Vodafone non-confidential response to Ofcom consultation on amendment to MNO charge control

Summary

Vodafone welcomes the opportunity to respond to Ofcom's consultation on an amendment to the MNO charge control[1] ('the Consultation'). The Consultation's central proposal is Ofcom's proposed Option 4, which seeks to adjust the charge controls recently mandated in Ofcom's separate statement on mobile call termination[2] ('the Statement') to cater for ported-in traffic which is explicitly excluded from the present charge control. Since this adjustment is proposed to be applied (to direct traffic) on top of the charge control, Vodafone refers to it below as a 'porting overlay'.

Whilst welcoming the opportunity to comment, Vodafone does have serious and fundamental objections to the intervention Ofcom is proposing. Vodafone doubts the legal basis for intervention. On a proper analysis, MNOs have no meaningful power over the pricing of ported-in minutes, so there is simply no basis for a remedy supposedly underpinned by SMP. Ofcom's assertion in the Statement that the market in which MNOs have SMP includes ported minutes does not bear close scrutiny. In the Statement, Ofcom argued that lack of control over the price of ported-in minutes did not negate SMP in relation to directly terminated traffic. It does not follow that SMP in relation to direct traffic extends to ported-in traffic since by Ofcom's own admission the competitive conditions are different. Whereas the Statement specifically confined charge controls to directly terminated minutes, the overlay adjustment seeks to extend their reach to include charges that are already constrained and not under the control of the MNOs concerned. This cannot be an appropriate application of SMP remedies.

In any event, commercial advantage to one MNO cannot be the correct criterion by which to judge the appropriateness of intervention. Ofcom must have regard to the interests of consumers, efficiency and sustainable competition[3] to which Vodafone submits the overlay adjustment is detrimental. Ofcom's proposal introduces more serious distortions than it purports to correct, and has additional adverse side-effects and policy consequences that Ofcom does not appear to have recognised let alone considered. For all these reasons, we believe Ofcom should think again.

Ofcom's stated rationale for the further intervention it proposes appears to be twofold[4]:

- Firstly, to address a perceived risk that H3G might fail to recover its efficiently incurred costs in the case where the rate it receives for terminating a call is below the actual cost of terminating that call, and;

- Secondly, to counter a perceived incentive under the existing porting arrangements for MNOs other than H3G to focus their acquisition strategies on H3G customers in order to

[1] Amendment to charge control on Mobile Network Operators 27th March 2007
[2] Mobile call termination statement 27th March 2007
[3] See Article 88(1)(b) of the Communications Act 2003.
[4] See paragraph 1.6 of the consultation, and paragraph 9.321 of the Statement, which states: *"existing arrangements could result in H3G failing to recover the efficient costs of provision in the case where the rate it receives for terminating a call is below the actual cost of terminating that call. H3G also argued that the existing porting arrangement gives an incentive to other MNOs to focus their customer acquisition strategies on H3G customers in order to benefit from the higher termination rate they would receive when a H3G customer ports a number to their network."*

benefit from the higher termination rate they would receive when a H3G customer ports a number to their network.

Throughout the consultation document, these perceived features of current porting arrangements are variously described as 'disadvantages' or 'distortions' which Ofcom's proposed further intervention aims to correct. Vodafone submits, however, that:

- Neither of the two declared rationales for further intervention bears close scrutiny;

- Ofcom's proposed intervention is flawed even in its own terms. Far from 'correcting' distortions, it threatens to introduce new distortions that Ofcom does not appear to have considered, and which run directly counter to the policy intentions clearly articulated in the Statement.

- Having regard to Ofcom's statutory duties, the substantive test for imposing a price control on calls to ported numbers is whether (i) there is a relevant risk of adverse effects arising from price distortion; and (ii) the proposed condition is appropriate for promoting efficiency, promoting sustainable competition and conferring the greatest possible benefits on the end users of public electronic communications services. "A relevant risk of adverse effects" is specifically and exhaustively defined as a risk of excessive pricing or a price squeeze.[5] For reasons set out more fully below, Ofcom's present proposals are simply incapable of meeting the correct substantive test.

With respect to the first "distortion", the risk that H3G fails to recover its efficiently incurred costs is negligible for most of the period covered by the charge control. H3G's glidepath allows sufficient margin above cost that even allowing for the dilution in revenue through the impact of porting, the effective rate remains appreciably above cost. Further to that, H3G's recovery over cost even on an effective rate basis is greater than for the other operators. Only in the final year does the headline TAC reach Ofcom's view of cost, by which time the rate asymmetry is substantially reduced and the resulting porting dilution is marginal compared with early years. To the extent that any problem remains, it could be addressed more proportionately (and without some of the unfortunate side-effects discussed below) by shading up the H3G headline TAC in the final year so that the effective rate covers cost.

In terms of the second "distortion", the suggestion that other MNOs disproportionately target H3G customers has no empirical basis. This theoretical possibility would require sophisticated acquisition strategies and commission structures, for which no empirical evidence has been requested or put forward. If the targeting theory were valid, then one would expect that ported-in customers would be disproportionately from H3G (relative to base): however Vodafone's real data shows that the reverse is true. There is no suggestion made by Ofcom that H3G is refusing to let new customers port in. It is difficult therefore to see that Ofcom has as yet made the case that the retail "distortion" propounded by H3G exists in reality.

Ofcom itself notes that current porting arrangements are not new[6], and that it has on several previous occasions considered and rejected specific intervention to 'correct' the 'problem' it

[5] See Section 88 of the Communications Act 2003.
[6] Paragraphs 9.229 et seqq. of the Statement

currently perceives as requiring urgent attention. Ofcom attempts to suggest that this apparent change of heart is explained by a progressive worsening of the problem over time. This assertion is not well supported by the evidence, however. Fundamentally, the 'problem' Ofcom perceives stems from asymmetry in termination rates between mobile operators. While some asymmetry remains under the charge control period covered by the Statement, it is an explicit purpose of the charge control to reduce asymmetry between MNOs with the advent of the current control and to progressively reduce it further over the period of the current control[7].

Ofcom also posits a steady and inexorable increase in the volume of ported traffic, implying that some (unexplained) materiality threshold has now been tripped. While the provenance of Ofcom's volume estimates and the nature of the implicit threshold test remain somewhat obscure, the evidence available to Vodafone suggests that Ofcom's current volume estimates may well be significantly overstated [✂].

Against this background, Vodafone believes the proposed intervention is seriously flawed in concept. Among other things, it stands to exacerbate the very asymmetries the Statement sought quite deliberately to reduce and cause effective rates to diverge from the appropriate TACs determined after due evidence gathering, cost-modelling and policy analysis, thereby sending the wrong price signals to all interconnecting operators.

Further Vodafone believes that Ofcom has not conducted a proper impact analysis to understand the effect of the charge control overlay on all mobile operators and on fixed consumers over the next four years. Whilst Vodafone believes the rationale for further intervention is highly questionable, Vodafone also doubts whether the practical effects of Ofcom's proposed intervention are actually as Ofcom describes them. There are several respects in which Vodafone believes the impact of Ofcom's proposed intervention is likely to differ significantly from that which Ofcom appears to anticipate, together with further (presumably unintended) consequences that Ofcom does not appear to have considered. In particular:

- Ofcom's focus on termination <u>revenues</u> ignores the knock-on impact on interconnection costs payable by MNOs and all other interconnecting operators. As a result of this partial analysis, Ofcom does not appear to have recognised that the overall impact of these two effects combined considerably magnifies the overall scale of intervention (and resultant distortions of competition in other wholesale and retail markets). Among MNOs, H3G alone receives a double dividend, while 900MHz operators such as Vodafone suffer a double whammy.

- The resulting redistribution between MNOs is not, as Ofcom appears to suggest, a zero sum game[8]. Ofcom describes the effect of its intervention as broadly neutral on Orange and T-Mobile with H3G's gains wholly accounted for by Vodafone and O2's losses. Vodafone's analysis, however, suggests that Ofcom's intervention is negative for all MNOs other than H3G, while also being unequivocally negative for all fixed operators and consumers.

[7] See paragraphs 9.128 and 9.132 of the Statement
[8] Paragraph 4.47 of the consultation

- Ofcom's intervention also runs directly counter to incentives for efficient porting. [✂]. It is also incompatible with a move to the direct routing solution of ported traffic, despite Ofcom having positively advocated a direct routing solution for all varieties of number portability, with mobile in the vanguard. A technical solution that enabled direct routing for ported traffic would obviate the need for the further intervention Ofcom now appears to propose as an alternative. While Vodafone has previously expressed doubts about the cost-justification for a mandated direct routing solution in the near term, it is curious and cannot be good administrative practice that Ofcom should have two approaches to ported mobile traffic under active consideration simultaneously, and without openly acknowledging the clear incompatibility between the two.

This document is structured into three parts: arguments concerning the legal basis for intervention, arguments that there is no case for intervention, and arguments that the proposed methods of intervention are flawed.

<u>Section 1 – legal analysis of ported-in traffic</u>

The conditions of competition are different for ported and directly routed calls. Therefore, they cannot form part of the same relevant market.

Ofcom asserts that its market definition in the Statement *"includes calls terminated on ported-in numbers"*[9] It also states: *"Ofcom's market definition relates to the supplier of termination rather than the MNO who sets the level of charges (which in the case of calls to subscribers with ported numbers could vary with the MNP arrangements)."*[10] This is patently misconceived.

The Commission's Notice on Market Definition[11] ("the Notice") makes it clear that a market definition exercise is not carried out to identify mechanistically the undertaking that delivers a particular service, but to identify the competitive constraints on firms' behaviour. This is clearly demonstrated by the approach the Notice takes to questions of market definition and the calculation of market shares. NCAs and NRAs examine market shares as a proxy for market power; therefore services over which an undertaking has no pricing power (and therefore, no market power) cannot meaningfully form part of its market share.[12] The Notice states:

> *"Market definition is a tool to identify and define the boundaries of competition between firms… The main purpose of market definition is to identify in a systematic way the competitive constraints that the undertakings involved face. The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings*

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[9] Consultation at paragraph 3.1
[10] Statement at paragraph 3.113
[11] Commission Notice on the definition of relevant market for the purposes of Community competition law (97/C372/03) at paragraph 2.
[12] A simple example makes this point. If, in relation to a particular product, a company operates both directly and through a series of agents or controlled subsidiaries where it retains the ability to set the prices for sales by those agents or subsidiaries, those sales will be attributed to the principal or parent company as it controls the terms of supply and not the agent or subsidiary company that actually provides the product or service.

> *involved that are capable of constraining those undertakings' behaviour and of preventing them from behaving independently of effective competitive pressure. It is from this perspective that the market definition makes it possible inter alia to calculate market shares that would convey meaningful information regarding market power for the purposes of assessing dominance…"* (Vodafone emphasis.)

This follows the established approach of the European Court and Commission to attribute sales when calculating market shares (and conduct) to the undertaking that ultimately controls the commercial terms of supply, not the undertaking that merely carries out those orders.[13]

This approach also accords with Ofcom's treatment of national roaming and on-net calls, but flatly contradicts its approach in the present case. Ofcom notes in the Statement that:

> *"Out of coverage, H3G uses termination on the 2G network of another MNO ("national roaming partner"). H3G effectively uses the supply of wholesale termination services by another MNO as an input into its own supply of termination services to originating operators. H3G does not currently charge a different price for termination which is carried purely over its 3G network or which utilises its national roaming partner's network as an intermediate step. Ofcom considers that this is evidence of a common pricing constraint and the relative homogeneity of competitive conditions of competition. Ofcom is therefore of the view that the most appropriate market definition in this case is wholesale voice call termination provided by H3G."*[14]

Two important points are made here. First, calls terminated on the network of H3G's national roaming partner are attributed to H3G because it is H3G who sets the termination rate, even though it does not actually deliver the service in every case. Second, Ofcom notes that H3G does not price discriminate according to whether a call is delivered over its network or that of its national roaming partner. In the very next paragraph, Ofcom recognises that this analysis does not apply to ported numbers:

> *"The market is not so narrow as calls to individual subscribers or numbers of a given MNO because it appears that when a termination charge is paid there is no discrimination for calls to subscribers of a given network (with the exception of ported numbers)."*[15] (Vodafone emphasis.)

Ofcom concludes that this lack of a common pricing constraint in respect of on-net calls means that such calls do not form part of the relevant market with directly routed calls originated by other Communications Providers. It makes the same point in relation to calls to ported numbers but fails to recognise that this means such calls are also provided under different conditions of competition

[13] See *Viho v. Commission* C-73/95P [1996] ECR I 5457 at paragraph 53. See also the Commission's Guidelines on Vertical Restraints at paragraph 99, where it makes clear that where a distributor makes sales through connected undertakings (that is, through undertakings where the distributor exercises control over the terms set by those undertakings) such sales must be attributed to the distributor.
[14] See the Statement at paragraph 3.164
[15] See the Statement at paragraph 3.165.

and thus cannot form part of the same market as directly routed calls.[16] Ofcom's analysis is therefore inconsistent and contradictory.

Finally, it is clear that Ofcom cannot rely upon the Commission's analysis of mobile call termination in its Recommendation on Relevant Markets[17] to defend a market definition including ported numbers. The Commission's approach in the Recommendation is wholly in line with its Notice by attempting to identify the competitive constraints on terminating operators assuming that those operators are free to set the termination rate for all calls to their networks.[18] This is not surprising as many Member States have porting arrangements based on direct routing of ported traffic where the terminating operator's termination rate is applied to all calls it actually terminates, so the issue of different competitive conditions does not arise. However, Ofcom faces a different factual situation from other NRAs and it is precisely because of this national variation that Article 11(3) of the Framework Directive requires Ofcom to define relevant markets appropriate to national circumstances and in accordance with the principles of competition law while taking the utmost account of the recommendation and the guidelines. Ofcom has failed to do this, so its analysis is clearly deficient in this respect. Vodafone submits that on a correct analysis, Ofcom would not find SMP in respect of ported-in calls but in any event Ofcom cannot impose remedies in relation to a market which it has not properly analysed.

Ofcom cannot "future proof" its market definition by imagining changes to the market it hopes will happen

Ofcom is required in its market analysis to take account of the actual operation of the markets in question including the actual technical or technological influences on those markets. Ofcom cannot impose a regulation upon MNO charges as if its preferred technical solution of direct routing already existed. The correct place for it to consider such options is in its separate consultation on MNP processes. Ofcom states that *"In the event that MNP arrangements change to allow MNOs to set the termination charge for all their own subscribers this would not affect Ofcom's market definition"*[19] Such a change to the technical (and presumably commercial) arrangements between operators should have a significant impact upon any proper market definition exercise. Ofcom cannot pre-suppose what those changes would be particularly when such changes remain the subject of an ongoing consultation process.

MNOs cannot have SMP over termination to ported-in numbers if they do not control the price for that termination

Ofcom has identified the correct tests for analysis of SMP. It states, in part:

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[16] See the Statement at paragraphs 3.165 and especially 3.131 where Ofcom states *"As discussed at paragraph 3.133 below, there are important exceptions to this common pricing constraint, namely self-supplied MCT (i.e. on-net termination) and ported numbers."*

[17] Commission Recommendation on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC

[18] See for instance, the Commission's statement at page 32 of the Recommendation that "Since the termination charge is set by the called network which is chosen by the called subscriber, the calling party in general does not have the ability to affect or influence termination charges."

[19] Statement at paragraph 3.133

> *"In the context of this review, Ofcom considers that MNOs will have SMP if they are able to sustain charges to an appreciable extent above the competitive level in the market for MCT."*[20] (Vodafone emphasis.)

Ofcom also examines *inter alia* the absence of countervailing buyer power and excessive pricing as indicators of dominance. However, Ofcom has not examined the actual conditions of competition in respect of ported-in numbers to see if in fact MNOs can sustain charges appreciably above the competitive level for termination to ported-in numbers. This failure is, in itself, sufficient to require Ofcom to undertake a further market analysis in respect of ported-in calls for the Consultation and may also invalidate this part of Ofcom's Statement. If Ofcom were to look properly at this issue, there is clear evidence that MNOs termination charges in respect of ported numbers are actually constrained and MNOs do not have SMP in this regard.

Put simply, terminating MNOs cannot credibly be held to have SMP in respect of call termination for ported-in numbers because, as Ofcom itself acknowledges, the terminating MNO has no control over the price which is set by the Donor Operator[21].

As Ofcom is well aware, SMP is equated under the Regulatory Framework with the competition law concept of dominance which is defined as *"the power to behave to an appreciable extent independently of competitors, customers and ultimately, consumers."* [22] But in respect of ported-in numbers, terminating operators cannot behave independently of their customers or competitors. In practice, their charges for this service are actually set by another MNO (which is the terminating operator's wholesale customer and retail competitor). An operator with no control over the price it charges for a service cannot possibly exercise SMP in relation to that service.

There is good evidence, which Ofcom has not considered, which suggests MNOs do not have SMP over calls to ported numbers

In accordance with the SMP Guidelines Ofcom is obliged to conduct its market review:

> *"based on existing market conditions… by taking into account expected or foreseeable market developments over the course of a reasonable period… NRAs should take past data into account in their analysis when such data are relevant to the developments in that market in the foreseeable future."*[23]

[20] Statement at paragraph 4.14. See also the Commission's SMP Guidelines which state that *"in an ex-ante environment, market power is essentially measured by reference of the power of the undertaking concerned to raise prices by restricting output without incurring a significant loss of sales or revenues."*
[21] This is how Ofcom itself characterises the point in the Consultation *"Technical arrangements, devised by the industry, for delivering calls to mobile telephones with ported-in numbers are such that the termination charge billed is that set by the MNO originally allocated the number rather than that set by the MNO to whom the user currently subscribes."* (Consultation at paragraph 3.3)
[22] *United Brands v. EC Commission* 27/76 [1978] ECR 206.
[23] Paragraph 20 of the SMP Guidelines

Ofcom itself acknowledges that it is the current technical arrangements which mean that the recipient operator has no control over the termination rate, but has made no attempt to analyse how this impacts its SMP analysis or how MNOs have actually acted in the past. Ofcom effectively recognises this point in its market definition discussion in the Statement. It states:

> *"Were MNOs able to freely set the MCT charges for calls to ported-in numbers, in the same way that they can freely set MCT charges for calls to other numbers (absent regulation of MCT charges), then Ofcom considers that the conditions of competition relating to the provision of MCT to both ported-in numbers and to other numbers would be relatively homogeneous*."[24]

The question before Ofcom is not what the conditions of competition would be if MNOs were able to freely set the MCT charges for calls to ported-in numbers. The simple fact is that, as Ofcom itself acknowledges, the current technical and commercial relationships which have arisen in relation to ported numbers means that recipient MNOs are not free to set those MCT charges. Those charges have, in fact, been constrained to the level of the donor termination charge minus the donor conveyance charge for onward routing**.**

Termination charges for calls to ported numbers have been constrained in the past without any direct regulatory obligation

[✂]

MNO's pricing behaviour for ported numbers contradicts that seen in respect of 3G

Moreover, in an analogous situation as regards 3G termination charges Ofcom bases its SMP case, in part, upon the fact that, absent regulation, underlying 3G charges proposed by three of the four 2G/3G MNOs have been "substantially greater" than the 3G charges being levied by H3G. Ofcom goes on: *"Furthermore, the underlying 3G charges proposed by all 2G/3G MNOs are substantially greater than Ofcom's estimates of efficient 3G unit costs for these operators. In some cases, the MNOs charges are more than double the level of Ofcom's view of a reasonable estimate of costs."*[25] In the case of mobile termination rates for directly routed calls, Ofcom concludes that in the absence of regulation, MNOs would set excessive and inefficient prices which would have a detrimental effect on consumers.[26] Ofcom concludes that absent regulation, MCTs would be set at 23.9ppm or, at the very least, 14.5ppm.[27]

Against these assumptions, Ofcom must analyse the actual pricing behaviour of the MNOs in relation to ported-in traffic where it has very different evidence. As noted above, absent any regulatory constraint, MNOs with higher costs have been unable (or have not even attempted) to pass those costs on by charging the same rate for ported-in traffic as directly routed traffic. Equally, operators with lower termination rates such as Vodafone have not attempted to charge rates approaching H3G's unregulated rate, much less the unregulated prices suggested by

[24] Statement at paragraph 3.133
[25] Statement at paragraph 4.45
[26] Statement at A19.1
[27] Statement at A19.36-19.39.

Ofcom's welfare analysis. Ofcom has made no attempt to address this issue. Vodafone submits, that had Ofcom addressed the issue properly in its Statement or, more properly, in the Consultation where its intention to regulate the charges for calls to ported numbers became clear, it would be bound to conclude that the available evidence does not support the inclusion of ported-in traffic within the same market as directly terminated traffic or a finding of SMP in relation to ported-in traffic. Therefore, Ofcom cannot properly rely upon Article 86 of the Communications Act 2003 to simply re-assert its market definition and SMP finding.

Ofcom's SMP analysis is inadequate

It is clear from the Statement that Ofcom only considered (briefly) whether a recipient operator's lack of control over the termination rate set by a donor operator would constrain its ability to exercise SMP in relation to directly routed traffic. Ofcom states:

> *"Each MNO is, in effect, currently a monopolist in the supply of termination for voice calls to its customers. As discussed in section 3, MNOs do not control the charge for all calls they terminate due to the current number portability arrangements. Nevertheless, it is Ofcom's view that porting has no impact on SMP in these markets as these arrangements do not constrain MNOs' ability to set MCT charges in respect of non ported numbers."*[28]

However, this paragraph (and both the Statement and Consultation taken together) gives no proper consideration to whether MNOs have SMP in relation to ported-in numbers themselves. Put simply, Ofcom has addressed the question the wrong way around. The observation that lack of power over price in respect of ported-in traffic does not negate a finding of SMP in relation to direct traffic does nothing to support the reverse proposition i.e. that SMP in relation to direct traffic can be 'stretched' to cover ported-in traffic too. The competitive conditions in relation to ported-in numbers which are clearly different from directly routed numbers have not been considered at all. To impose regulatory obligations in relation to these numbers requires a proper market analysis by Ofcom including a full national and European consultation under Articles 6 and 7 of the Framework Directive.

Ofcom has not met the legal requirements to impose a price control obligation on calls to ported numbers

In addition to Ofcom's general duties set out at Sections 3 and 4 of the Communications Act, Ofcom is required to meet a higher threshold before it imposes a price control measure which, of course, represents the most intrusive form of possible regulation. As noted above, Ofcom must show that:

(i) there is a relevant risk of adverse effects arising from price distortion; and
(ii) the proposed condition is appropriate for promoting efficiency, promoting sustainable competition and conferring the greatest possible benefits on the end users of public electronic communications services.[29]

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[28] Statement at paragraph 4.36
[29] Section 88(1) of the Communications Act 2003.

Section 88(3) provides:

> *"For the purposes of this section there is a relevant risk of adverse affects* [sic] *arising from price distortion if the dominant provider might-*
> *(a) so fix and maintain some or all of his prices at an excessively high level, or*
> *(b) so impose a price squeeze,*
> *as to have adverse consequences for end-users of public electronic communications services."*

Ofcom puts forward no evidence whatsoever in the Statement or the Consultation that MNOs have been pricing calls to ported numbers excessively or that there is any danger of them doing so in the future. It does not set out the legal test for excessive pricing and makes no mention whatsoever of the possibility of a price squeeze in relation to the termination of calls to ported numbers. In fact, there is evidence which Ofcom has not even considered that the price of such calls has been constrained and it makes no more than a passing reference in the Consultation to the possibility of (wholly unsubstantiated) possible adverse effects for end-users.[30] This is clearly insufficient to meet the legal test set out in the Communications Act.

Equally, Ofcom cannot impose an SMP obligation on directly routed calls to fix a "problem" with a market where it has not found SMP or met the requirements for direct regulation

Ofcom cannot claim that the legal test above does not apply to its findings in respect of calls to ported numbers on the basis that it is modifying the charges for directly routed calls rather than imposing a price control upon calls to ported numbers per se. The clear intention and effect of Ofcom's proposals is to regulate the charges for calls to ported numbers (or introduce a measure of equivalent effect). To claim otherwise would leave Ofcom in breach of its obligation to apply appropriate regulatory remedies. Article 8(4) of the Access Directive requires Ofcom to only impose regulatory obligations which are *"based on the nature of the problem identified, proportionate and justified in the light of the objectives laid down in Article 8 of [the Framework Directive."*

While Ofcom has identified an (alleged) market failure in respect of directly routed traffic, it has not identified any such problem with ported-in traffic but must do so if its proposed measures are to stand. Otherwise, to amend the charge control for direct traffic to take account of ported traffic would be perverse. It would mean that the charge control for direct traffic is no longer based on the nature of the problem identified because it now addresses issues that are out of scope of that analysis. On this logic, what is to stop Ofcom from adjusting the MCT charge controls to make up for any other perceived "over recovery" elsewhere in Vodafone's business?

<u>Section 2 – there is no case for intervention</u>

[30] Consultation at paragraph 4.59.

The impact of porting on termination revenues is not a distortion but benign

Vodafone accepts that the impact of ported traffic on effective termination rates is that it tends to increase the effective termination rates[31] of O_2 and Vodafone, to be broadly neutral for T-Mobile and Orange's rates, and to reduce the effective rate for H3G. In effect each operator has two inbound revenue streams, direct traffic[32] which is priced at its own termination rate, and ported-in traffic[33] which is priced at OMOs' termination rates. The effective rate is in practice the blended product of the two. As a result therefore H3G did not in 2006/07 receive for all inbound traffic their headline termination rate of approximately 10.8p, but rather the consequence of receiving ported-in traffic at other operators' termination rates means that H3G's average or effective termination rate across all inbound traffic was reduced to a lower sum. The effect of porting-in can be characterised as diluting the rate asymmetry: Vodafone believes that the impact of this is not a distortion but rather is benign in the context of Ofcom's intentions with the imposition of charge controls, and that intervention to reverse this is not warranted.

Ofcom's methodology in section 9 of the termination Statement is firstly to set a target rate in 2010/11, and then secondly to work out the most appropriate glidepath to reach this rate, using as a starting point the 2G regulated rates in 2006/07 for the 2G/3G operators, and for H3G their current rate of approximately 10.8p. It discusses several alternative glidepaths for the three operator groupings, ranging from an immediate cut to cost in 2007/08 to a straight-line path from Ofcom's starting points. For the 2G/3G operators Ofcom makes two significant conclusions: that all four operators should have the same termination rate, and that there should be straight-line convergence to that point from existing headline 2G levels over the charge control period, with the 900MHz and 1800MHz operators having different, but converging rates over the years from 2007/08 to 2009/10. For H3G Ofcom concludes that since current rates are significantly above costs, an immediate sharp reduction is warranted followed by a subsequent straight line glidepath.

Crucially the levels established by Ofcom's chosen glidepath for 2007/08 to 2009/10 for all operators are therefore <u>not</u> Ofcom's view of underlying cost, merely steps on the trajectory to reach cost – it is only in 2010/11 that the termination rates converge on cost. 'Porting dilution' is not a new feature arising from the new charge control effective from 1st April 2007; instead it has been in a feature since porting began in 1999. The fact that H3G's rate is only regulated from April 2007 is irrelevant: what is relevant is that H3G's effective termination rate has always differed from its headline termination rate, and thus from an effective termination rate point of view its starting point on entering the charge control is not its headline rate of 10.8p but a lower level resulting from porting dilution, to which it has already become adjusted.

It is relevant to consider the effect of porting dilution on rate asymmetry. In 2006/07 the rate asymmetry (on headline 2G rates) was 0.7p between the 900MHz and 1800MHz operators[34] and over 4.5p between the 1800 operators and H3G: by 2010/11 these will be reduced to 0.0p, and 0.8p[35], a substantial reduction. Ofcom discusses in the Statement the merit of reducing the rate asymmetry in several places. Paragraph 9.128 of the main consultation – "*As explained in the preceding paragraph, Ofcom considers that a benefit of removing differentiated charge controls is*

[31] As defined by Ofcom in 1.6 of the consultation document
[32] Calls to those of its customers who are on its own number ranges
[33] Calls to those of its customers who are on other OMOs' number ranges
[34] In terms of blended rates the asymmetry was higher, up to [✂] between T-Mobile and Vodafone
[35] This document follows Ofcom's approach of generally quoting rates in 2006/07 prices

a reduction in future regulatory burdens. In this context, T-Mobile's suggestion (of retaining 900 vs. 1800 asymmetry) *does not fit well with Ofcom's longer-term view that it is desirable for MCT charge controls to become more closely aligned. By aligning 2G/3G MNOs' MCT charges by 2010/2011, Ofcom is acting in accordance with this policy position."* Paragraph 9.132 – "*For the reasons set out above, Ofcom considers that it is desirable to move towards a position where a single charge control is applied to all MNOs."*

These rate asymmetries are of most concern to the lowest cost operators, i.e. Vodafone and O_2. Termination rates impact not only inbound revenue but also outbound interconnect costs. Vodafone suffers a double disadvantage since it receives a below average revenue for direct inbound traffic and suffers an above average cost for outbound traffic to mobile (since three of its four mobile interconnect partners currently have higher termination rates). H3G by contrast has the highest termination rate, and the lowest interconnection cost rate.

The Statement on termination was published simultaneously with the charge control overlay consultation. Ofcom was aware of the impact of porting in modifying the headline termination rates on direct traffic when drafting the statement and setting the charge control levels and in fact uses the term "effective rate including porting" in the Statement[36].

The asymmetry between operators in terms of effective termination rates is not as great as it is for headline termination rates, as the table below shows for 2006/07, using Vodafone approximations of impacts on 900MHz operators and H3G, and taking Ofcom's estimation of no material impact on 1800MHz operators.

[✂]

Given that at [✂]p[37] H3G's estimated effective termination rate is still comfortably above Ofcom's view of costs in 2006/07 of 6.8p, and that the impact of porting is to reduce the asymmetry, then it would seem that the impact of porting is beneficial in the context of Ofcom's policy intention to reduce operator rate asymmetry: it both brings the rates of the 2 types of 2G/3G operator closer together and reduces the difference between H3G's and the 1800MHz operators' rates.

It is worth also looking at this over the charge control years from the point of view of the difference by operator types between rates set by the glidepath and Ofcom's view of the underlying cost[38]. In the table below all rates are at 2006/07 prices.

[✂]

It can be seen that on direct traffic, H3G is being allowed to recover considerably more over cost than the 1800 MHz operators, and the 900MHz operators rather less than the 1800MHz operators. However when substituting Vodafone's estimation of what the effective rates after allowing for porting dilution might be then the differences between cost by operator type become narrower. This is shown in the table below – the values should be considered illustrative rather than

[36] Figure 2.2 of the Statement shows Ofcom's calculation for each operator of its headline regulated charge, regulated WAF adjusted rate, effective rate including porting, and its 2G/3G blended rate.
[37] [✂]
[38] Taken from option 3 of the glidepath graphs in section 9 of the Statement.

definitive. It is clear however that when considering effective rates[39] asymmetries in average recovery over cost are narrower than on the headline rate charged on direct traffic alone.

[✂]

For example on direct traffic alone H3G is estimated to be recovering 2p above cost on every inbound minute in 2007/08, but when considered across the blend of porting and direct traffic, on average its excess recovery over cost is reduced to [✂][40]. Also the 900MHz operators' cost recovery differential vs. the 1800MHz operators is reduced at the effective rate level over that derived from the direct traffic only.

Ofcom in 4.17 of the consultation characterises this as "*for some MNOs, particularly the 900/1800MHz operators, over-recovery relative to costs is actually further increased by the current charging arrangements for calls to ported-in numbers".* To Vodafone the more significant point is that the over-recovery relative to costs for direct traffic under the Statement is greater for the 1800MHz operators and H3G – the impact of porting serves to bring any over-recovery for 900MHz operators closer to those of the other operators.

In Vodafone's view therefore the practical impact of porting dilution is and has been to bring all operators closer to the "level playing field" that H3G seems so keen on. The intention of the charge control overlay is to change the effective termination rate to the headline rate of the present charge control. It would thus reverse this beneficial dilution and increase both rate and cost asymmetry over the blend of porting and direct traffic. To put it more plainly, <u>the charge control overlay if implemented would permit H3G to recover more above cost than they would otherwise be allowed to do in the period 2007/08 to 2009/10.</u>

Whilst in 2007/08 to 2009/10 H3G is recovering in effective rate terms more above cost than the 2G/3G operators, there may be a case that in 2010/11 (where the intention is that all operators exactly recover their cost) H3G's effective rate is actually below its efficiently incurred cost, and thus in that year alone some intervention may be warranted for H3G alone. The materiality of any such deficit is questionable and would clearly need to be calculated upon better data than Vodafone's rough estimate, but it might be deemed appropriate and more proportionate for a single adjustment to be made to a single operator, i.e. H3G's termination rate[41] could be slightly increased in 2010/11 alone to ensure that the effective rate, rather than the headline rate was 5.9p (in 2006/07 prices).[42] Vodafone sees no reason for adjustments to the charge control for the other mobile operators in this or any other year.

Setting of rates by glidepaths

As discussed above, in the Statement Ofcom has selected a glidepath for each operator type to take that operator's termination rate from approximately where it was in 2006/07 to a target in 2010/11 – in none of the years 2007/08 to 2009/10 are the rates actually reflective of underlying

[39] At least in the situation where the Statement is in force without the charge control overlay
[40] This is still considerably more than the other operators
[41] To be applied to direct traffic
[42][✂].

cost. Given that Ofcom clearly understood the impact of porting in modifying headline termination rates to effective termination rates, in setting the starting point and the subsequent annual levels for the glidepath for 2007/08 to 2009/10 for each operator type there were two options:

a) Consider direct traffic only, and use the current headline termination rates as applied to direct traffic as the starting point for the glidepath, in which case all subsequent rates that are set must refer to direct traffic only.

b) Consider all inbound traffic i.e. direct and ported-in as an aggregate, and use the effective rates achieved as a result of “porting dilution” as the starting point in which case all subsequent rates must also refer to the effective rates, i.e. the two revenue streams of direct and porting weighted together.

The levels established by the glidepath and the scope of the charge control cannot be seen as separate and independent. A glidepath set on the effective rate would have a different starting point and thus different levels for all years (apart from the final year when at cost) from a glidepath set on direct traffic only. A glidepath that is set on method (a), using the current headline termination rates for H3G, for example, will start from 10.8p and set subsequent points that relate to direct traffic, in the knowledge that the effective termination rates will be slightly different. It cannot be correct, whilst charges are above cost to alter the charge control method so that it allows these levels that have been set for direct traffic to be recovered on all inbound traffic. A glidepath that is set on method (b) however would set annual target effective termination rates, i.e. for total inbound traffic. Here it would perhaps be appropriate to make an adjustment similar to that of the charge control overlay so that the direct traffic rate was adjusted up or down in order for the target effective rate to be achieved across all traffic.

The difference between the two methods is best seen with reference to H3G. In the section above we have estimated that H3G’s headline termination rate in 2006/07 was 10.8p and its effective rate [✂]. It can be seen from back-tracking Option 1 in figure 9.4 of the Statement, that the 2006/07 starting position for H3G for the setting of the glidepath options was approximately 10.8p, i.e. the direct traffic starting point[43]. In other words, the level of the charge controls would appear to have been set so as to apply to direct traffic only. The charge control as set will give H3G an *effective* termination rate in 2007/08 of say [✂]. This is still comfortably above the cost level of 7.0p[44]. It is fairly clear therefore that the intention in the Statement was to set a glidepath that applied to direct traffic only.

The Option 2 glidepath that was adopted for H3G by Ofcom appears on inspection, allowing for rounding, to be a 22% first year reduction, followed by three equal cuts of approximately half the first year rate, or 11%. If the glidepath had been set to include ported traffic on method (b), i.e. on the effective termination rate, the glidepath would have been from [✂] (Vodafone’s estimate of the effective rate in 2006/07) to 5.9p, or assuming the same pattern, [✂]. This is clearly a very similar

[43] There is a clear differentiation in treatment between H3G and the 2G/3G operators. The starting point for H3G is their actual 2006/07 unregulated rate. However the 2G/3G operators’ starting points are not their actual (blended) rates but the rather lower 2G regulated rate, which only applied to a portion of their terminating traffic. Blended rates for 2G/3G operators were approximately [✂] higher than headline regulated rates in the second half of 2006/07.

[44] Taken from glidepath Option 3 in figure 9.4 of the Statement as 6.8p and uplifted to 2007/08 nominal by one year’s RPI

effective rate to that derived above from method (a) once diluted by porting. Equally on method (b) in order to achieve the effective rate of [✂] as an average across both direct and ported traffic, the rate to charge on direct traffic would have to be increased, perhaps by means of the charge control overlay – this would result in a rate to be charged [✂] very similar to the direct rate output from method (a).

In other words method (a) without the charge control overlay and method (b) with the charge control overlay achieve similar levels of both effective rates and headline direct rates. It is very clear from this that the glidepath set by Ofcom in the Statement relates only to the rates that should be recovered on direct traffic – a glidepath established across ported and direct traffic combined intended to establish regulated effective rates would have had lower values for H3G in all years of the charge control except the last year.

Ofcom's error however in the present consultation is to suggest that the rates established for direct traffic should be recovered across all inbound traffic – in effect it is attempting to apply the charge control overlay on top of method (a). The impact of this would be to allow H3G (assuming a 1st April 2007 implementation) to recover the direct TAC of 9.1p over ported and direct traffic in aggregate. This will mean that rather than the deep cut planned by Ofcom in the Statement to move H3G substantially towards cost (7.0p in 2007/08 nominal terms), the effective rate received by H3G would fall in the first year only [✂] a mere [✂]. By contrast the present charge control without the overlay reduces the headline direct rate from 10.8p to 9.1p, i.e. 15%, and the effective rate [✂] also 15%[45]. The porting charge control overlay thus moves away from the intention of the Statement.

From the point of view of rate asymmetry, the 2006/07 effective rate difference between the 1800MHz operators and H3G is estimated by Vodafone to be [✂]. In 07/08, the difference on effective rates is [✂]. If the charge control overlay were to be implemented, the difference in 07/08 would rise to [✂]. A similar but opposite impact can be observed on the 900MHz operators. However the objective of the charge control is for H3G's rate and the 900MHz operators' rate to converge on that of the 1800MHz operators'. The impact of the charge control overlay would be to increase, not reduce the effective 900MHz vs. 1800MHz and H3G vs. 1800MHz rate asymmetries.

In summary therefore the impact of porting on effective termination rates is to narrow the rate asymmetry between operators: whilst operators are differentially above cost, this can only be benign. Implementing the proposed charge control overlay will widen rate asymmetries between operators, put H3G further above cost than it would otherwise be, and reduce the effective size of the planned P_0 reduction for H3G, changing the curve of H3G's glidepath. All of these effects seem to go against the intentions and objectives of the termination Statement. It is hard to see why this is Ofcom's intention in the consultation.

Retail distortions to switching and porting

Ofcom in the consultation in paragraphs 4.22 et seqq. introduces an new issue that the proposed charge control overlay apparently needs to address, that of distortions in retail markets caused by

[45] The 2007/08 rates in this paragraph are at 2007/08 nominal levels to be consistent with the absolute values by operator type of 9.1p, 6.2p and 5.7p in the charge control

differences in effective termination rates[46]. These concerns were not alluded to in the glidepath setting section of the Statement, where they have at least equal merit in relation to the consideration of the setting of termination rates above underlying costs. Vodafone believes that Ofcom has got the solution to the "problem" turned the wrong way round: that if these distortions were to be considered real then they are a product of differences in effective termination rates by operator, and that the best way to eliminate them would have been to more rapidly reduce the rate asymmetry, rather than to increase it, as the charge control overlay is proposing. At the very least they should have been discussed and their merits explored as a component of the glidepath setting process in the Statement, but they were not.

Vodafone however does not in any case accept that these distortions are any other than theoretical. Ofcom cites in 4.22 without supplying empirical evidence that the present charge control in the Statement gives rise to two potential distortions to:

1. "*the incentive to encourage subscribers to switch from one network to another"*
2. *"the incentive to encourage subscribers that do switch to port/change their number*"

The former seems strange. The retail competition to attract new subscribers is very strong. H3G's thesis appears to rely on the importance of the incoming revenue[47] generated by a new customer in determining the attractiveness of that customer to an operator, and thus the degree to which the operator is incentivised to target and secure that customer. There must thus be a clear linkage in H3G's theory between incoming revenue from a customer and the retail or CARS costs of acquiring and retaining that customer. Yet Ofcom have been very clear in the course of the termination review that the costs of attracting and retaining customers cannot be recovered from termination revenue[48]. To suggest that the impact of differential porting revenues will distort competition in encouraging or discouraging specific operators to target the customers of another operator seems to be fundamentally flawed. To go further and suggest that the presence or absence of the porting charge control overlay on termination will impact the degree to which operators compete for customers is an unlikely hypothesis.

Ofcom points out in the Statement that termination revenues are approximately 15% of total operator revenue[49]. The bulk of the future value that a new customer represents is thus his outbound usage, not inbound. It follows therefore that a small difference in termination revenues, that may be on the order of 1% of total customer revenue for the [✂] or so of customers who port is unlikely to be a significant factor in influencing the retail competition for good customers.

Paragraph 4.23 attempts to explain the claimed distortion on the basis that operator C will target customers of operator A more than those of operator B as candidates for switching, given that operator A is the high cost operator, in the hope that they will port their numbers, so that B's customer base will be under less pressure than A's. Similarly operator B will target customers of operator A more than operator A will target customers of B. This is simply wrong. Retail channels are incentivised to attract new customers: it is irrelevant as to whether the prospective customer is presently a customer of operator A or B or is a new customer to mobile. Fundamentally operators

[46] As paragraph 9.131 of the Statement makes clear, the source of this argument is H3G.
[47] And the underlying rate at which it is charged.
[48] Except indirectly for marginal customers through the externality.
[49] Paragraph 2.17

are generally unable to target customers of specific other operators except where acting improperly:[50] rather it is customers who are targeted, not operators. The idea that a retail channel would be offered a higher incentive to attract a current customer of A rather than of B, disincentivising retail staff from attracting a customer who turned out to be presently registered with B is impractical to operate, even if it were perceived to be an appropriate strategy, as Vodafone does not. As Vodafone has previously explained in the termination consultation, the levels of incentives are set based on expectations of the future lifetime value of a customer (in which inbound revenue plays a relatively small part). For an independent retailer offering the choice between A, B and C, what will incentivise the retail staff is the degree of bonus offered by the networks: to the extent that the revenue from incoming traffic is relevant, the high cost operator with the greatest margin above costs will be able to offer the largest bonus to attract a given customer.

In fact C can only attract customers of A or B who express an interest in leaving their existing network. It may be that a customer of A is more likely to want to switch than a customer of B, but that would be a reflection of the relative customer experience of A vs. B rather than any targeting of customers by C.

H3G's second distortion appears to have a little merit, that once a customer of A or B has decided to switch to C, there will be more advantage in persuading a customer of A to port than a customer of B. It should be said that porting always provides a distortion since it is an activity that involves cost to the operator but no additional benefit over and above that provided by a customer who switches without porting. H3G's argument presumably goes that there is in fact a benefit from incurring these costs if the customer is coming from A since A's higher termination rates could be captured, but a disadvantage if the customer is coming from B since B's termination rates are the same or lower than C's. For this distortion to be able to work in practice it requires a well constructed retail script, making sure that the question "what network are you coming from" is asked before "I think you want to keep/change your number". Ofcom cites as evidence that this distortion exists an argument from Vodafone relating to elimination of 900MHz vs. 1800MHz rate asymmetry[51] but provides no other evidence. Vodafone sees porting as a customer, not an operator choice.

Ofcom concludes in paragraph 4.28 that "*the current MNP and TAC interactions provide scope for distortion of competitive incentives in downstream retail markets*". Vodafone believes that this is insufficient: in order for Ofcom to use this as a reason for rejecting the do nothing Option 1 it has to demonstrate that these distortions are real. It would not have been very difficult for Ofcom[52] to have requested data from the operators to substantiate the existence of this distortion, but it has apparently not done so. Ofcom states in 4.25 that 900MHz operators have "*a clear incentive to target customers on H3G's number range*". Vodafone has tested the practical impact of this claimed incentive against its own porting volumes. In 2006/07, H3G's termination rate was in excess of 5p greater than Vodafone's and O_2's, so if the distortion is real its impact should be

[50] O_2 response to porting consultation November 2006, page 10 discloses details of a case of mis-selling and misrepresentation concerning a dealer called Landmark, who "*had been calling O_2 customers, misrepresenting themselves as O_2 and signing those customers to 3, without their knowledge. Under the settlement agreement Landmark has agreed to pay O_2 £500,000."*

[51] Vodafone believes that it is being quoted out of context, but more significantly the argument does not represent empirical evidence that the theoretical incentives exist in practice.

[52] Apart from the time constraint imposed by the recent provenance of H3G's argument

visible in this year[53]. Vodafone can thus cast itself as operator C and look at porting volumes from A (H3G) and B (O_2). [✂].

Interestingly H3G are currently running a prepay promotion, offering prospective customers an additional £10 top up if they port their number. [✂]. If the distortion were real neither of these would be happening.

Vodafone thus sees no evidence from its own data that this potential distortion exists in reality: it believes that Ofcom has yet to make the case that these distortions claimed by H3G exist and provide any justification for the imposition of the charge control overlay.

Ofcom is missing a very important point. It is the customer who chooses to switch and port, not the operator who persuades the customer. If a customer wishes to port their number, there is no way that the operator will attempt to dissuade them from doing so, given that there is a risk that this might lead the customer to choose operator D rather than operator C.

There seems to be an underlying assumption in the distortion argument that the rate set in the glidepath is identical to underlying cost in all years i.e. that the effect of porting dilution is that H3G is failing to recover their efficiently incurred costs. This is not correct. As discussed above, Ofcom in setting the glidepath have allowed H3G to recover termination at levels significantly above cost, to a degree greater than the other operators, in the years up to 2009/10. H3G thus obtains a bigger benefit over underlying cost for the inbound minutes attracted a given customer than any other operator and can thus bid more for a given customer than the other operators. This might be seen as a distortion to the incentive to encourage subscribers to switch from one network to another. Unlike the impractical targeting distortions dismissed above, this is more tangible, since the real effect is that H3G can afford to put out a bigger incentive bonus into the retail channels for a given customer than other operators. The impact of the implementing porting charge control overlay would be to increase H3G's superior recovery over cost, as shown in the tables above, *increasing* this retail distortion.

Vodafone thus does not believe that these potential distortions identified by Ofcom have any evidential or logical justification. If there is any distortion to switching it is that H3G is allowed under the glidepath to collect revenues at a level above costs, to a greater extent that any other operator. To argue that H3G's effective termination rate should be *increased* to eliminate such a distortion is wrong. To introduce the concern on retail "distortions" only in the porting consultation is also wrong and inconsistent. If Ofcom had been concerned in the Statement on eliminating any alleged distortions on encouraging switching it could have set glidepaths so that all operators' termination rates were equally different from underlying costs in every year, or moved directly to cost. This is in fact an argument that rate and cost asymmetry should be reduced at a faster not a slower pace, but it is not an argument that was considered important or even relevant to Ofcom in the context of setting glidepaths.

The impact of porting under the current charge control, by reducing H3Gs effective termination rate is thus to damp down any retail distortion. The effect of the proposed charge control overlay would be to increase H3G's effective termination rate and thus increase the distortion.

[53] With the asymmetry lower in 2007/08 than in 2006/07 and falling in subsequent years presumably any impact of the distortion will be commensurately reduced.

The contrast between porting and national roaming

Vodafone's estimate is that as a result of porting dilution H3G's revenue could be reduced by on order of £[✂]m[54] in total over the four years to 2010/11 from that possible if all H3G inbound minutes were to be recovered at the relevant annual TAC[55]. It is clear that because of the progressive reduction in rate asymmetry the revenue impact falls year by year. Vodafone has argued above that this dilution is not an unreasonable outcome. However the point at issue here is that Ofcom has chosen to intervene.

This is in considerable contrast to the issue of national roaming. The impact of national roaming for H3G is that its costs are diluted: it pays the national roaming partner a rate, assumed to be close to the 2G rate for calls passed to the 2G/3G operator, and only pays its own costs for calls that it keeps on its own network. In the termination review process O_2 have argued cogently that H3G should be required to charge a blended rate representing the 3G rate for traffic terminating on their 3G network and a 2G rate for traffic that is carried by their 2G national roaming partner. Ofcom in the Statement paragraph 9.30 stated that "*by 2010/11 the volume of traffic that is terminated on the 2G roaming partner's network is expected to be very small, therefore the effect of O2's suggested adjustment to the termination charge is negligible. For this reason, Ofcom has concluded that altering the model to account for national roaming would not impact its final conclusions on charge levels."* Certainly if H3G does roll out its 3G network so that by 2010/11 the proportion of traffic that is routed to the national roaming partner is negligible, then in 2010/11 the profit impact of the cost dilution is small. However this is not true of the other years of the charge control.

Vodafone's belief is that Ofcom did not in fact have to modify the model: the model as presently constituted outputs 2G costs for 2G/3G operators and 3G costs for H3G[56]. A blending of these two rates using Ofcom's forecast of the national roaming proportion could have been made exogenously to establish the average cost of H3G's termination in each year. Given that the 2G rate is below H3G's 3G rate, the result would have been a determination that H3G was further above cost in 2007/08 than calculated in the Statement, leading to a lower glidepath for H3G, and hence lower TACs than the charge control for the period 2007/08 to 2009/10, reducing the year by year rate asymmetries for these years, without necessarily changing the closing 2010/11 target value.

There are two observations worth making. First, H3G can secure a higher return on a national roaming minute than on a 3G minute, since the revenue it receives for both is the same, but the national roaming cost to H3G is lower[57] than the 3G cost rate output by the model. This sets up a

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[54] This is calculated from the model of porting traffic flows for all operators that Vodafone has built, described elsewhere in this document.
[55] I.e. if the TACs established in the Statement were deemed to be applicable to all inbound minutes, rather than just direct traffic.
[56] The 3G costs for H3G as modelled are based on volumes excluding national roaming traffic
[57] It is not clear to Vodafone whether H3G will pay its national roaming partner a rate equivalent to its 2G/3G blended rate or its 2G rate. Paragraph 5.19 of the H3G SMP assessment September 2006 identified that in 2006/07 H3G paid O2 its 2G regulated rate, i.e. 5.63p under the old regulatory regime, for national roaming. In 2007/08 onwards, there are arguably three rates, the TAC set by the charge control, the underlying cost which is in effect a 2G/3G blended rate and which is below the TAC, and the cost of 2G alone, which is

distortion in that H3G is disincentivised from rolling out its 3G network. H3G can increase its return on inbound traffic in all years by carrying a higher proportion of traffic on national roaming than is forecast by the model.

Second, even if H3G's 3G network is deployed and performs as forecast, it will still make a substantial favourable return from national roaming under the proposed charge control in the years 2007/08 to 2010/11, albeit declining year by year. Vodafone's inspection of the traffic volumes provided to the operators as part of release 3 of the LRIC model suggests that the proportion of national roaming traffic of the 3G only operator's total inbound traffic was forecast as [✂]% in 2007/08, falling [✂] in subsequent years. Taking the 900MHz operator rate (as set in the charge control) as a surrogate for the cost to H3G of national roaming, and assuming that these percentages are still correct, Vodafone calculates that H3G is benefiting by not having its termination rate reduced to a blended rate[58] by just under £[✂ - *a very similar sum to that for porting]*m over the four years. Like the alleged porting disadvantage, the sums involved are substantial in 2007/08, and shrink over time to a small sum in 2010/11.

Vodafone believes therefore that under the charge control laid out in the Statement, the benefit that H3G receives from national roaming and the apparent disadvantage (which as argued above Vodafone believes in fact to be benign) that H3G suffers from porting are more or less equal and opposite, and thus at worst cancel themselves out. Vodafone finds it disturbing that Ofcom is prepared to intervene on one to correct the immediate "disadvantages" of porting that taper off as the rate asymmetry shrinks, but does not see any cause for action on the other on grounds that as the difference is small in 2010/11 there is no need to correct any impacts in 2007/08 to 2009/10, even though they are also substantial now and also reduce over time to a small sum in 2010/11. This appears both discriminatory and inconsistent.

Given Ofcom's decision in the statement not to adjust H3G's rate for national roaming, Vodafone suggests that the common sense solution to the apparent issue of porting is to take into account the offsetting impacts of national roaming and porting on H3G's profitability, and seek to adjust for neither. Vodafone would view the implementation of the proposed charge control overlay not as a balanced solution, but as a one-sided one.

The impact of porting may be exaggerated
[✂].

Section 3 - proposed interventions are flawed

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below the blended rate. The actual rate H3G pays is obviously a product of commercial negotiation: here it is assumed that the rate is identical to the 900MHz operator TAC, i.e. 5.7p in 2007/08 etc, rather than the lower underlying cost rates.
One of the odd side effects of the proposed charge control overlay is that it will actually lower the 900 operator TAC and hence potentially reduce the national roaming rate to H3G, giving them a further benefit.

[58] I.e. H3G's TAC and the 900MHz TAC weighted by H3G's own conveyed and national roaming proportions of inbound traffic.

Vodafone non-confidential response to Ofcom consultation on amendment to MNO charge control

The impact of Option 4 has been inadequately measured

Vodafone believes that Ofcom has failed to do a proper assessment of the impact of the proposed charge control overlay on individual operators. Vodafone shares Ofcom's belief that regulation should be evidence based, but is surprised that on this occasion it appears that Ofcom has yet to gather appropriate evidence. Ofcom states in its impact assessment guidelines "*to be effective, the process of doing an Impact Assessment should begin right at the start of a project, with the Impact Assessment being developed from then onwards. An Impact Assessment should therefore be a core part of the policy-making process, not a bureaucratic add-on."*[59] There is no apparent evidence that this has occurred in the charge control overlay consultation.

During the course of the termination review, Vodafone responded to several information requests from Ofcom on costs, traffic and other matters. However the most recent information that Ofcom has requested on ported-in traffic was up to September 2005. This however was not by operator. Vodafone did supply ported-out traffic volumes by destination as part of the porting consultation up to June 2006, but [✂] this is not the same thing at all. It is difficult to see how in the absence of more up to date information Ofcom can be certain of the effect of the proposed charge control overlay on operators in 2007/08: for adequate assessment, Ofcom requires for each operator ported-in [✂] by operator and direct traffic, for the whole of 2006/07 together with forward looking projections for the charge control period.

It is not clear therefore to Vodafone that Ofcom has actually asked for and received the necessary data to conduct a proper impact analysis. In Vodafone's view a full impact analysis would have compared the alternative of Option 1, do nothing against the intervention Options 2, 3 and 4 over the four years of the charge control for each operator, and for the fixed operators as a whole. This would have included not only the impact on termination revenue, but also on the interconnect cost of calls to mobile for mobile and fixed operators. Vodafone can find no reference in the text of the consultation indicating that such an impact analysis has been carried out.

Paragraph 2.24 of the Statement concerning the effect of porting contains the comment "*Ofcom believes that the impact of any effects is likely to have increased since 2004*". Vodafone believes that it is legitimate to question if Ofcom does not <u>know</u> in March 2007 whether the porting impact has increased from 2004 why Ofcom is initiating a consultation to "correct" it without first undergoing a proper data collection exercise and impact analysis. Ofcom appears to have failed to have conducted an evidence-based review of the impact of porting but still unaccountably prefers an option of intervention.

Option 4 is defective in several respects

In 4.47 of the consultation Ofcom states that "*the impact of the amendment on the five MNOs would vary depending on the TAC for each operator, and the proportion of minutes each MNO receives that are terminated on ported-in numbers. For example Ofcom estimates that under the current charging mechanism, in the first year of the charge control H3G could receive between*

[59] Better Policy Making, Ofcom's approach to Impact Assessment, July 2005, paragraph 1.6

£20-£30m more termination revenue if Option 4 were implemented. In contrast, Vodafone and O2 would have their revenue reduced by roughly half of this amount each." By way of footnote, Ofcom adds: *"these figures are calculated by taking the difference between actual revenue received by each MNO on ported-in minutes compared to the revenue it would have received had the minutes been terminated directly. Ofcom in calculating these figures, has used information supplied by MNOs on the total terminated minutes and the proportion of those minutes for each MNO terminated on ported-in numbers from each donor operator."*

Vodafone has built its own model of porting and direct inbound traffic and outbound to OMO interconnect traffic for the period 2006/07 to 20010/11 for the purpose of evaluating the potential impact of Option 4, the charge control overlay, and attempted to populate it with its best estimates of other operators' traffic patterns. Ofcom however is uniquely placed to gather actual inter-operator ported traffic and build its own model. [✂]. Vodafone has used total inbound volumes per the termination rate market review (i.e. for simplicity assumed all 2G/3G operators are identical in size), its own ported-in, ported-out and interconnect traffic patterns to estimate appropriate values for the other mobile operators. Also to reduce the uncertainties of the model, it is assumed that termination rates are charged on a flat basis throughout the week.

This admittedly estimated model permits several conclusions on the impact of imposing Ofcom's preferred Option 4:

1. Ofcom's assertion in 4.47 that the impact of the proposed charge control overlay on termination revenues of the operators is more or less zero sum and hence broadly neutral is not correct. The Vodafone model suggests that H3G benefits in 07/08 on a full year basis[60] by £[✂]m more revenue than the 2G/3G operators in total lose. This difference represents the increase in cost that the fixed operators will have to bear by the introduction of the charge control, rather more than the "less than £10m" suggested by Ofcom in 4.49. The aggregate adverse impact on the fixed operators is approximately £[✂]m over the four years of the charge control[61].

2. The model confirms the suggestion in 4.48 that for T-Mobile and Orange the impact is broadly neutral in 2007/08. However, as 4.48 hints, the impact on them becomes adverse as the 900MHz to 1800MHz rate asymmetry declines, so that by 2010/11 a substantial adverse impact on revenue is recorded for these operators, approximately twice that of the 900MHz operators.

3. [✂].

4. Option 4 ignores the impact on the originating operator and thus creates distortions on interconnect costs for both fixed and mobile operators.

5. Ofcom's assessment of the impact of Option 4 needs to take account not only of revenue but also of interconnect cost impacts on each mobile operator. Option 4 for the high cost

[60] This seems to be the basis adopted by Ofcom for its impact values given in 4.47 et seqq

[61] There is no particular reason why the proposed adjustment should zero out. The impact on a particular operator is determined by its own proportion of ported-in traffic – even if the number of customers porting between operators were completely symmetrical, different operator sizes and other factors will give rise to a different ported-in proportion by operator.

operator not only increases inbound revenue but also decreases outbound interconnect costs, and for the low cost operators both decreases revenue and increases costs. Vodafone's modelling suggests that [✂].

[✂]

Impact of Option 4 on the originating operator: interconnection costs

An obvious disadvantage of Option 4 is that it sets entirely the wrong rate to the originating network. Consider the situation of operator C, a fixed operator, passing calls originated on its network to operators A and B with the same traffic profiles and TACs as in the section above. [*A has a termination rate of 6p and B 9p, and each ports 10% of inbound traffic to the other*]. [✂] Operator A has a TAC of 6p, but is charging (*assuming option 4 is applied*) 5.67p on calls to its number ranges, and operator B has a TAC of 9p, but is charging 9.33p for calls to its number ranges. Thus operator C will pay operator A 5.67p for all calls routed to it, even though we know that 10% of these calls will be to customers who have ported-out to operator B and which should cost 9p, and that the remaining 90% should cost 6p. In other words operator C should pay the low cost operator A not a discounted rate of 5.67p but a premium over its TAC to reflect the fact that a proportion of the calls end up on the high cost operator B. Effectively C should pay a blended rate of 6.3p to A, and reflect this in its retail rates to its own customers. Similarly calls to the high cost operator B should be priced at a discount to B's headline TAC to allow for the fact that a proportion of the calls will actually be terminating on the low cost operator A, i.e. a rate of 8.7p. The charge control overlay, however, is doing exactly the reverse of this with the rate asymmetry being increased rather than decreased:

Operator C pays for calls to NNGs operated by:

	Per Ofcom statement	With Option 4 overlay	Correct cost to reflect TAC of terminating network
Operator A	6p	5.67p	6.3p
Operator B	9p	9.33p	8.7p

These price signals are particularly relevant from the viewpoint of the originating operator when the retail rates of operator C follow the wholesale rates[62]. There is a real impact here of the charge control overlay in that the premium charged to a call to operator B's number ranges is being subsidised by the discount to calls to operator A.

Of even greater significance however is the fact that operators A and B, being mobile operators, are also originators of calls to each other, and will hence bear an interconnect cost that is altered by the charge control overlay. This fact does not seem to have been covered by Ofcom in its discussion of the pros and cons of Option 4[63]. (A full impact analysis would no doubt have

[62] BT's retail F2M rates for residential customers show a difference between H3G and the 2G/3G operators: their rates for business customers vary by operator.
[63] Paragraphs 4.47 and 4.48 only address the impact of Option 4 on termination <u>revenue</u> for each mobile operator.

highlighted the point.) The high cost operator B should pay 6p for calls that it sends to operator A, but under the proposed charge control overlay will only pay 5.67p, and thus will save 0.33p per outgoing call as well as gaining 0.33p on every incoming call, and hence makes a double benefit from the charge control overlay. The lower cost operator A however faces a double whammy – not only will it lose 0.33p in revenue on every inbound minute, but also it will face 0.33p in higher cost on every minute that it sends to operator B.

Vodafone's model clearly shows this interconnect cost result: a further, material adverse impact on Vodafone and O2, an adverse impact about two-thirds this size on T-Mobile and Orange[64], and an additional favourable impact on H3G. Vodafone assumes that this is an unintended consequence of Option 4.

This would appear to be an odd and discriminatory result in the context of a charge control based on a set of glidepaths aiming to reduce rate asymmetry: under Option 4 not only is the benign impact of ported-in traffic in reducing rate and cost asymmetries being frustrated, but also the impact on interconnect costs means that the lower cost operators will pay more on mobile interconnection than before and the higher cost 3G only operator will pay less on mobile interconnection than before, further increasing the rate and cost asymmetry.

Further disadvantages to Option 4

There are further disadvantages to Option 4 that Ofcom does not consider.

[✂].

Conclusions on Option 4

Vodafone thus believes that Option 4 suffers from many more disadvantages than Ofcom has as yet identified. [✂]. The impact on interconnect costs will mean that originating operators will pay a less correct rate for interconnection under Option 4, and that the low cost mobile operators will bear an additional burden and the high cost operator receive an additional benefit. Overall the impact of Option 4 would be to transfer value from the low cost mobile operators and from the retail customers of fixed networks to H3G, increasing the total industry costs of mobile termination and widening the asymmetry of mobile rates: this would thus be the exact opposite of the successes highlighted by Ofcom of the termination rate Statement.

Issues with Options 2 & 3

Ofcom considers in the consultation two further methods of intervention to the charge control laid out in the Statement. Option 2 is to seek a self-regulated inter-operator financial settlement system,

[64] The aggregate impact on T-Mobile and Orange (revenue plus interconnect) is now clearly negative in all years.

and Option 3 is to change the TACs set by the charge controls. Putting aside Vodafone's arguments against any intervention, it is not clear to Vodafone that from a mechanical viewpoint either of these will work any better than Option 4.

On Option 2, if Ofcom is envisaging that only individual reciprocal adjustments between pairs of operators is anticipated, then it seems correct that it is unlikely that individual set of "advantages" and "disadvantages"[65] will result in an equitable result for all operators. Vodafone finds the hypothetical example in paragraph 4.35 to be somewhat contrived, but it does however bring out one interesting point. Ofcom states in 4.32 that Option 2 would also "remove the distortion to incentives in the market". Vodafone does not see this at all: if H3G's claimed distortions on switching/porting were to be real, in the example in 4.35 the incumbent low cost operator would in fact be incentivised to persuade all customers transferring from the new high cost operator to switch without porting, since the low cost operator would bear the cost of porting but any benefit from porting traffic would be immediately surrendered to the high cost operator. If Ofcom believes therefore that the porting/switching distortions are real, as Vodafone does not, then Option 2 would lead to the low cost operators discouraging porting. Given Ofcom's concern set out in 4.27 that "*number portability is an important consumer right and Ofcom wishes to ensure that there are no perverse financial incentives distorting a provider's behaviour when a customer switches to them*" it does seem that Option 2 is counter-productive.

It could be possible to modify the methodology of Option 2 to improve the opportunities for revenue exchanging by setting up a clearing house system, so that individual operators in apparent "surplus" hand over these sums at regular intervals to a central authority which distributes the total surplus to all "disadvantaged" operators in some manner such that all operators are equitably treated. This would however be somewhat convoluted. As a result of commercial confidentiality, individual operators would have no way of seeing and reviewing the calculations of the clearing house. Also, given that each charging period is 12 months long it would not be possible to identify how much "advantage" a low cost operator had received from porting until after the year had finished so transfers would probably have to be made annually in arrears. Further, operators would effectively receive gains or losses that could not be reliably quantified in advance of receipt, making forecasting, accurate financial reporting etc troublesome. Option 2 would thus be administratively extremely difficult to implement and operate.

The real problem however with Option 2 that Ofcom only hints at in 4.38 "*there may well be insufficient MCT revenues to allow for sufficient transfers between MNOs to effect a solution"* is that as Vodafone has discussed in connection with Option 4 above, there is no zero-sum solution: the only way to fully address what Ofcom perceives to be an issue is to charge the fixed operators a higher average rate for termination. Option 2 does not do this so there will not be enough money in the central kitty to go round.

Vodafone does not therefore believe that Option 2 has any merit.

Option 3 suggests that the TACs in the charge control are modified by Ofcom to take account of forecast ported-in traffic. This would be complex, requiring Ofcom to make a forecast of each individual operator's proportion of ported-in traffic from each other operator. [✂]. Such a forward looking projection would inevitably be wrong:

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[65] [✂].

1. It would require a certainty of prediction of MNO customer and traffic behaviour that the MNOs themselves do not possess – in particular Ofcom would be creating and imposing a central view of the future of the porting market on the mobile industry.

2. It is hard to see how such predictions could be transparent and equitable – operators would be incentivised to "game" forecasts supplied to Ofcom to obtain financial advantage. It is unclear whether Ofcom would or could reject or modify a forecast supplied by an operator.

3. Operators would under Ofcom's distortions approach be incentivised to beat or under-perform against the forecast to maximise financial outcomes, setting up the opportunity for targeted switching/porting behaviours.

4. What would happen to any forecast error? Would it be adjusted somehow, it would it represent a windfall gain or loss to each operator?

Vodafone concludes that down this road lies the potential for many disputes, between the operators, and with Ofcom, as well as the potential distortionary disruptions that Ofcom is apparently so concerned about. Vodafone agrees with Ofcom that Option 3 is not a suitable approach.

Impact on any change to direct routing

The consultation on the porting charge control overlay is apparently running in parallel with the other consultation on porting, which relates to two aspects of porting, the SLA for port times and the routing of ported traffic. One of the options discussed in the November consultation on the latter was direct routing: this would mean that separate porting traffic flows would no longer occur. It is not clear to Vodafone that these matters are entirely separate from the charge control overlay, as direct routing is in effect Option 5: Option 4 and Option 5 appear to be mutually exclusive.

If Ofcom were to mandate direct routing or individual operators were to implement it on a reciprocal basis, then the existing charge control would not present any obstructions. Traffic that was previously routed as ported-in would become direct, and charged at each operator's current TAC. However the existence of the charge control overlay prevents any implementation of direct routing, since the direct traffic in the first year of implementation of direct routing would be charged after application of the porting overlay not at the TAC rate, but at some different rate based on the prior year ported-in traffic proportion. Unless this error was to be eliminated, a low cost operator would suffer a deficit, and the high cost operator would receive an undeserved gain. This means that the only way direct routing could be introduced would be on a big bang method, mandated by Ofcom, at the beginning of a tariff year: and this only after another change to the charge control mechanism to repeal Option 4[66]. The scope for individual reciprocal phased implementation of direct routing, or for re-pricing of calls from the donor termination rate to the recipient termination rate [✂] would be eliminated by the proposed charge control overlay. It would be impossible to implement any such change without creating windfall losses or gains.

[66] The same point would apply to options 2 and 3.

It would appear to be sensible therefore for the position on direct routing to be resolved before seeking to impose the charge control overlay or any other intervention: the issues should be run in series rather than in parallel.

Vodafone response to specific Ofcom questions

Vodafone believes the text above covers in detail Vodafone's arguments that the proposed charge control overlay should be rejected (or in other words Option 1, no action, should be adopted), but to avoid misunderstanding, a brief summarised response to each of Ofcom's specific questions is included below.

Question 1: *What are respondent's views on the appropriateness of Option 1 as a solution to the distortions created by the existing MNP mechanism on MCT?*

Vodafone has serious and fundamental objections to the intervention that Ofcom is proposing. We believe that Ofcom has neither established any legal basis on which intervention is warranted nor conducted an adequate impact analysis with current robust data [✂] sourced from the mobile operators. Vodafone does not accept Ofcom's premise that the impacts of the existing MNP mechanism on MCT can be fairly characterised as "distortions". Vodafone sees the impact of porting dilution as beneficial in securing the objective of the Statement in reducing rate and cost asymmetries. The glidepaths for the years 2007/08 to 2009/10 were set on the basis that the charge control applied only to direct traffic: extending it at the same levels to ported-in traffic is not justifiable. It is only for H3G in 2010/11 that some minor adjustment may be required. Vodafone does not accept that the hypothetical impacts on retail switching and porting adduced by H3G are real: the only possible impact on the retail market that Vodafone sees is where operators are differentially above cost and thus can differentially compete to attract new customers – here the any intervention in terms of Options 2-4 will increase, not decrease any retail distortion. Intervention would only benefit one operator, H3G, to the detriment of fixed and mobile consumers. The impacts of porting and of national roaming on H3G are opposite and approximately equal: Vodafone does not see that the adjustment for one but not the other is a proportionate and balanced solution. Thus in Vodafone's view Option 1, "no action" is the only possible outcome to this consultation.

Question 2: *What are respondent's views on the appropriateness of Option 2 as a solution to the distortions created by the existing MNP mechanism on MCT?*

As per the response to question 1, Vodafone does not believe that any intervention is warranted. Notwithstanding this, Vodafone agrees with Ofcom that Option 2 is unworkable.

Question 3: *What are respondent's views on the appropriateness of Option 3 as a solution to the distortions created by the existing MNP mechanism on MCT?*

As per the response to question 1, Vodafone does not believe that any intervention is warranted. Notwithstanding this, Vodafone agrees with Ofcom that Option 3 is unworkable.

Question 4: *What are respondent's views on the appropriateness of Option 4 as a solution to the distortions created by the existing MNP mechanism on MCT?*

Vodafone non-confidential response to Ofcom consultation on amendment to MNO charge control

As per the response to question 1, Vodafone does not believe that any intervention is warranted. Further, in Vodafone's view, the disadvantages of Option 4 are not fully explored by Ofcom: specifically the fact that interconnect costs are not considered, the unfavourable impact on all operators, both fixed and mobile except for H3G, the lack of a full impact analysis [✂]. Overall the impact of Option 4 will be to transfer value from the low cost mobile operators and from the retail customers of fixed networks to H3G, increasing the total industry costs of mobile termination and widening the asymmetry of mobile rates: this is the exact opposite of the successes highlighted by Ofcom of the termination rate Statement.

Question 5: *Do respondents agree with Ofcom's conclusion?*

No.

Question 6: *What do respondents think about Ofcom's proposed amendment to the compliance formula?*

Vodafone is strongly of the view that there is no case for the proposed amendment. See responses to questions 1, 4 and 5.