk sending misleading investment signals to competitors, which may be reversed in future when better cost allocation information is available.

Returning to the data of Figure A7.9, Vodafone has already expressed concerns about the asset allocations between regulated and non-regulated services. This naturally leads to a questioning of allocations between different services within Openreach's regulated activities. Ofcom alone is in a position to rigorously audit Openreach's allocation procedures (since it alone has access to all the information). (See Ofcom's Question 6.9.)

**Conclusion**

Since Openreach is currently earning a return on core regulated rental services in excess of its cost of capital, and there must be questions about the accuracy of the existing projections and cost allocations, Vodafone believes the case for making adjustments to the balance of prices at this time is very weak.