



Virgin Media's comments on BT's response to Ofcom's Draft Determinations dated 9 February 2012 to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services

18th May 2012



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1. EXECUTIVE SUMMARY

Virgin Media continues to broadly support Ofcom's approach to resolving these Disputes as outlined in its earlier response. It disagrees with the submissions made in BT's response.

1.1 We are responding to Ofcom's letter of 4 May 2012, offering the opportunity to comment on BT's response¹ to Ofcom's provisional findings in the Ethernet disputes.

1.2 Our comments made in our own response dated 20 April 2012 remain valid, and we consider, remain very relevant in addressing the issues that BT seeks to raise in its response. In this additional submission, we seek to highlight some matters that we consider would usefully assist Ofcom in its determination of the dispute, but we do not seek to address every issue raised in what is a very lengthy document. Where we do not address a matter, it should not be taken that we agree with BT's views either in whole or in part.

1.3 We are particularly concerned to comment on the following sections of BT's response:

Connections and Rentals;

DSAC errors; and

"Nascent market" and similar considerations

In this response we deal with each of those sections in turn, but in summary, we consider that:

1.4 Connections and rentals should not be regarded as a single service and that it is appropriate that the basis of charges obligation applies to both services individually. We consider that the meaning of the SMP condition is clear. There are sound reasons for treating connections and rentals separately, from both factual and regulatory perspectives. Further, we consider that BT's analysis of the effect of aggregation is neither directly relevant in terms of compliance with the obligation nor complete as it omits to consider effects on BT's competitors.

1.5 BT's proposed methodology change to determine DSACs should not be permitted. The purpose of Ofcom's adjustments are clear, and ensure a consistent approach between this dispute and other related regulatory decisions taken by Ofcom. BT's identified "error" relates to their cost allocation methodology and is designed to shift costs from one area to another; it is not the case that costs have not been recovered under their existing

¹ BT's response to Ofcom's Draft and Provisional Determinations and Conclusions to resolve disputes between BT and each of Sky, TalkTalk, Virgin Media, Cable and Wireless and Verizon regarding BT's charges for certain Ethernet services dated 20 April 2012



methodology. It would be inherently unfair, not on BT, but on BT's customers if this adjustment was made, and would undermine the regulatory regime going forward.

1.6 Virgin Media do not accept that this market was "nascent" in the manner that BT suggests. Retail products that formed the basis for wholesale products were well established and both their costs and demands were well known to BT. The nature of the market was fully taken account of by Ofcom in setting the basis of charges condition in the first place.

1.7 Virgin Media continues to broadly support Ofcom's approach to resolving these Disputes, and submits that Ofcom should not be distracted by the lengthy, but what we consider to be, flawed arguments raised by BT to reduce genuine repayment liabilities. In particular, we encourage Ofcom to now conclude these outstanding Disputes as soon as reasonable practicable in accordance with their obligations under the Act.

2. CONNECTIONS AND RENTALS

2.1 BT seeks to differentiate the position in the PPC judgement which specifically considered different bandwidth, trunk and terminating segments from the aggregation of Ethernet connections and rentals, which it contends is “one service”², that of network access.

2.2 The basis of charges condition HH3.1 requires BT to ensure that “*each and every charge, offered payable or proposed for Network Access covered by condition HH1 is reasonably derived from the cost of provision....*”.

2.3 This wording is familiar to BT from a variety of markets in which it has been found to hold SMP, and a basis of charges obligation imposed. Network Access is, as found by the CAT in their PPC judgement³, defined in very broad terms in section 151(3) of the Act. In short, the term Network Access, as used in SMP conditions in this market and in many other markets is not restricted to a meaning of “connection plus rental” for any service, and basis of charges conditions apply to all services offered within the market.

2.4 Equally, it cannot be said that connection and rentals must be regarded as a single service within a wider umbrella of Network Access. The two services have completely separate functions and purposes and, as Ofcom stated could give rise to cross subsidisation between customers. This is as true in this market as it is in the wide number of markets where rentals and connections are subject to forms of price control, including separate requirements under charge controls, for example rental and connection services being separately controlled, or subject to sub cap controls within a basket.

2.5 There is no de facto ‘linear’ relationship between connection and rental: they may, for example, be purchased at different times and in differing proportions.

2.6 Virgin Media is strongly of the view that connection and rental charges each have economic significance in their own right. In practice the level of, or change in, each of them is assessed separately for the purpose of developing or reviewing business cases. Their relative weightings in any business case will also vary by purchaser, depending in particular on the anticipated duration of the contract. The cross subsidisation to which aggregation of these two charges could give rise therefore presents, ultimately, a risk of market distortions.

2.7 In this particular market it is particularly significant that a significant proportion of customers migrated from LES to WES services, and as such did not require “connection” service, and therefore could be significantly disadvantaged if rentals were cross subsidising connections. The only charge, on such a migration, in addition to the rental was an administrative circuit migration charge. It is significant that in 2007, whilst the connection charge for a WES 10 circuit was £2,200⁴ (per local end), the cost to migrate a LES 10 to a

² BT Response para 169

³ Paragraph 225 : British Telecommunications Plc v Office of Communications (Partial Private Circuits) 2011 CAT 5, Judgment of 22 March 2011 (<http://www.catribunal.org.uk/238-5136/1146-3-3-09-British-Telecommunications-Plc.html>),

WES 10 was £37⁴. This example directly contradicts BT's assertion that "*no customer would ever be allowed to pay a rental to use a service without having first paid the connection fee*"⁵

2.8 BT states that Ofcom's analysis of 07/08 data is not representative of subsequent years. Irrespective of whether there was cross subsidisation between services, this analysis, in our view, misses the point of the obligation. The requirement for each service to be cost orientated follows from the identification of a relevant risk of adverse effects arising from price distortion as identified in the market review. That BT seeks to demonstrate that cross subsidisation did not occur does not relieve them of the obligation. This goes to the point made by the CAT in the PPC judgement⁶, that the need to show economic harm of any sort is not a pre-requisite for a finding that the Condition has been breached.

2.9 It is also significant that the relative balance between connections and rental charges affect not only BT's customers, but also BT's competitors who have their own network, such as Virgin Media. This is a factor that is not taken account of by BT in their response at all.

2.10 BT also suggests that proposed international accounting standards⁷ and best accounting practice support its views on the aggregation of rentals and connections⁸. Virgin Media notes that such standards and practice are irrelevant to BT's RFS, which are produced pursuant to an SMP obligation with the sole purpose of monitoring compliance with other SMP obligations.

⁴ Prices quoted from 30 June 2007: WES charge effective from 14 Jun 07 (ACCN OR036); LES charge effective from 17 Jan 05 (ACCN OR020)

⁵ BT response paragraph 169

⁶ Paragraph 327 [2011] CAT 5

⁷ BT acknowledges that the standards they rely upon have "not yet been adopted", which is especially significant in the context of a historic dispute.

⁸ BT response section 5.5 – 5.6

3. DSAC ERRORS

3.1 BT contend that the change to the basis upon which they now calculate their RFS is as a result of an “error” which means that previously stated DSACs in the RFS are “not fit for purpose”.

3.2 BT suggest that the “error” they discovered in their RFS should be treated in the same way as the errors identified by Ofcom when it made its own adjustments to the RFS.

3.3 Virgin Media consider that there are four key points that it important for Ofcom to consider:

- 3.3.1 the nature of the adjustments made;
- 3.3.2 regulatory consistency;
- 3.3.3 the role of Ofcom as regulator; and
- 3.3.4 proportionality.

The nature of the adjustments made

3.4 Ofcom's starting point was to use the published DSACs adjusted for “factual errors”⁹. By this it meant volume errors and adjustments made in the 2009 Leased Lines Charge Control to the extent they were relevant. This approach concurs with the CAT's view that where there is no error, BT's RFS should stand without great investigation or adjustment by Ofcom¹⁰.

3.5 Virgin Media notes that Ofcom devoted a considerable amount of time to this issue in the draft determination. In particular, Ofcom commented that it had “reviewed in detail the outputs of BT's LRIC model”¹¹. They found that there was no obvious mathematical error, nor was their approach to calculating DSACs obviously inappropriate. Mathematical error, in this context, does not equate to using the wrong formula or wrong methodology. BT appears to be trying to stretch Ofcom's wording to suit its purpose. It is of note that BT previously conceded that it was not a calculation error, but the calculation method that was wrong¹².

3.6 Virgin Media does not regard the change in cost allocation methodology as an error that is required to be corrected.

⁹ Paragraph 11.44 Ofcom draft determination

¹⁰ Paragraph 161 [2011] CAT 5

¹¹ Paragraph 11.57 Ofcom draft determination

¹² Paragraph 11.58 Ofcom draft determination

Regulatory consistency

3.7 Ofcom is required by section 3(3)¹³ of the act to have regard to the principle of consistency when discharging its regulatory duties.

3.8 BT's "error" involves significant amounts of cost being reallocated to Ethernet services from other services including PPCs. If an adjustment was made in this regard, in excess of £200m would be reallocated away from PPCs. The previous methodology was relied upon by Ofcom to set ex ante controls¹⁴ and determine disputes including the level of overpayment by CPs to BT. Moreover, it has been relied upon by CPs in the course of developing their business plans in the legitimate belief that it was the enduring standard.

3.9 BT suggest that it is inherently unjust for Ofcom not to correct for their "error" as this will, in their view, result in excessive repayments to CPs. In fact, it would be inherently unfair to BT's customers to shift cost in this way, meaning that, when faced with a dispute about overcharging in earlier years, BT could significantly improve its position on repayment.

3.10 Of course, any improvements to BT's RFS going forward can be agreed, as has occurred in this case. What should not be permissible is for the methodology to be retrospectively altered when this would create incompatible and inconsistent results in relation to the dispute determination on services with linked and shared costs.

3.11 Ofcom recognised this when it identified the need to make adjustments to BT's RFS in this dispute. The primary purpose for the adjustments was to ensure consistency between its regulatory approach in the LLCC and PPC disputes.

The role of Ofcom as regulator

3.12 BT also suggest that Ofcom is unfair in making certain adjustments, but not also adjusting for their proposed "error". Virgin Media would suggest that BT has fundamentally misunderstood the regulatory obligations of both Ofcom as regulator and itself as a regulated entity subject to SMP obligations.

3.13 Firstly, it is for BT to demonstrate compliance with the basis of charges obligation¹⁵. BT was under an obligation imposed by Ofcom to ensure that its prices were cost oriented. The burden was on BT to show to the regulator that this was the case; they failed to discharge that burden. In those circumstances, Ofcom was entitled to determine, in its own judgement, whether BT was complying with the basis of charges obligation. As the CAT determined in the PPC case, Ofcom has a discretion as to how it makes that determination. It is able to consider DSAC (as a potential method of assessing compliance), and as the regulator is entitled to make reasonable adjustments to costs and data supplied.

3.14 Stakeholders, are in a wholly different position, and for BT to suggest that a self-serving change in cost allocation methodology is a required adjustment, does not provide an

¹³ Communications Act 2003

¹⁴ Leased Lines Charge Control 2 July 2009

¹⁵ Paragraph 297 [2011] CAT 5

entitlement for that adjustment to be made. It is for Ofcom to consider the representation in the round, and Virgin Media would emphasise the need to consider the need to ensure consistency of decisions in this regard.

3.15 It is also wrong for BT to categorise Ofcom's proposed repayments as amounting to a fine for a mistake in its RFS¹⁶. The CAT held that¹⁷ repayment does not amount to fining BT.

Proportionality

3.16 Ofcom are also required under section 3(3) of the Act to have regard to proportionality.

3.17 In this regard and notwithstanding our concerns about the implications of correcting for BT's suggested "error" on the outcome of this dispute, we consider that the wider implications of making that adjustment would be hugely disruptive to the market, leading ultimately, to detrimental consequences for end users. Furthermore, the confidence of BT's customers would also be fundamentally undermined, as future certainty around the retrospective stability of the RFS would be removed at a stroke.

3.18 Ofcom have already proposed to take into consideration any anomalous DSAC/FAC ratios when considering whether or not overcharging has taken place¹⁸, which Virgin Media considers to be a more appropriate and proportionate approach in the circumstances.

¹⁶ BT response ES24

¹⁷ Paragraph 338(3) [2011] CAT 5

¹⁸ Paragraph 11.53 Ofcom draft determination

4. “NASCENT MARKET” AND SIMILAR CONSIDERATIONS

4.1 BT suggests that Ofcom has failed to give sufficient consideration to the fact that the Ethernet market was a new and evolving market at the time of the disputed charges.

4.2 In fact, as BT notes Ofcom did discuss the fact that the retail market was well understood, and therefore Ethernet products at the retail level were established and could not be described as new. This is also relevant to the inherent “riskiness” of the launch of an associated wholesale product. The launch of such a product as a genuinely new venture is wholly different from the situation here, where BT was launching wholesale products into a market with an already established and sizable retail market.

4.3 Clear evidence of this link between retail and wholesale products can be seen by manner in which CPs were allowed to migrate their retail LES products to wholesale WES products. The cost of migration (£37 as detailed above for a LES10/WES10 migration) amounted to an administrative cost to adjust the account. We understand that no technical work was required for the migration, nor were any other costs incurred, meaning that the cost of provision for a migrated WES circuit would be well known to BT. To suggest that “*BT was acting without the benefit of experience*”¹⁹ and “*There was so much uncertainty as to costs*”²⁰ is simply not accurate.

4.4 BT suggest that the fact that retail products were well understood is “simply not material”²¹ in light of the 2004 LLMR²² and subsequent Undertakings that created Openreach. They provide no further comment on why this is not material, despite the fact that it is a clearly relevant factor, which has been taken properly into account by Ofcom.

4.5 In fact, Ofcom specifically considered the state of the AISBO market in the 2004 LLMR. Ofcom considered whether to impose a price control on AISBO services, but took the view that the market was in “a relatively early stage of development”²³, and whilst it was appropriate to impose a cost orientation obligation, it would not impose a more stringent price control, and would further consider the issue when the market was next reviewed. :

4.6 Additionally, Ofcom also commented that the cost orientation obligation allowed for new services that, on a case by case basis could “*warrant a different regulatory approach*”²⁴, although it is of note that BT did not seek any such variation for new products.

4.7 It is clear from the above that Ofcom fully took the state of the market, including that the services were new wholesale offerings, into account when imposing the basis of charges obligation. It would be a form of double counting for BT to suggest that, having avoided the imposition of a more stringent charge control remedy *ex ante* due to the relatively early stage

¹⁹ BT response paragraph 336

²⁰ BT response paragraph 341.1

²¹ BT response footnote 204

²² Ofcom Leased Lines Market Review 2004

²³ Ibid paragraph 7.63

²⁴ Ibid paragraph 7.59



of development of the wholesale market, they should also benefit *ex post* in a way that loosened the SMP condition.