Vodafone's response to Ofcom's consultation

Changes to BT and KCOM's regulatory and financial reporting 2013/14 update

January 2014

VODAFONE

Headquartered in the UK, Vodafone is a global business investing and innovating in all the markets we serve to deliver for our customers. Our home market is no exception and Vodafone in the UK has now successfully integrated the former fixed line business of Cable & Wireless Worldwide resulting in the creation of a genuinely unique converged communications provider. With £2.5M being invested each day in our UK network, we remain committed to delivering the very best for our customers.

INTRODUCTION

We welcome this opportunity to respond to Ofcom's proposals to change the regulatory accounting output for 2013/14. Regulatory Accounting is a key part of the regulatory regime, forming a vital part of the assurance wrap to indicate if BT has met its regulatory obligations where market failure exists and SMP remedies have been imposed. In setting regulatory remedies around price, Ofcom is seeking to protect consumers of all types from the impact of market failure by replicating as far as is possible the outcomes achievable in a competitive market.

Although Ofcom is retreating from remedies like cost orientation, the requirement for robust regulatory accounting information has never been greater and it remains a vital part of being able to understand if the prices charged in SMP markets have been both fair and efficient, absent from the normal incentivising impact that competition would bring.

The focus of this consultation is on the content of the forthcoming regulatory accounts to be published in the summer of 2014, with wider policy questions around reform of the regulatory accounting regime contained within a parallel consultation. Nonetheless, it is important not to overlook on-going stakeholder concerns that the current regulatory accounting regime affords BT far too much discretion, enabling it to shape its regulatory accounting output to fit its own commercial objectives, shifting common costs between products to improve outcomes for its own business in charge control setting and disputes, thus falling well short of the unbiased and matter of fact reference material that it should be. The continued practice of restatement or the introduction of very material changes in attribution or valuation decisions from year to year erodes confidence and reminds us of the urgent need to overhaul the regime to provide stakeholders with stable, reliable, unbiased and usable information. While we appreciate that these very significant issues will not be addressed as part of this particular consultation and we will of course be responding in detail to the policy consultation, we remain mindful of the need for a new approach to ensure consumers are protected as far as possible from the impact of market failure, with the regulatory accounts becoming the reliable point of reference that they should be.

PROVIDING TRANSPARENCY ON SMP PROFITABILITY

The cycle of market reviews and charge controls creates a considerable burden on Ofcom and stakeholders. The regularity and urgency to complete each review or charge control generates a risk of a blinkered approach to project completion. We consider there is an urgent need to stand back and take a more general appraisal of how BT is performing as a regulated entity to ensure that the market review process is better informed and remedies are set appropriately.

As Ofcom is aware Frontier Economics undertook a review of BT's past financial performance of regulated service markets where price regulation existed[1]. This review looks back at a seven year period 2006 to 2013, concluding that BT has earned revenues of £4.9bn more than if its returns on capital were consistent with its WACC. We consider that this information is squarely in the public interest and should be produced routinely and made accessible to all stakeholders, with the regulatory accounts representing the ideal place to publish it.

We believe this information could easily be incorporated in the 2014 published output, giving stakeholders access to information around BT's profitability on all regulated services in aggregate, that isn't obscured by the need for additional adjustments (such as RAV). This simple output would help scrutinise the overall level of profitability achieved across SMP markets, putting into context any attempt to shift costs between markets. Although the regulatory accounts provide much of the underlying data, it is not currently presented in an understandable way, with calculations and adjustments required before BT's true level of profitability on regulated services is apparent. The proposals to re-format the regulatory accounts to align them with individual market reviews, while appearing logical also somewhat obscures that aggregate position on overall regulated profitability reporting. The introduction of an annual profitability statement either produced by BT (to an Ofcom specification) or by Ofcom itself to accompany BT's regulatory accounts would be an important step forward in providing visibility to stakeholders. This annual statement, covering all regulated services will allow for an understanding of how much profit is being made by BT in each SMP market utilising BT's common cost base and how that has evolved over time.

We are in no doubt that Ofcom is able to impose such additional regulatory obligations pursuant to the provisions of section 87 of the Communications Act governing SMP operators. These provisions confer expansive powers upon Ofcom to stipulate the conditions governing accounting methods in circumstances where accounting separation has been mandated, categories of cost and significantly the rules to be applied for the purposes of a cost accounting system. If Ofcom so wished the information could be produced as an Additional Financial Information (AFI) document and not as a section in the Current Cost Financial Statements.

[1] http://www.frontier-economics.com/_library/publications/frontier%20report%20-%20bt%20regulated%20profitability.pdf

Such a modification would attain Ofcom's obligations to promote transparency and principles of best regulatory practice as envisaged by section 3 of the Communications Act. Equally importantly, Ofcom's obligations to realise the objectives mandated by the harmonised EU regulatory framework would be attained through the modification that Vodafone proposes. The modified obligation would relate to the regulatory framework governing BT across a wide range of product markets where BT controls access to inputs critical to the intensity of competition in downstream markets. A revised RFS obligation requiring enhanced levels of transparency and potentially resulting in more effective regulation at an upstream level would thus clearly operate to improve competition and ultimately consumer outcomes in a wide range of retail markets.

The modification would be very limited in terms of the additional burden that it imposes upon BT and is thus entirely consistent with the principle of proportionality.

PROPOSAL ON THE REMOVAL OF PUBLICATION OF DSAC & DLRIC

We continue to have significant concerns over Ofcom's proposals in relation to the lack of disclosure of DLRIC and DSAC information. Ofcom has not provided stakeholders with any guidance around when it will use DLRIC and DSAC information available to it.

Clearly Ofcom sees merit in preserving the ability to access DLRIC and DSAC information, even if it does not form part of a publication obligation, yet stakeholders have little idea how Ofcom would make use of this information. As it stands these proposals enable Ofcom to access the data if they think there may be a problem, but at the same time prevent stakeholders from getting to see it, thus helping Ofcom avoid external pressure from stakeholders who will be kept in the dark about the criteria that Ofcom will assess the information under and also be prevented from seeing the information itself.

This is not a satisfactory outcome for stakeholders and Ofcom must set out clearly how it intends to use the information in the future and at the same time provide adequate disclosure to stakeholders. It is our firm view that there must be a means of judging if charges in regulated markets are appropriate for the circumstances to see how effectively the issue of market failure is being addressed by regulated pricing remedies.

It is therefore important for this detail to remain visible and that year to year comparisons are made possible. There are many examples of where information ultimately proves to be both poor and unreliable due to poor disclosure. If stakeholders are to have trust in the process then we should have the same level of access to DSAC and DLRIC data for regulated products as Ofcom. Stakeholders themselves remain instrumental in ensuing the appropriate level of scrutiny over regulated charges is maintained.

REPORTING FOR NEXT GENERATION ACCESS

We are disappointed that the consultation does not contain any discussion about improvements that could be made to BT's reporting for its NGA products. Currently some very high-level details are provided on capital expenditure to highlight aspects of state aid funding, however given the growing importance of NGA we would like to see the 2013/14 RFS output cover details of internal and external sales split by FTTP and FTTC product variants and believe this does not require a market review to mandate its inclusion with RFS output.

REGULATORY REPORTING FOR ETHERNET

We remain uncomfortable with the lack of progress on efforts to improve transparency on the Ethernet Backhaul Direct (EBD) product and would like to see Ofcom take a similar approach to the reporting approach for EAD, by requiring BT to identify both external and internal volumes separately. We raised this issue in 2011, 2012 and again in 2013 and while we understand the Equality of Access Office may advocate the status quo, we believe that Ofcom has the final say on this matter and we would urge Ofcom to take steps to improve disclosure.

We would reiterate that we don't believe BT has provided any justification for the information to be withheld, nor do we believe it would be onerous to provide. BT's claim that they use EBD solely as an input to Wholesale products and therefore report it indirectly as part of their wholesale cost base isn't a credible reason for not including internal EBD volumes within their RFS output. EBD is an EoI product and if BT makes use of the service it should report on volumes. The fact that some or all of that internal consumption is used to support downstream wholesale products is irrelevant. EBD is a strategic growth product, meeting demand for both new supply and also as a direct replacement for legacy services. We consider it essential that we have this disclosure to ensure compliance, as without it there remains the potential for BT to discriminate against external supply and avoid detection.

Q&A

Question 1: *Do you agree with Ofcom's proposed amalgamation of certain services of the same nature in the Call Origination and Call Termination markets?*

We have no objections to the proposals to amalgamate ISDN Call Termination with Narrowband based call termination and ISDN Call Origination with Narrowband Call Origination.

Question 2: *Do you agree with the proposed changes to the presentation of the RFS?*

We see some merit in aligning the format of the accounts with the various market reviews undertaken, however attention should also be paid to the aggregate picture across SMP markets, helping to fulfil Ofcom's obligation to ensure that meaningful information is provided to stakeholders. There is a requirement to provide transparent aggregate information to reflect the common cost base of BT's regulated businesses and their profitability, as this is a key concern in charge controls and disputes and helps in assessing the effectiveness of remedies designed to combat market failure. We are therefore advocating that Ofcom publishes an annual profitability statement either produced by BT (to an Ofcom specification) or by Ofcom itself to accompany BT's regulatory accounts that would cover all regulated services and allow stakeholders to immediately understand how much profit is being made by BT in each SMP market and in aggregate without the need for calculations or adjustments. Please see refer to the main body of this response for further details.

Question 3: *Do you agree with Ofcom's proposals to amend the list of Network Components?*

BT is now the only scale provider of emergency call handling services and we have concerns that the removal of any information around the costs associated with providing this service will limit Ofcom's ability to understand the true cost to supply this vital service. Stakeholders have raised concerns with Ofcom over BT's monopoly position in this market and their fears over prices going forward. Due to the nature of the service and the need for a critical mass of end users to underpin a viable service, this market is unlikely attract new entrants. If we are to lose this limited insight into emergency call handling costs it should be replaced with a more robust analysis of the cost of provision. We understand from the variation in the values published in the narrowband charge control consultation and final statement that emergency call handling costs account for a material proportion of call origination costs, underling the need to retain a degree of visibility on those costs.

Question 4: *Do you think we have fairly reflected the decisions of the relevant market reviews in the scope, form and content of the RFS?*

Given that the changes to the remedies in the Narrowband market were only introduced towards the end of September 2013 and the new pricing stemming from the changes will not be implemented until February 2014, we believe it to be inappropriate for Ofcom to release BT from the requirement to provide regulatory accounting details for narrowband services in 2012/13, when the prices charged under the 2009 Market Review and Charge control applied for 10 out of 12 months of the financial year. There is an expectation that when a remedy is set it should apply for the duration of the period intended and as the regulatory accounts are produced in arrears it is only reasonable to expect the accounts to cover the entire period covered by the original remedy. While these proposals may be appropriate for the 14/15 RFS output, Ofcom is premature in releasing BT from this obligation. Likewise we would like Ofcom to secure an understanding of the costs involved in providing the regulated transit product up until the point of its removal as an SMP service. It was a finely balanced decision to remove Single Transit from the list of regulated UK markets and should any competition concerns arise in the future it would be beneficial if a contemporaneous record of the underlying cost of providing this vital service was retained.

Vodafone Limited
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