Oftel Office of Telecommunications

Draft Direction in respect of two disputes relating to Vodafone's Credit Vetting Clause

A draft Direction issued by the Director General of Telecommunications

5 June 2003

Responses due by 19 June 2003

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DRAFT DIRECTION UNDER REGULATION 6(6) OF THE TELECOMMUNICATIONS INTERCONNECTION REGULATIONS 1997 RELATING TO A DISPUTE BETWEEN VODAFONE LTD AND BOTH NTL LTD AND MCI WORLDCOM LTD OVER VODAFONE LTD'S CREDIT VETTING CLAUSE

Whereas:

(A) The Secretary of State granted to Vodafone Ltd ("Vodafone") on 9 December 1993 a licence under section 7 of the Telecommunications Act 1984 ("the Act") for the running of telecommunications systems specified in that licence ("the Vodafone Licence");

(B) The Secretary of State has granted to ntl Ltd ("ntl") on 23 June 2000, a licence under section 7 of the Act for the running of telecommunications systems specified in that licence;

(C) The Secretary of State has granted to granted to MFS Communications Limited on 24 September 1993 and to WorldCom International Inc. on 31 March 1994 licences under Section 7 of the Act for the running of telecommunications systems as specified in those licences

(D) Both MFS Communication Limited and Worldcom International Inc. are now part of MCI Worldcom Ltd ("MCI");

(E) ntl entered into an agreement for interconnection with Vodafone on 11 December 2002, and MCI entered into an agreement for interconnection with Vodafone on 10 December 2002 (each a "New Agreement" and together the "New Agreements");

(F) Both ntl and MCI have stated that although they entered into the New Agreements they disputed certain aspects of Clause 4 of the New Agreement (the "Credit Vetting Clause"), and therefore signed the New Agreements under protest;

(G) On 20 December 2002, in accordance with the provisions of Regulation 6(6) of the Telecommunications (Interconnection) Regulations 1997 ("the Regulations"), ntl referred a dispute relating to the Credit Vetting Clause to the Director General of Telecommunications ("the Director") for determination;

(H) On 31 March 2003, in accordance with the provisions of Regulation 6(6) of the Regulations, MCI referred a dispute relating to the Credit Vetting Clause to the Director for determination;

(I) Regulation 6(6) of the Regulations provides that where there is a dispute concerning interconnection between organisations, the Director shall, at the request of either party, take steps to resolve the dispute within six months of the date of the request. The direction which the Director makes to resolve the dispute must represent a fair balance between the legitimate interests of the parties, and must be notified to the parties in accordance with Regulation 8(3). The parties are entitled to a full statement of the reasons on which the direction is based;

(J) The Director has considered inter alia, the information provided by the parties and the matters set out in Regulation 6(8) of the Regulations. The principal points are summarised in the explanatory memorandum which accompanies, and is published with, this direction;

(K) The Regulations place upon the Director the general responsibility to encourage and secure adequate interconnection in the interests of all users;

(L) The Director issued a draft of this direction and the explanatory memorandum which contained the Director's reasons on 5 June 2003 and responses were invited by 19 June 2003**.**

(M) Non-confidential comments were received from **[…]** as detailed and discussed in Chapter **[…]** of the explanatory memorandum which accompanies and is published with this direction. The Director in making this direction has taken these comments into account;

THEREFORE:

Pursuant to Regulation 6(6) of the Regulations, and having considered, inter alia, the views of the parties and those matters set out in Regulation 6(8) of the Regulations, the Director makes the following direction to resolve the dispute between Vodafone and both ntl and MCI:

1. Vodafone shall amend its New Agreements so as to make clear that, where Vodafone have sought financial security in accordance with the terms of the New Agreement, the parties have scope to reasonably endeavour to agree a form of financial security that may be appropriate in the circumstances, and which represents a fair balance between the legitimate interests of the parties.

2. Vodafone shall amend the New Agreements so as to make clear that payment history is to be taken into account when carrying out an internal credit check.

3. Except as otherwise defined in this Direction, words or expressions used shall have the same meaning as in the Act, the Vodafone licence or the New Agreements as appropriate.

4. This direction shall take effect on the day it is published.

HEATHER JULIE CLAYTON

DIRECTOR OF INVESTIGATIONS

A person authorised under Paragraph 8 of Schedule 1 to the Telecommunications Act 1984

………. 2003

Explanatory memorandum

Chapter 1

Summary

1.1 The Director General of Telecommunications (“the Director”) has issued a draft Direction in accordance with the provisions of Regulation 6(6) of the Telecommunications (Interconnection) Regulations 1997 (“the Regulations”) for the resolution of a dispute between Vodafone Ltd (“Vodafone”) and both ntl Ltd (“ntl”) and MCI Worldcom Ltd (“MCI”).

1.2 The dispute concerns clause 4 (‘the Credit Vetting Clause’) of Vodafone’s revised interconnect agreement (‘New Agreement’). The Director has been asked to consider the following three issues in order to resolve this dispute:

- first, is it reasonable for Vodafone to credit vet all operators that it currently interconnects with (‘Operators’);
- second, should the instigation and withdrawal of an obligation by an Operator to provide a form of financial security be based solely on payment record; and
- third, should an Operator have a contractual right to make more frequent/rapid payments, pursuant to receipt of an invoice, instead of providing a payment in advance or a bank guarantee, in the event that the Operator is deemed a credit risk.

1.3The Director proposes to determine the following:

- first, the Director does not consider it unreasonable for Vodafone to credit vet all Operators. The Director considers that the universal application of credit checks to all Operators does not provide cause for concern, providing that credit vetting is not applied in a manner which distorts competition;
- second, the Director considers that the use of third party reports is a reasonable method of assessing an Operator’s creditworthiness, and does not give Vodafone the opportunity to act anti-competitively. Therefore, the Director is not requiring Vodafone to instigate and withdraw financial security obligations solely on the basis of late payment. However, the Director is minded to conclude that Vodafone should amend the New Agreement to make it clear that recent payment history is an additional objective criteria which should be taken into account by Vodafone when carrying out its own internal credit checks;

- third, the Director does not propose to require Vodafone to offer Operators more frequent and/or rapid payment, pursuant to receipt of an invoice, instead of providing a payment in advance or bank guarantee. Different financial security obligations have different impacts on Vodafone's credit risk and an Operator's cash flow, and requiring Vodafone to offer more frequent and/or rapid payments pursuant to receipt of invoice may not in all cases represent a fair balance between the interests of the parties. However, Vodafone is required to amend its financial security clause to make it clear that the parties have scope to agree a form of financial security and that Vodafone must reasonably endeavour to agree a form of security that may be appropriate to the case in hand.

1.4 The Director is conscious of the impact on the resolution of this dispute of the new regulatory regime for electronic communications networks and services, which is due to come into effect on or after 25 July 2003. In order to ensure that any obligations imposed under the current regime continue to be enforceable during the transition to the new regime, the Director is considering issuing a continuation notice under the terms of paragraph 7 of Schedule 18 of the Communications Act 2003 to carry over the obligations imposed under any final direction issued in relation to this dispute for the period from 25 July 2003 until such time as the new obligations proposed in the Review of Mobile Wholesale Voice Termination Markets come into force.

Chapter 2

Background

2.1 As a result of having been designated with Significant Market Power ("SMP") under the EC Interconnection Directive (97/33/EC), Vodafone is obliged to meet all reasonable requests for interconnection from Operators seeking access to its network by virtue of Condition 45 of its licence. Condition 45 also requires Vodafone to secure that such interconnection is offered on reasonable terms and conditions.

2.2 Operators interconnecting with Vodafone may purchase interconnection services from Vodafone in accordance with the terms that are set out in Vodafone's interconnection agreement. The interconnection requested in this case relates to services that originate on ntl's and MCI's network and terminate on Vodafone's network. As of the date of this draft direction, 13 Operators directly interconnect with Vodafone.

2.3 Vodafone has stated that during the early part of 2001, it recognised that the financial standing of a number of operators was deteriorating and that this trend was likely to continue for the foreseeable future. As a result, at the end of November 2001 Vodafone sought to introduce the New Agreement containing the Credit Vetting Clause. Vodafone has stated that the aim of this clause was to limit its financial exposure resulting both from financially unsound new operators entering the market and existing operators becoming insolvent. Vodafone served 12 months notice for Operators to terminate their existing agreements.

2.4 Oftel has recently issued a draft direction[1] ('the BT credit vetting draft direction') and a direction[2] ('the BT credit vetting direction') in respect of credit vetting measures that BT sought to introduce into its Standard Interconnect Agreement. Interested parties should consult these documents in order to familiarise themselves with relevant background to this area.

[1] http://www.oftel.gov.uk/publications/licensing/2002/credit1102.htm#2
[2] http://www.oftel.gov.uk/publications/licensing/2003/credit0203.htm

Chapter 3

History of the Dispute

ntl

3.1 ntl provided the Director with a summary of negotiations regarding direct interconnection with Vodafone. Ntl stated that negotiations began on this matter in 1998, and that they had been unsuccessful as far as ntl is concerned.

3.2 Following Vodafone's signalled introduction of the New Agreement, ntl and Vodafone had discussions regarding the Credit Vetting Clause. During this time revisions were made to the New Agreement.

3.3 ntl signed the version of Vodafone's interconnection agreement which did not contain the credit vetting clause ('Old Agreement') on 31 October 2001. ntl's Old Agreement expired on 8 December 2002. ntl has stated that in order to ensure continuity of service from Vodafone, ntl signed the New Agreement. ntl provided the Director with a copy of this agreement[3]. Negotiations continued between the parties regarding the New Agreement.

3.4 ntl referred this dispute in to the Director on 20 December 2002. ntl stated that the Credit Vetting Clause is unreasonable in three respects:

3.4.1 it is unreasonable for Vodafone to apply credit vetting rules to all operators seeking interconnection with Vodafone;

3.4.2 the terms of the Credit Vetting Clause are not sufficiently transparent; and

3.4.3 the Credit Vetting Clause does not contain a robust dispute resolution or appeals process.

3.5 Subsequent to this matter being referred, the Director had discussions with both ntl and Vodafone. Further to these discussions, ntl and Vodafone confirmed that they would be entering into commercial negotiations regarding the determination requests set out above at 3.4.2 & 3.4.3. Therefore these requests were removed from the scope of the matters under investigation.

[3] The agreement considered by the Director for the purposes of resolving this dispute is the agreement provided by ntl in its referral of 20 December 2002.

MCI

3.1 MCI signed Vodafone's Old Agreement on 22 June 1995.

3.2 MCI has stated that negotiations began with Vodafone regarding the New Agreement in April 2002. During this time revisions were made to the New Agreement.

3.3 Vodafone and MCI continued negotiations regarding the Credit Vetting Clause. On 10 December 2002, Vodafone and MCI agreed to execute the New Agreement[4], however MCI stated that they considered that the credit vetting clause was unreasonable.

3.4 MCI stated that throughout these negotiations Vodafone refused to concede ground on the core issue that concerned MCI, which was the lack of objectivity of the Credit Vetting Clause.

3.5 On 31 March 2003 MCI submitted a determination request to the Director regarding Vodafone's Credit Vetting Clause. MCI requested a determination that:

3.5.1 an Operator should have the option to make more frequent/rapid payments, pursuant to receipt of an invoice, instead of providing a payment in advance or a bank guarantee, in the event that the Operator is deemed a credit risk;

3.5.2 the Credit Vetting Clause should contain an objective late payment credit vetting trigger for existing interconnect parties; and

3.5.3 the Credit Vetting Clause should contain an objective payment trigger for exiting the obligation.

3.6 As the issues submitted by MCI were closely related to request that had been previously submitted by ntl, MCI's determination request has been handled in parallel with the existing ntl dispute.

[4] The agreement considered by the Director for the purposes of resolving this dispute is the interconnect agreement between Vodafone and MCI Worldcom of 10 December 2002

Chapter 4

Submissions of the parties

ntl

4.1 ntl stated that in imposing the Credit Vetting Clause, Vodafone is not offering terms and conditions which are reasonable. ntl stated that it has considered the BT credit vetting draft direction, and has concluded that Vodafone's Credit Vetting Clause does not comply with the principles applied by the Director in that draft Direction.

4.2 ntl considered that Vodafone is acting unreasonably by applying credit vetting rules to all Operators, rather than adopting the approach taken by BT. Under BT's credit vetting policy, BT credit vets all new interconnecting operators, but existing interconnecting operators are only credit vetted when they have made late payments on two occasions in twelve months.

4.3 ntl considered that Vodafone's approach to credit vetting has the effect of allowing Vodafone to block interconnection with any Operator, rather than giving the Operator an opportunity to develop a good payment record with Vodafone.

4.4 ntl referred to paragraph 5.75 of the draft BT credit vetting direction, which states that the credit vetting measures applied by an operator with SMP status must be reasonable and proportionate. ntl also referred to BT's comment set out in that draft Direction, in which BT asserted that the application of credit vetting rules across the board would be 'draconian'.

4.5 ntl stated that in the BT credit vetting draft direction the Director articulates the view that BT's approach to triggering credit vetting is 'reasonable and proportionate', and argued that the Director implies that 'immediate application across all operators with which BT interconnects' would not be a proportionate response for BT to make to the issue in question. ntl stated that the same reasoning should be applied equally to Vodafone, which has equivalent SMP status to BT.

4.6 ntl concluded that Vodafone is failing to offer 'reasonable' terms of interconnection to Operators under its New Agreement. Ntl stated that the credit vetting clause is out of all proportion to the perceived risk, and in practice makes it impossible for many Operators to achieve full interconnection with Vodafone.

MCI

4.7 MCI stated that the terms included in the Credit Vetting Clause are damaging, and that Vodafone is able to require any of the following types of financial security at its discretion:

- a deposit equal to three months' run-rate within 14 days of request;
- a bank guarantee for an amount equal to three months' run rate[5];
- payments in advance at least five working days prior to the first day of the month to which the payment relates;
- a set off arrangement whereby Vodafone may set off against invoices due under the New Agreement any debt or sum owing to Vodafone under any agreement entered into between Vodafone and MCI for the duration of the period during which the Financial Security is requested; and
- any combination of the above or other financial security agreed between the parties.

4.8 MCI stated that Vodafone is entitled to reasonably protect itself against financial risk through objective credit vetting provisions. However, it considered that the provisions were not in line with those that would be applied in a normally functioning competitive market. MCI stated that by imposing onerous security requirements Vodafone is leveraging its market power in order to reduce its financial risk to zero, thereby raising entry barriers, damaging the competitive process and causing detriment to the consumer.

4.9 MCI stated that cash flow has replaced revenue generation as the primary indicator of a company's performance. MCI considered that the financial security that can be requested by Vodafone could have a serious adverse impact on cash flow. MCI stated that the potential cost of Vodafone's financial security provisions is extremely high, and provided a confidential assessment of the impact that the potential cost of Vodafone's financial security arrangements would have on the termination rate. Inter alia, MCI provided evidence of the impact that a three month deposit requirement has on the termination rate. MCI argued that the provisions are disproportionate in relation to the aims of the Credit Vetting Clause.

4.10 MCI stated that Vodafone's credit vetting clause is detrimental to competition. Many fixed network operators have no efficient commercial alternative to direct interconnection with mobile operators and little if any countervailing buyer power.

4.11 MCI's stated that there is no 'objective trigger' for instigation of the potentially onerous Credit Vetting Clause. MCI stated that the Credit Vetting Clause allows Vodafone, at its discretion, to carry out credit checks which it considers are necessary or proportionate, which include, but are not limited to:

- external credit checks using information from appropriate independent external agencies including but not limited to Dun & Bradstreet;
- internal credit checks in relation to the Operator; and
- checks in relation to the directors of the Operator.

[5] 'Run Rate' means the value of the Operator's forecasts for Calls for the month or the value of the Actual Calls made for the preceding month, which ever is the higher multiplied by the Current Weighted Average Termination Rate

4.12 MCI argued that internal credit checks are subjective and difficult to challenge, and that the other checks outlined in the previous paragraph are ‘without limitation’. MCI stated that the only way of ensuring that a dominant supplier does not abuse its position is to insist on a financial security on the basis of an objective trigger, which should be late payment. MCI argued that interpreting information produced by any credit vetting exercise is arbitrary and subjective.

4.13 MCI considered that by invoking the credit vetting clause, Vodafone is reducing its financial risk to zero. MCI further stated that in the provision of services where fixed operators directly compete with mobile operators, such a clause could unfairly allow Vodafone to raise rivals’ costs.

4.14 MCI also submitted a paper, on behalf of a group of operators[6], which sought to address the policy issues that should be taken into account in considering the financial security terms of interconnect contracts with mobile operators. This paper provided argument in support of MCI’s determination requests.

4.15 This paper considered that regulation is justified in respect of Vodafone’s Credit Vetting Clause as competitive pressures are not sufficient to obviate the need for regulatory intervention. Furthermore, after considering that regulation is justified in this instance, it assessed the measures that should be applied. This assessment addressed the appropriate trigger for activating measures to reduce credit risk, the nature of measures and how they are allowed to be applied, and the conditions for releasing a party from any non-standard payment obligations.

4.16 MCI also referred to a policy statement issued by the Federal Communications Commission (‘FCC’) in the matter of the Verizon petition for Emergency Declaratory and Other Relief[7]. In this statement the FCC provided guidance on carriers seeking to revise their deposit and payment provisions. MCI argued that in this paper the FCC recommended that Verizon’s definition of the 'proven history of late payment', which enables Verizon to request a deposit, should be based on failure to pay in any two of the last 12 months.

4.17 MCI also considered how the criteria set out in Regulation 6(8) of the Interconnection Regulations apply to resolution of this dispute. In particular, MCI stated that:

- the Credit Vetting Clause is not in the interests of users;
- the Credit Vetting Clause enables a dominant operator to stifle competition. Such an outcome will reduce the quality of telecommunications services available to users;
- the alternative to direct interconnection with Vodafone is not a commercially viable one, because of the extra cost;

[6] MCI requested that the identities of the operators who support this paper remain confidential
[7] http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-02-337A1.pdf

- the imposition of onerous financial security terms on interconnect agreements will slow the development of a cohesive and efficient network, and are contrary to the need to maintain the integrity of the telecommunications network and the interoperability of services; and
- determining in favour of MCI reflects the market position of the parties. Fixed network operators, despite having ‘monopoly’ control over termination on their networks, do not hold the same degree of market power as Vodafone. The value of services sold by MCI to Vodafone is small compared with those sold by Vodafone to MCI.

Vodafone

4.18 Vodafone stated that it has made every attempt to introduce its credit vetting requirements in a way that is reasonable and proportionate. Vodafone argued that it has considered and incorporated many changes requested by different operators and has continued to negotiate further changes, to ensure that the Credit Vetting Clause is clear and fair.

4.19 Vodafone referred to the Director’s BT credit vetting draft direction in support of its measures. In particular, Vodafone stated that it agreed with paragraph 5.7 of the BT credit vetting draft direction, which states that “the imposition of an effective credit vetting policy, which prevents bad debt from occurring in the first place, is more efficient than taking steps only after the bad debt has been incurred”.

4.20 In addition, Vodafone referred to paragraphs 5.16 – 5.17 of the BT credit vetting draft direction, which states that “the requirements set out in the EC Interconnection Directive (Directive 97/33/EC) and Regulations support the application of a reasonable credit vetting policy. For example, a number of the criteria set out in Regulation 6(8), such as the user interest, the desirability of stimulating innovative market offerings, and of providing users with a wide range of services, will be best served where a solvent operator does not have to bear costs incurred as a result of the financial instability of an insolvent operator”.

4.21 Vodafone responded to ntl’s argument regarding the application of credit vetting to all Operators, and ntl’s request that the rules should only apply to an Operator once it has made late payments on two occasions in twelve months. Vodafone stated that it had not adopted this approach because late payment is not necessarily an indicator of the credit status of an operator. Vodafone argued that the circumstances of Operators can change very rapidly, and that past performance does not act as an effective measure of a party’s ability to meet its payment obligations. Vodafone stated that if an Operator, which has always paid its bills on time, becomes insolvent, Vodafone is exposed to lost charges for up to 90 days before it can take action.

4.22 Vodafone referred to paragraph 5.19 of the credit vetting draft direction in support of its position, which states that “The Director has also obtained evidence from other EU Member States as to how other incumbent operators have

attempted to minimise the financial risk they suffer as a result of operators' insolvency. In all but three Member States the incumbent's reference interconnection offer contains terms on a form of security payment. The need for such payment, in general, is objectively justified on the basis of either the rating of a credit vetting agency, or previous payment history".

4.23 Vodafone stated that its policy is designed to provide as much flexibility as possible to the Operator, and considered that it is more flexible than BT's credit vetting policy. Vodafone argued that this is shown by the fact that its policy includes set-off arrangements. Vodafone also stated that it has shown itself willing to consider any financial security offered by an Operator.

4.24 Vodafone disagreed with the argument that Vodafone's credit vetting clause is out of proportion to its perceived risk, and in practice make it impossible for many Operators to achieve full interconnection with Vodafone. Vodafone provided information showing that it directly interconnects with thirteen operators, and that five of these Operators provide a form of financial security as a result of being designated as a credit risk by a credit vetting agency.

4.25 Vodafone provided the Director with evidence of how two Operators were returned to standard financial terms following a change in the credit vetting report on the Operators in question.

Chapter 5

The Director's draft decision and reasons

5.1 The Director confirmed in the direction in respect of BT's credit vetting policy that he considers it is reasonable in principle for an operator, even one designated as having SMP, to have a credit vetting policy. The direction stated that it is reasonable for operators to take steps to avoid bad debt occurring, as long as the mechanisms employed to achieve this objective are not in themselves disproportionate, resource intensive, do not distort market incentives, and do not raise barriers to entry or expansion. However, this decision emphasised that any policy should be reasonable and proportionate, and should not enable a dominant operator to apply it in a way that would have an adverse impact on competition.

5.2 The Director does not propose to change his views. The criteria set out in Regulation 6(8) of the Regulations, such as the user interest, the desirability of stimulating innovative market offerings, and of providing users with a wide range of services, will be best served where a solvent operator does not have to bear costs incurred as a result of the financial instability of an insolvent operator. Poor creditworthiness on the part of an interconnecting operator is a consideration that can be taken into account by an SMP operator in this regard. The Director's goal of stimulating a competitive market and promoting competition will not be adversely affected if a credit vetting policy is reasonable and does not restrict the ability of operators to compete.

5.3 Both complainants to this dispute have confirmed that they do not dispute that credit vetting is reasonable in principle, even when applied by dominant operators. However, ntl and MCI consider that the manner in which Vodafone seeks to apply it Credit Vetting Clause can enable it to distort competition between it and fixed network operators.

Is it reasonable for Vodafone to carry out Credit Checks on all Operators?

5.4 Under Vodafone's policy, all Operators seeking interconnection agreements ('New Operators') and existing interconnecting operators ('Existing Operators') are subject to credit checks[8], which are carried out in order that Vodafone can assess each Operator's creditworthiness. Vodafone has confirmed that it carries out the following credit checks on all Operators on a quarterly basis:

- external credit checks in relation to the Operator using information from appropriate independent external agencies including but not limited to Dun & Bradstreet;

[8] The terms 'credit vet' and 'credit check' are used interchangeably throughout this document. They both refer to the process by which a service provider ascertains whether an operator constitutes a credit risk.

- internal credit checks in relation to the Operator (Vodafone has confirmed this includes payment history); and
- checks in relation to the directors of the Operator.

5.5 This approach is contrary to the one that BT has adopted. BT differentiates between New Operators and Existing Operators. Under BT's policy, BT credit vets all New Operators, but only vets an Existing Operator when that Operator has made a late payment. If such late payment has been made, credit vetting agency reports and payment history are taken into account for the purpose of identifying the creditworthiness of an Operator.

5.6 ntl has contended that it is unreasonable for Vodafone to carry out credit checks on all Operators, and has referred to BT's approach in this area in support of its argument. ntl has argued that Vodafone's approach is disproportionate, and the Director has been asked to determine that Vodafone be required to adopt the same approach.

5.7 ntl has referred to the BT credit vetting draft direction, which stated that BT's policy 'is a proportionate response to the issue that has been identified, as opposed to immediate application across all Operators with which BT interconnects'. ntl has asked for the reasoning from that draft direction to be applied to Vodafone, which it asserts has equivalent SMP status to BT.

5.8 By way of background, the Director's final position in respect of BT's credit vetting measures was set out in the BT credit vetting direction. In response to the argument that BT's approach of automatically credit vetting New Operators and not Existing Operators constituted undue discrimination between these two categories of Operator, the direction stated the following:

'It is the Director's opinion that the present arrangements do not unduly discriminate between New and Existing Operators, as the differences in arrangements should not have a material adverse impact on competition. Credit Vetting an Operator should not give BT the opportunity to act anti-competitively, and any allegation that this is the practical effect of credit vetting in individual cases can be referred to Oftel for resolution'.

5.9 Therefore the Director has not previously concluded that only credit vetting New Operators on an automatic basis is a proportionate response to the risk posed by insolvency. The Director's position has not changed in this regard. The Director considers that the universal application of credit checks to all Operators does not provide cause for concern, providing that the application of Vodafone's credit vetting clause does not give it the ability to act-competitively. Whether or not the application of Vodafone's credit vetting clause gives it the ability to act anti-competitively is considered further below.

Should the requirement to provide a form of financial security be instigated and withdrawn solely as a result of payment history, or is it reasonable for Vodafone to use credit vetting agency reports to identify when an Operator is a financial risk?

5.10 This determination request relates to the information that Vodafone relies upon when assessing if an Operator constitutes a credit risk. It has been argued that when dealing with a dominant operator, the primary source of information for assessing credit risk should be an objective one based on payment history. In making this request, it has been stated that the use of credit vetting agency reports to assess whether an Operator is a credit risk provides too much scope for subjective interpretation of the results.

5.11 Before considering this request, it is necessary to set out how Vodafone's credit vetting clause works in practice. Under this clause, Vodafone may issue a 'Financial Security Notice' requesting financial security from an Operator if an Operator has been designated as a 'Credit Risk' following a credit check.

5.12 An Operator may be judged a Credit Risk, and may be required to place a form of financial security with Vodafone, if (in relation to a credit check carried out by an external credit agency), any of the following events occur:

- the report produced by an external credit agency indicates that the recommended credit level each month is less than Run Rate for that month;
- the report produced by an external credit agency indicates that it is advisable to obtain financial securities.

5.13 The direction in respect of BT's credit vetting policy stated that credit vetting by operators in other Member States is objectively justified by either the rating of a credit vetting agency, or previous payment history. In the BT credit vetting direction, the Director did not dispute the use of credit vetting reports as a method for assessing the creditworthiness of an Operator.

5.14 The Director is minded to conclude again that the use of reports generated by external credit vetting agencies is a legitimate method of assessing the creditworthiness of an Operator. Such reports aim to provide objective and non-biased data on the financial viability of an Operator.

5.15 During the course of the Director's investigation, ntl stated that it has obtained a third party report which contradicts the credit vetting report utilised by Vodafone to assess ntl's credit risk. ntl argued that this highlights the need for late payment to be used as the means by which an Operator is deemed to constitute a credit risk, as it does not leave scope for such conflict.

5.16 However, Vodafone's Credit Vetting Clause states that the Operator may provide at its option information regarding its financial situation, and Vodafone is required to consider such information. In addition, Vodafone has signalled its

willingness to incorporate dispute resolution provisions into the agreement. Therefore if an Operator disputes the way in which a credit vetting report and any other information utilised by Vodafone has been taken into account by Vodafone, it can be referred to a third party for resolution. The drafting of these provisions is currently being negotiated between ntl and Vodafone, and therefore is not considered further by the Director at this time.

5.17 Furthermore, an operator can provide additional information directly to the credit rating agency. Vodafone considered that a certain Operator's credit rating had, in the past, been altered following representations made by that Operator to the independent credit rating agency. Following this alteration, Vodafone extended more credit to the operator. This has been confirmed to the Director by the operator in question. The Director would expect organisations to liaise with such agencies on an ongoing basis in order to ensure that credit ratings in respect of that company is appropriate. ntl has stated that it does so.

5.18 Vodafone's Credit Vetting Clause also requires it to carry out quarterly reviews of an Operator's credit status once that Operator has been deemed a Credit Risk. The Director considers that this process provides an appropriate opportunity for a requirement for financial security to be withdrawn if it is no longer appropriate. Vodafone has provided the Director with evidence of cases where an Operator has been returned to normal credit terms following a change in independent credit vetting agencies credit rating of that Operator.

5.19 It has been put to the Director that the 'internal credit checks' that Vodafone takes into account when assessing an Operator as a credit risk are not sufficiently defined. The Director notes Vodafone's statement following the referral of this dispute that it does take late payment into account when carrying out an internal credit check on an Operator. The Director considers that for reasons of transparency, Vodafone should amend its New Agreement to explicitly state the type of late payment that is taken into account when classifying an Operator as Credit Risk. For example, BT's policy states that late payment in this case is defined as two late payments in any consecutive twelve months.

5.20 As a result of the dispute resolution provisions still under negotiation between ntl and Vodafone, it is expected that an Operator will be able to refer a dispute to an appropriate third party if it considers that its designation as a credit risk is unreasonable. The Director would expect that the third party would be able to consider both the application of the Operator's agency report and any other evidence submitted by the Operator.

5.21 In arguing that the basis for the instigation of Vodafone's credit vetting clause is not objective, MCI put it to the Director that this clause can be applied in a manner which is both inefficient (in that it discourages direct interconnection) and anti-competitive. If an Operator is passing a significant amount of traffic for termination on Vodafone's network it will normally be efficient for that operator to interconnect directly with Vodafone. MCI stated that where the value of the traffic

being passed from an Operator is much less than the value of traffic being passed from Vodafone to the Operator, that Operator has no countervailing power in dealings with Vodafone. As a result, MCI argues that this lack of countervailing buyer power provides Vodafone with very strong leverage to set the terms for direct interconnection. Furthermore, it has been stated that credit vetting allows Vodafone to discourage direct interconnection, thereby removing Vodafone's credit risk and increasing originating operators' costs, by forcing them to use third party transit services.

5.22 In considering this argument, the Director has assessed the extent to which Operators interconnecting with Vodafone have been required to place a form of security. Information received from Vodafone indicates that there are a number of cases where Vodafone has not requested a form of financial security from a fixed-network originating operator. The Director is currently of the view that this evidence suggests that Vodafone has been attempting to minimise its credit risk appropriately, as opposed to preventing interconnection to remove its credit risk.

5.23 In addition, the Director has considered whether the imposition of a requirement to provide a form of security to Vodafone distorts competition. It is necessary to differentiate between the impact that a requirement for security may have on a competitor, and the impact that such a requirement may have on competition within a market. An impact on competition is something that will alter the behaviour of firms in the market, or the structure of the market, in an adverse way – for example, by giving a firm a strategic advantage or raising a barrier to entry.

5.24 The Director does not dispute that the imposition of a requirement to provide a form of financial security has a cost impact on a competitor, and this is discussed later in this document. However, as has already been stated, the evidence provided to the Director during the course of the investigation indicates that Vodafone has a range of security arrangements in place, including no security, with a mix of operators. The Director does not believe at this stage that this evidence supports a view that Vodafone is seeking to use credit-vetting procedures to reduce competition, either by deliberately attempting to raise rivals' costs or by giving itself a strategic advantage.

Should Vodafone's New Agreement be amended to provide Operators with the option to make more frequent/rapid payments, pursuant to receipt of an invoice, instead of providing a payment in advance or a bank guarantee, in the event that the Operator is deemed a credit risk?

5.25 The Credit Vetting Clause states that if an Operator has been deemed to constitute a Credit Risk, Vodafone may at its option issue a Financial Security Notice. In such a scenario the Operator selects one of the financial securities specified in the Financial Security Notice, or such alternative financial security that is agreed in writing between the parties.

5.26 Examples of financial securities are outlined in the Credit Vetting Clause:

- a deposit equal to three times the monthly Run Rate, calculated from the month in which the Financial Security Notice is dated.
- a bank guarantee for an amount equal to three months Run Rate;
- payments to Vodafone on a monthly in advance basis equal to the Run Rate;
- a set off arrangement whereby Vodafone may set off and withhold against invoices due any debt or sum owing by Vodafone under any agreement entered into between Vodafone and the Operator for the duration of the period during which the Financial Security is requested; and
- any combination of the above securities or other financial security agreed between the parties in writing.

5.27 In its determination request, MCI stated that it should have the option to make more frequent/rapid payments, pursuant to receipt of a Financial Security Notice, instead of providing a deposit, a payment in advance or a bank guarantee.

5.28 Under Vodafone's standard payment terms, an Operator has 30 days in which to settle an invoice. On the assumption that it takes Vodafone 3 days to raise an invoice, this means that an Operator has to pay 33 days after the end of the month. This essentially equates to 48 days credit for the Operator (measuring to the middle of the month of service).

5.29 MCI has essentially requested that an Operator should have the option of settling an invoice more speedily after receipt of that invoice. This would reduce the amount of credit extended to the Operator. For example, an Operator may make payments 15 days after receipt of an invoice, which equates to 33 days credit, reducing Vodafone's credit risk.

5.30 In support of its argument, MCI considered the appropriate instruments that may be used to reduce credit risk. It argued that in the commercial world, contracting parties typically agree on more frequent payments and/or more rapid payments more readily than they agree to payments in advance, deposits or bank guarantees. MCI stated that payments in advance, deposits and bank guarantees are by contrast expensive and burdensome, and have a negative impact on cash flow. MCI has argued that allowing a mobile operator complete freedom to apply security deposits, bank guarantees or payments in advance imposes excessive and unnecessary cost and uncertainty on the industry.

5.31 As a result, MCI has asked the Director to determine that an Operator seeking interconnection services from Vodafone should be able to make more frequent/rapid payments to reduce the credit cycle before more severe remedies such as advance payments, deposits and bank guarantees are considered.

5.32 In assessing what constitutes an appropriate financial security measure, the Director is minded to agree with MCI that it is necessary to strike a reasonable balance between the interest of the operator providing services in guarding itself against bad debt and the interests of the Operator in avoiding an obligation which would have an unduly adverse impact on its cashflow.

5.33 In reaching a position on the impact of certain financial security measures that Vodafone may seek to employ, the Director has considered the cost impact that each measure might have on an Operator. The Director's analysis is set out in Annex A. This analysis assumes a hypothetical operator has monthly mobile termination costs of £1,000,000, with services provided evenly over the month. Under normal circumstances, the Operator is extended 48 days' credit. The analysis calculates the effect on cash flow of moving to a variety of financial security arrangements and the monthly cost of this cash flow impact assuming a cost of capital of 13.5 per cent.

5.34 It can be seen from this analysis that some financial security obligations have a greater monthly cost than others. For example, a deposit equal to three times the run rate has a monthly cost of £31,826, while an arrangement where an Operator pays monthly in advance has a monthly cost of £24.046. In contrast, an arrangement where an Operator makes twice-monthly payments at the middle and the end of the month of service has a monthly cost of £14,322. An arrangement whereby an Operator makes twice monthly payments at the start and the end of the month has a monthly cost of £16,974.

5.35 The Director has been asked to require that Vodafone offer Operators the opportunity to make more rapid or frequent payments rather than requiring a security deposit, bank guarantee or advance payment. In referring this matter to the Director, MCI has argued that Vodafone's financial security measures are not reasonable, as they eliminate Vodafone's credit risk.

5.36 However the Director is not minded to conclude that this is always the case, as all measures, with the exception of set off, result in some residual risk for Vodafone. For example, and as set out in Annex A, a scenario where an Operator makes twice monthly payments, with one in the middle of the month of service and the other at the end means that 15 days charges are outstanding when the payment falls due. It will take 33 days for a breach notice to be issued and service to be suspended, which results in a potential exposure to Vodafone of 48 days charges.

5.37 Full set off does result in Vodafone's credit risk being eliminated. However, set off has countervailing benefits for the Operator in that it is no longer required to extend credit to Vodafone. This benefit (under the assumptions set out in the appendix) means that the cost to the Operator of this form of financial security is nil.

5.38 The introduction of more rapid payment periods pursuant to the issue of an invoice will have less of a monthly cost than alternative financial security arrangements such as a requirement to place a three month deposit. However, it will not reduce Vodafone's credit risk as significantly as other financial security arrangements.

5.39 The Director can envisage circumstances where this arrangement could be seen as being a mutually beneficial outcome following commercial negotiations. However, requiring Vodafone to offer more frequent/rapid payments may not in all cases represent an appropriate balance between the interests of Vodafone and the interests of the Operator. It may be fair and reasonable in the circumstances of a particular case to initially allow for a significant reduction in credit risk. Therefore it would not represent a fair balance between the interests of the parties to require Vodafone to always agree more frequent/rapid payments in the first instance. The Director does not therefore propose to determine that Vodafone be contractually required to offer such an arrangement in advance of other forms of financial security.

5.40 However, MCI has also argued that Vodafone's Credit Vetting Clause provides Vodafone with unreasonable discretion regarding the financial security that can be requested from an Operator. The Director is keen to ensure that an affected Operator is given sufficient flexibility to provide a form of financial security that would effectively mitigate Vodafone's credit risk without being unduly costly to the Operator. The drafting of the Credit Vetting Clause does not currently indicate that this is the case, as it states that in the event that an Operator constitutes a credit risk "Vodafone may at its option issue a Financial Security Notice and the Operator shall select one of the financial securities specified in the Financial Security Notice and provide the selected Financial Security or such other financial security as is agreed in writing between the parties". Therefore on a literal reading Vodafone is able to limit the options for financial security by way of the Financial Security Notice.

5.41 What may be an appropriate security is likely to depend on the case at hand, and therefore it is not feasible for the Director to specify in this direction what type of security an Operator should provide in the event that it has been designated as a Credit Risk. However, it may be appropriate for more rapid payment periods to be introduced in a scenario where the Operator constitutes a limited financial risk. The Director proposes that negotiation, backed up by effective dispute resolution provisions, should enable a proportionate and reasonable security to be agreed in any particular instance. Vodafone should therefore be required to reasonably endeavour to reach agreement on the alternative forms of security which may be provided by an Operator who has been determined to be a Credit Risk. Such a position is consistent with the approach taken in the BT credit vetting direction, paragraph 4.5 of which stated:

"BT would be expected to endeavour to agree terms with that Operator that would enable that Operator to continue trading. Such terms may include more frequent

payments, the set-off of payments, or any other terms that may be agreed between the parties. The facts of each particular case will no doubt differ, and what may be appropriate for one Operator may not be appropriate for another. Differences in arrangements that do not give rise to competition concerns are unlikely to be considered discriminatory, providing that any measures adopted to suit the position of a particular Operator are reasonable and justifiable in the circumstances".

5.42 It should be noted that evidence provided to the Director during the course of the investigation indicates that Operators do in practice have scope to negotiate the type of financial security that may be provided. However, as indicated in paragraph 5.40, the drafting of the Credit Vetting Clause should reflect this.

Chapter 6

Consultation and timetable for responses

6.1 The Director General's draft decision is being made available to interested parties, together with the Director General's reasons, so that they may have a reasonable opportunity to make representations.

6.2 Please e-mail or send comments in writing to:

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50 Ludgate Hill
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6.3 Oftel is applying a ten working day consultation period in this case, therefore comments on this consultation must be sent to Oftel by 19 June 2003. As set out in paragraph 1.4 of this document, the new regulatory regime for electronic communications networks and services is due to come into effect on or after 25 July 2003. Under the new procedures[9], consultations will usually be open for ten working days. Oftel is applying these new procedures to this dispute.

6.4 Oftel does not intend on this occasion to hold any comments-on-comments phase during which observations may be made on the representations made by others. Nevertheless, in the interests of transparency, all non-confidential representations will be published.

6.5 Confidential responses should not be sent via e-mail. Written comments will be made publicly available in Oftel's Research and Intelligence Unit, except where a respondent indicates that a response, or part of it, is confidential. Respondents are therefore asked to separate any confidential material into a clearly marked annex. In the interests of transparency, respondents are asked to avoid confidential markings wherever possible.

6.6 The final Direction will be made as soon as possible after the end of the above mentioned consultation period

[9] See 'Dispute resolution under the new EU Directives – a statement by Oftel and the Radiocommunications Agency' at http://www.oftel.gov.uk/publications/eu_directives/2003/eud0203.htm

Annex A

Credit terms comparison

Basic assumptions

- X provides mobile termination services to Y
- Y also provides equivalent value telecommunications services to X
- Financial security arrangements are imposed by X on Y
- The services are provided evenly over each month
- Under normal circumstances X and Y are required to pay each other 30 days after receipt
- Invoices are received three days after the end of each month for services received in that month
- Measuring to the middle of the month of service (MOS), each operator therefore receives 48 days credit
- Where payment is missed, a breach notice is issued in 3 days, and service is suspended 30 days later.
- Impact of each scenario is assessed against normal payment terms as a benchmark.
- Monthly termination costs £1,000,000
- Annual discount rate 13.500%
- Monthly discount rate 1.061%

Scenario	***Payment terms***	***Days credit***
1	Normal payment terms	48
2	Payment 15 days after receipt of invoice	33
3	25% on each of the 1st, 8th,15th,22nd of MOS	-3.5
4	50% on 15th and 50% on 30th MOS	7.5
5	50% on first and 50% on 30th of MOS	0
6	Monthly in advance 5 days before MOS	-20
7	3 month deposit	-42
8	Full set off	0

Scenario	***Cash Flow Impact(£)***	***Cost of Capital (per month) £***	**Max likely V exposure, days**	**Min likely V exposure, days**	**Days exposure saved**	**Cost per day of exposure saved £****
1	0	0	96	96	0	N/a
2	-500,000	5,304	81	81	15	354
3	-1,716,667	18,211	34	34	62	294
4	-1,366,667	14,322	48	48	48	298
5	-1,600,000	16,974	48	34	48	354
6	-2.226.667	24,046	28	28	68	354

7	-3,000,000	31,826	6	6	90	354
8	0	0	None*	None*	96	0

*Under assumptions no exposure. Exposure could however result if Y ceased or scaled back services.
**Monthly cost to Y of a reduction of one day in X's exposure as a result of the financial security arrangements