Virgin Media's response to Ofcom’s Narrowband Market Review Consultation

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Non - Confidential Version

Contents

Introduction

The Narrowband Market Review provides the basis for regulation applying to key markets for fixed operators, and as we remarked in both our response to Ofcom's Call for Inputs and in response to last years Modelling Consultation, we emphasised the importance and significance of this review. In particular, the level of revenues and costs generates within markets that fall within the remit of this review remains significant and proposals that materially affect those revenues and costs will have a proportionally significant effect.

In the proposals, Ofcom have indeed set out a regulatory framework designed to completely remodel the landscape of the wholesale termination and origination markets, and in this regard, Virgin Media considers that the radical nature of the proposals have not been sufficiently scrutinised in order that they are demonstrably appropriate regulation for the UK markets, and even if they are determined to be so, there has been a lack of consideration on the true impact of these proposals on industry.

Whilst the proposed shift to pure-LRIC termination rates has been foreshadowed by the EC Recommendation on the treatment of termination rates ("the Recommendation")[1], Ofcom's approach in setting MTRs and comments made in the preceding consultation documents, it is only in this consultation that stakeholders have had the opportunity to see the full impact of the proposal and to understand what it will mean for their business. In that regard we were disappointed that Ofcom felt it appropriate to consult for a period of only 8 weeks, in relation to a complex set of proposals which will have a significant impact on industry. This period (which is itself practically curtailed by concluding immediately following the Easter break), is three weeks shorter than that allowed for the previous narrowband review (11 weeks), and two weeks shorter than the period suggested by Ofcom Guidelines[2]. We would welcome the opportunity to further discuss our response with Ofcom, as we are continuing to work through the potential impact on Virgin Media, and consider that the consultation period has not allowed us to present a complete view in this response.

The main focus of our response relates to Ofcom's proposals to regulate termination and origination rates through the Network Charge Control; Section 1 below, sets out our substantive concerns over the proposals. Section 2 of our response provides the answers to the specific questions posed in the consultation document.

As mentioned, we would appreciate further engagement with Ofcom with regard to the proposals made in this consultations, and look forward to being able to assist Ofcom in understanding their potential impact were they to be implemented.

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[1] COMMISSION RECOMMENDATION of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU (2009/396/EC) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF

[2] Ofcom Consultation Guidelines http://stakeholders.ofcom.org.uk/consultations/how-will-ofcom-consult

Section 1 : Charge Control Proposals

Ofcom are proposing to regulate termination rates at the level of pure LRIC derived from a new model built during the course of this review. At the very highest level the result is that UK fixed termination rates will decrease from 0.2ppm to 0.04ppm[3] on 1 October 2013, which will cause a significant impact on the industry. A consequence of this approach is that the "lost" common costs previously recovered through the regulated termination charge are now allowed to be recovered through the call origination charge.

The proposed approach appears to be largely driven by adherence to the Recommendation. Virgin Media would repeat its concerns made in our previous responses that Ofcom need to look at whether adopt the Recommendation is the most appropriate approach to regulation of fixed termination for the UK. However, whilst we do not endorse Ofcom's proposal to adopt an approach based on the Recommendation we seek to provide more focused comments in this response addressing two key areas in which we consider the proposal is flawed and inappropriate for the domestic market:

- The lack of glide path
- The model design

These combine to give rise to an overarching concern that the proposals, as they stand, will have a substantial negative effect for our business, and therefore our customers.

Lack of Glide Path

The proposal is that rates should be aligned with the modelled pure-LRIC cost of termination at the commencement of the control. The rationale for this is set out in Section 11 of the consultation.

Ofcom identifies a number of effects that it considers to be in favour of an immediate reduction of termination rates to LRIC, citing competition between fixed and mobile operators, the nature of termination being a two-sided market, and consistency with the Recommendation. Ofcom also purport to have assessed any potential negative effects on consumers, competition and incentives to invest, and provisionally concluded that there are no reasons not to make an immediate adjustment to LRIC.

Virgin Media considers that the analysis concluded by Ofcom fails to capture the real world effects that this proposed reduction in termination will have combined an overstatement of the importance of the Recommendation, which, as they acknowledge in the consultation should not be slavishly followed.

We have identified a number of issues that we consider provide support to the imposition of a glide path, however, it is useful to first set out our view on the Recommendation, and why Ofcom's approach to it is flawed.

EC Recommendation on the treatment of termination rates

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[3] Approximate rates based on base case proposals as discussed at Consultation paragraph 11.29

The Recommendation was issued in draft in 2008, and published in final form in 2009. Ofcom were obliged to take utmost account of it when setting fixed termination rates in 2009[4]. In reviewing BT's Network Charge Controls, Ofcom specifically concluded that it was not appropriate to follow the Recommendation for the UK market at that time.

Ofcom suggest in this consultation at paragraph 11.32 that the reasons for not complying with the Recommendation related to the timing of modelling on an NGN basis, the need to re-consult on a different duration, and the low level of termination rates within the UK in any event. These reasons appear to have been derived from the 2009 NCC statement (published September 2009), which was primarily concerned with the issue of whether the control should align with the implementation date in the Recommendation. In that document, Ofcom specifically stated that full consideration of how it had taken utmost account of the Recommendation was contained in the consultation document[5] (March 2009), and that the Statement should be read in conjunction with that consultation[6]. The current consultation does not appear to reference the reasoning within the 2009 consultation, whereas we would suggest that it provides the essential context as to Ofcom's approach to the EC Recommendation at the time of the last round of review.

The 2009 NCC Consultation document identified the underlying purpose and aim of the Recommendation and proposes that continuation of an NCC that set costs on a CCA FAC basis would:

> "*address and meet the concerns expressed by the Commission*".

Ofcom also consider that they had:

> "*also taken into account the aims of the Recommendation, and consider that our proposed approach is consistent with those aims, and taking into account the current state of the market in the United Kingdom, the most appropriate way to seek to achieve those aims during the period proposed in the review*"[7]

In summary, Ofcom believed that they were following the spirit, if not the letter, of the Recommendation and had good reasons for proceeding as they did.

It is also of note that Ofcom were not taken by surprise by the implementation period set by the Recommendation. In proposing a four year control they acknowledged that:

> "*it is likely that the end date for a four year NCC (i.e. 30 September 2013) would be later than the ending of the transitional period*."[8]

Therefore, Ofcom consciously took a decision to depart from the Recommendation setting a control that would extend beyond the implementation date for the

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[4] Ofcom's review of BT's Network Charge Controls 15 September 2009
[5] Paragraph 4.95 Review of BT's Network Charge Controls statement
[6] Paragraph 1.3 Review of BT's Network Charge Controls statement
[7] Paragraph 4.190 Review of BT's Network Charge Controls consultation March 2009
[8] Paragraph 4.38 Review of BT's Network Charge Controls consultation

Recommendation, exercising their discretion to provide a reasoned alternative regulatory path, having taken utmost account of the (draft[9]) Recommendation.

It is beyond argument that things have moved on since the setting of the last NCCs. Whilst we do not seek to add to our previously stated position on the appropriateness of setting termination rates based on pure LRIC, or the use of a modelled NGN core network (save in relation to our comments in relation to model design below). We are concerned that Ofcom is placing too great a reliance upon the implementation date for the Recommendation. Virgin Media considers that it is entirely appropriate (and correct given the circumstances of the fixed line market in the UK), to delay the imposition of LRIC termination rates by applying an appropriate glide path approach.

Ofcom have, by their conscious decision in the 2009 NCC Review, created the situation where the current termination charge control expires some 9 months after the Recommendation's implementation date. This was a reasoned and considered decision, based (correctly) on national circumstances. It is not therefore appropriate for Ofcom to cite as a reason for not imposing a glide path, being "late" for the deadline.

If there were circumstances that would indicate that an immediate drop to LRIC was appropriate, then, of course, this may provide a reason to deviate from its normal approach to glide path charge controls. However, for the reasons we develop below, we do not consider such circumstances exist.

Even assuming Ofcom remains wedded to compliance with the Recommendation, we consider that it is entirely consistent with taking utmost account of it (developing the model and reducing rates to LRIC over the control), to set an appropriate glide path and would urge Ofcom to revise its proposals accordingly.

In assessing the appropriate rate to set, it remains instructive to have regard to rates within Europe. We accept Ofcom's assertion that it is not appropriate to set rates necessarily aligned to rates set by other regulators; indeed this was the principle relied upon by Ofcom in 2009 when it decided to favour the prevailing conditions in the UK over a full implementation of the Recommendation. It is certainly the case that regulation should be imposed that is appropriate to national circumstance.

Ofcom has examined rates within Europe, and whilst it has been able to suggest most major NRAs adopted or will soon adopt LRIC based FTRs[10], this does not show the complete picture. The Analysis Mason report confirmed that (at the date of publication), only France has implemented LRIC termination rates (which notably were set at 0.08EuroCents, significantly toward the higher end of Ofcom's proposed ranges). Ofcom have confirmed in their consultation that five countries have or are expected to have LRIC termination rates in 2013. One of five countries is the Czech Republic who proposed rates 0.16 and 0.31 EuroCents, significantly higher than Ofcom's range[11]. The other countries have rates significantly higher than Ofcom's

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[9] Although the Recommendation was in draft at that time, Ofcom was at pains to point out that in making its proposals in its consultation document it would have discharged the burden of taking utmost account of the document had it been in final form.
[10] See paragraph 8.12 consultation
[11] This is subject to Phase II investigation by the EC, although BEREC's opinion of 21 January 2013 considers that the Commission's "serious doubts" are not justified.

proposed rates (including rates that reduce over time[12]). This leaves significant other players within Europe who have decided to adopt a Pure LRIC approach on a glide path basis / later than 2013 (for example, Italy), and countries that have not followed the recommendation, most notably Germany, where common costs are proposed to remain recoverable through termination rates[13].

In short, the picture is mixed, with a bias against strict application of the Recommendation. Aside from France (whose review of the termination market considerably preceded Ofcom's current review) no country adopted the Recommendation by 31 December 2012, and of the remaining countries who have sought to follow the Recommendation, some have adopted glide paths and some are anticipating the later adoption of LRIC. It is of note, that in compiling this information, all of these countries (by the fact of at least having proposals to be quoted) are "ahead" of Ofcom in reviewing this market, yet Ofcom appears to be wedded to an immediate implementation.

It is also instructive to consider the Italian notification to the Commission, where a glide path was proposed using LRIC+ in the first two years of the control. The Commission sent a serious doubts letter opening a phase II investigation into the notification earlier this year, as AGCOM had, in the Commissions preliminary view, failed to justify the departure from the Recommendation. BEREC have now issued their opinion on the notification[14] and conclude that AGCOM might have legitimate reasons to set a glide path (because of, in the context of the Italian market, constraints on migration to IP-interconnection which impact the use of this technology during the migration period) with the transition FTRs being based on the costs of both TDM and IP networks.

Additionally, it is also of note that given the level of the "LRIC" rates set in Europe, it would suggest that Ofcom has modelled on a particularly low cost basis. The average pure BU-LRIC FTR is 0.1135 EuroCents/minute[15]. Of course, Ofcom is entitled to construct a model as it sees fit, however, where the proposed rates are significantly lower than other LRIC rates, it is sensible to ensure that a more cautious approach is adopted to ensure that rates are not set at too low a level. One way to ensure that operators are insulated from such an effect is by use of a glidepath which would allow time for Ofcom to monitor the suitability of its modelling approach during the course of the review period.

The key theme is that taking utmost account of what is a Recommendation of considerable impact, leads to a country by country approach to determine what is best with considerable latitude given to the date of implementation even in cases where NRAs have followed the underlying approach. Of course in taking utmost account and deciding to divert from the Recommendation, objective reasons need to be set out. Virgin Media considers that there are a number of factors that indicate that a glide path approach would be appropriate in the circumstances of the UK, and

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[12] For example Ireland who have set rates at 0.098EuroCents in 13/14, to fall to 0.072 in 15/16

[13] Additionally, Holland have proposed rates based upon a common cost mark up, as the National Courts have determined that the NRA should not follow the Recommendation.

[14] http://berec.europa.eu/eng/document_register/subject_matter/berec/opinions/1241-berec-opinion-on-phase-ii-investigation-case-it20131415call-termination-on-individual-public-telephone-networks-provided-at-a-fixed-location-market-3-in-italy

[15] BEREC Opinion on Italian termination rates (footnote 10).

we set out, in the following paragraphs our consideration of how an immediate and full one off adjustment would affect both Virgin Media and the wider market.

Adverse Effect of no Glide Path

Ofcom suggest that they have fully considered the effect on consumers, competition and investment incentives in provisionally concluding that there is no reason for not immediately setting prices at LRIC.

Ofcom's assessment that the proposed immediate change to LRIC based pricing will result in an impact of £1.85/line assuming a 100% waterbed effect. We do not consider that this is an accurate assessment of the potential effect of the change, nor does it seek to differentiate the different nature of the players within the fixed line market. It is of note that the analysis is based upon that conducted in the MTR review. The nature of the fixed and mobile markets is considerably different in that the mobile market consists of four main players all with their own network. In contrast the fixed market is considerably different, comprising of a number of significantly different players in terms of how their businesses are structured and how they operate. Ofcom has failed to sufficiently analyse the effect on the fixed market, and has read across its analysis of the mobile market and placed too great a reliance upon it, inferring an excessive level of support from the CC's judgement approving LRIC rates for the mobile market. Even in relying upon comments from the CC it is of note that their judgement approved the use of a glidepath, and specifically rejected BT's suggestion of a partial one off adjustment to LRIC+ (and modified glidepath thereafter).

Ofcom have proposed an immediate reduction to LRIC in the absence of any meaningful analysis of the counterfactual, a three year glide path to LRIC by the end of the control. In failing to fully consider that option, the dismissal of any negative effects on consumers, competition and investment incentives is premature.

Virgin Media's Impact Assessment

Virgin Media is conducting its own impact assessment of the proposals. We are finalising this work and will submit this to Ofcom as soon as it is available. Given the time available to us in responding to this consultation, we aim to submit the detail of our assessment in a separate submission[16].

The provisional conclusion of our assessment to date was that the proposals put forward by Ofcom have the potential to have a significantly negative impact on our business. [✂].

Transit Disadvantage

In addition [✂], Virgin Media also suffers from the nature of its network architecture. Historically, we have had fewer interconnects with BT's local exchange level, than for example, CPs who have focused on unbundling (specifically requiring significant exchange presence). The nature of our network architecture is reflective of the

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[16] This approach was discussed with Ofcom as an acceptable approach in responding to this consultation.

evolution of the cable networks within the UK, and whilst this has previously been an issue that concerned us in relation to reciprocal termination rates, it has been brought into significantly sharper focus in light of these proposals.

Under these proposals termination rates would be reduced to minimal levels. Transit rates, as unregulated services, would remain unaffected unless BT decided to alter the commercial terms upon which they were offered.

BT's CPL confirms that LTC (daytime rate) is currently charged at 0.1155 ppm[17]. Therefore, assuming an in-bound termination rate of 0.04ppm, the cost of a BT customer calling a VM customer (assuming interconnection at BT's Tandem layer) will reduce to 0.04ppm, whereas the cost of that VM customer calling the same BT customer will cost 0.1555 ppm.

That our network is not as interconnected at the BT DLE level as some of our competitors is not reflective of us not being an efficient operator, but reflective of the interplay between our individual incentives as a CP providing the services that we do, and the regulation that is imposed within the UK. Thus, unbundled operators who have high DLE interconnectivity due to local loop regulatory incentives are at a considerable advantage, yet are not necessarily any more "efficient". Given the potential for longer term industry migration to NGN, the rationale for investment to increase local exchange connectivity is significantly lessened, despite the incentives created by this proposed regulation.

[✂].

Termination of Ported Traffic

Additionally, we have also considered the effect on incoming ported traffic. Where we acquire a customer from another provider and they are able to port in their number, any call terminating on that customers line attracts, not only the cost of termination, but the additional cost associated with porting.

Charges related to the provision of portability are cost oriented under the terms of General Condition 18[18]. However, based upon current APCC charges and the proposed termination rates, the provision of termination to an OCP calling a ported number may mean that there is a cost to Virgin Media to terminating these calls. Clearly, such a situation is unacceptable, given that this would have substantial negative effects for both CPs and consumers, and would significantly alter the incentives to port numbers.

Ofcom have discussed the issue of how the APPC may impact a terminating CP. It concurs that there may be circumstances where the provision of termination for calls to subscribers which have ported their number will result in a long run loss. However, the provisional conclusion was that, as the APPC regime was separate from the issue of how to address SMP in the market for fixed termination, it was not appropriate to account for this effect in setting regulated termination rates.

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[17] https://www.btwholesale.com/shared/document/CPL/SectionB1_Telephony/b1_01.xls, LTC rate quoted calculated by deducting the Call Termination LE rate from the Single Tandem Call Termination rate.
[18] General Condition 18.5(a)

Virgin Media considers that this appears to side step the issue of whether the proposed termination rates would give rise to negative effects for consumers, competition and investment incentives. To create, by regulation, a situation where a CP is obliged to provide a termination service at a loss will clearly have an impact on the CP. Although Ofcom dismiss the overall effects by suggesting that non-ported numbers will not be affected, it is still significant that any termination of ported traffic will result in an overall recover across all termination of an amount below-LRIC. There will be differences between operators, such as those operators who have fewer "own number" customers, therefore there may well be an effect on competition within the market.

Ofcom note that the APPC is regulated through General Condition, but suggest that the matter will be resolved through industry negotiation. This implies that a dispute will be the final way in which this issue will be resolved. Given that disputes can only be referred to Ofocm following the exhaustion of commercial negotiations, and that disputes often take a significant time to resolve (notwithstanding the 4 month time limit, there remain a significant minority of disputes that are cited as having exceptional circumstances allowing a longer resolution), there is, on current proposals, the potential for a considerable period of uncertainty regarding APCC rates when termination rates are regulated at LRIC.

Although Ofcom remain of the view that the APCC and termination rates are separately regulated, Virgin Media considers that the concerns expressed above provide a significant argument in support for a phased introduction of the reduced termination rate in order to minimise the effect of the cost of terminating ported numbers on adoption, which would allow industry to assess how it needed to comply with the cost orientation obligation in GC18 in light of LRIC based termination rates. If a Glide Path approach was adopted this would allow for such an approach, whilst still maintaining Ofcom's ultimate proposed approach to the regulation of termination rates (alignment with LRIC, albeit at the end of the control), and it would not compromise the separate and distinct regulatory regimes that Ofcom want to keep apart.

Potential Consequences

We have highlighted where we consider that Virgin Media will be significantly impacted by Ofcom current proposals to set LRIC based termination rates. We have also indicated that the diverse make up of the fixed market means that the effect will be markedly different between operators, which we submit will lead to a significant and negative effect upon the market.

Call Origination Incentives

In proposing an immediate drop to LRIC for termination rates, Ofcom have proposed that common costs associated with termination, should be recovered in the regulated charge for origination.

Virgin Media do not have an objection for common costs to be recovered in this way, but consider the proposed method of implementation will give rise to perverse incentives over the course of the controlled period and have negative effects for competition and investment.

Taking the base case for regulated origination and termination rates, Ofcom are proposing the following[19]:

	2012/13	2013/14	2014/15	2015/16
Origination	0.252	0.297	0.269	0.244
Termination	0.204	0.040	0.037	0.034

This creates a “saw toothed” effect for origination rates; increasing the regulated rate for 2013/14 and the decreasing it again over the next two years to reach a final year value of below the starting point.

Ofcom have considered saw tooth effects in charge controls previously, most recently when considering regulated WLR charges in 2010. In that case a potential first year reduction of the regulated charge followed by subsequent increases was felt not to be appropriate, and an alternate approach was followed (maintaining charges from the outset of the control, and applying an increase in later years to ensure the same end point was reached.)

The impact of implementing a saw tooth control will, for example, see the costs of CPS operators significantly increase in year one of the control as they purchase wholesale call origination from BT. However, given the increase only lasts for a temporary period, the creation of this distortion in the market seems entirely unnecessary.

Virgin Media considers that were Ofcom to adopt an approach in line with the approach taken in previous charge controls, then a flat origination rate of 0.252 ppm should be applied as a ceiling for years one and two of the control (13/14 and 15/16), with the rate reducing in the final year to 0.244ppm.

The effect of this would ensure that the disruption in wholesale origination costs was minimised, and negative consequences would be avoided.

Overall Conclusion on Glide Path

We consider that the current proposals set out by Ofcom are inappropriate for the regulation of both termination and origination rates in the short term, and that the imposition of a glide path would be appropriate and provide a better regulatory approach for both industry and consumers, given the context of the national market, and that taking utmost account of the EC Recommendation on Termination would not be compromised by the adoption of such an approach.

In considering it necessary to propose an immediate one off adjustment, Ofcom have not fully taken account of the effects of their proposals on the industry, and we would submit that the arguments, set out above, that there is considerable potential for an adverse effect. The nature of the effect would be substantially mitigated should a glide path be applied, and we would urge Ofcom to reconsider their approach, by implementing a “traditional” glide path from the current regulated charge to align rates with LRIC cost by the end of the period.

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[19] Extracted from table 1.1 consultation

Further, Ofcom has not considered at all the possibility of a partial initial reduction followed by a glide path. If our primary submission that it remains appropriate to impose a full glide path is not accepted by Ofcom, we consider that Ofcom need to examine the possibility of a partial reduction glide path at the very minimum.

We set out above our concern over the proposal to create a saw-toothed call origination rate, and the potentially perverse effects this may have within the industry.

We consider this concern can be addressed in tandem with our concerns over the sharpness of the decline in termination rates. In order to normalise the effect on origination, and setting a charge ceiling based upon the level of the current regulated charge, the formerly allocated termination common costs not recovered in years one and two of the origination control should be retained within the termination charge itself, thus providing a more appropriate glide path to the pure LRIC termination rate by year three of the control.

We have explored this and the potential effect it would have on termination rates and set out at Annex 3 our methodology to reach the conclusion that rates could be set as follows:

	13/14	14/15	15/16
Ofcom's Proposed Origination Charge	0.297	0.269	0.244
Ofcom's Proposed Termination Charge	0.04	0.037	0.034
Adjusted Origination Charge based on ceiling set at current charge	0.252	0.252	0.244
Adjusted Regulated Termination Charge	0.095	0.058	0.034

The adjusted rates suggested above would allow a smoother transition to pure LRIC after the second year of the control, and would, in so far as Ofcom is concerned to ensure that they have taken utmost account of the Recommendation, also provide a level of charging throughout the control that was able to be benchmarked against other European LRIC rates as being in line with the level of costs charged for the service across the EU.

The adjusted rates that would apply would all be significantly below the average pure BU-LRIC for FTRs of 0.1135 EuroCents/minute, which was specifically quoted by BEREC in considering the appropriateness of a glide path approach for AGCOM. In particular, the level of rates proposed in the adjusted rates would not give rise to any concern based upon the creation of barriers to the internal market, with other rates in the EU being set on a LRIC basis.

Whilst this would not fully alleviate the concerns we have associated with the reduction of the termination to LRIC, it would provide some cushioning of the impact and reduce the stark effect of imposing an RPI-87% reduction in year one of the control, which would considerably benefit industry players, and help to address the negative impacts we have outlined above.

Virgin Media consider it particularly significant that Ofcom have not considered any form of partial one-off adjustment, and as such we consider that there is a fundamental gap in impact assessment, especially in light of demonstrable negative effects of a full adjustment, and a viable proposal for a glide path based on rates that would not distort the wider European market.

Model Design

Virgin Media considers that the design adopted by Ofcom gives rise to an overall concern that the rates set may not reflect the costs of an efficient operator.

There is an inherent riskiness in estimating the LRIC cost value of a service, as if an underestimate is proposed then regulation will result in the underecovery of costs and that this could lead to foreclosure of competitive market entry and of certain types of competition. In our response to the Modelling Consultation we stressed the importance of ensuring that real world cost checks to ensure that a theoretical bottom up model based on NGN infrastructure would not produce an inappropriate result.

We have noted the position of other European regulators setting LRIC rates in our comments on the lack of a Glide Path, but it remains a relevant factor that the Ofcom proposed rate is significantly lower than France, Ireland and Denmark as the cited NRAs setting LRIC rates.

Ofcom have set out their cross checks at Annex 14 of the current consultation, however, the cross checks applied still do not anchor the model to the real world. For example. to cross check against BT's network using depreciated assets does not provide an insight into the relevant cost base for an efficient TDM operator.

Virgin Media identifies the following areas of particular significance to the robustness of the model results and believes that the decision to proceed with the results requires Ofcom to exercise a larger degree of caution to the model results than it has demonstrated:

- Model Verification
- Network Start Date
- Market Share
- Assumptions driven hypothetical NGN model.

Model Verification

Ofcom in the past 'has calibrated the outputs against actual operator data'[20], but readily admits that it is not possible to calibrate the NCC model in this way[21]. Instead Ofcom sets out a possible approach that relies upon three checks to verifying the cost model outputs[22].

The first of these conditions Ofcom cites as now being inappropriate so we are left with an approach left with two checks on the model outputs. These are, as set out in paragraph A12.918:

> ii) The model should not recover more costs in historic periods than was possible given the level of regulated charges; and
> iii) The unit costs from the model should allow BT to recover efficiently incurred costs.

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[20] paragraph A12.196
[21] paragraph A12.197
[22] paragraph A12.198

Virgin Media believes that Ofcom has not been able to show that the model outputs comply with either of the two remaining checks. Virgin Media sets out its concerns below.

Check ii)

Figure A12.10 shows that compliance with ii) above has not been met, as Ofcom acknowledges in paragraph A12.201. Instead of acknowledging the cross check is not met and adjust the model or its inputs, Ofcom seeks to make a forward looking adjustment to the model outputs that seeks to "recover the difference between the costs that the unadjusted model allows to be recovered and those that it was actually possible to recover"[23]. This appears very unsatisfactory approach to modelling as it appears entirely superficial adjustment to the output of the model, rather than rejecting the models outputs and inputs as being inappropriate basis to set a Charge Control.

Virgin Media's understanding of the NGN model indicates that the falling historic unit costs, as set out in Figure A12.10, comes as a consequence of growing traffic with a Network Start Date of 2007/8. It would be more appropriate to assume that the model starts at the beginning of the charge control (i.e. 2013) – this would avoid the need for a forward looking adjustment to be made as no recovery of historic costs would be made before 2013. Virgin Media believe that the adjustment is evidence that there is a fundamental flaw to the Network Start Date of 2007/8 and to the NGN model approach that Ofcom is proposing. We elaborate further on the Network Start Date in the subsequent section.

Check iii)

In addition, Ofcom has not demonstrated that iii) has been achieved; what Ofcom has identified is that the investment in the NGN exceeds that of the depreciated TDM model[24]. This test is flawed as the TDM network tells us little about efficient deployment rather that the TDM network is a largely depreciated network, as explained in paragraph A12.203, as Ofcom has not made the 'hypothetical ongoing network adjustments", an important part of the 2009 NCC TDM model which included "increasing the Net Replacement Costs".

The test that we would have expected Ofcom to apply is to model BT's market share in order to establish whether using BT's traffic applied within the bottom-up NGN model (as a proxy for an efficient NGN deployment) would still be allowed to recover their costs.

In summary, Virgin Media does not believe that Ofcom has demonstrated that any of the three Conditions has been achieved. As such, Ofcom has failed to sufficiently cross-check the model results for them to be relied upon to set the Charge Controls.

Network Start Date

Figure A14.14 highlights the Termination LRIC to different network start dates. The key conclusion is that the start of deployment has a very large significance on the resulting LRIC Termination.

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[23] paragraph A12.201
[24] paragraph A12.205

For example, if a new entrant were to enter into the market in 2012/13 they would have a Termination LRIC of 0.072ppm – while had they entered in 2005/6 their Termination LRIC would have been 0.036ppm. Ofcom's decision to start roll-out in 2007/8 (see A14.15), with a resulting 0.04ppm Termination LRIC is set out in Annex 13 where little justification as to the reason why 2007/8 is appropriate is provided. The only references we found are as follows:

Annex 13, Paragraph 7.27 states:

> "*BT stated that the model start-date of 2005 is not appropriate and that the start date of the model should coincide with the start of the new review period. In addition BT makes the point that the model utilises elements which were not available in 2005 (e.g. 100GE core routers)*."

Paragraph 7.28 goes on:

> "*A sensitivity has been included to understand the impact of moving the start date forwards to 2009 (the beginning of the last review period) or 2012 (the beginning of the new review period). Based on evidence we have collected regarding the time of NGN deployment in the UK, we now believe that a 2007/08 start date is appropriate*."

Virgin Media believes that the evidence above is not cited anywhere in the consultation documents and that it is not sufficient for such a significant input to be left unchecked. It points to a serious deficiency in the modelling. Ofcom's results taken at face value (under the Medium Case) would mean that a new entrant would not be able to enter the market in 2013 under these conditions and expect to recover even their incremental costs of termination.

A more reasoned approach that ensures the charge control is consistent with the idea of a contestable market where a new entrant could enter the market, it would be more appropriate if the network start date were consistent with the start of the charge control (i.e. 2012/13), or, that the network is built from scratch each year.

As such, Ofcom's medium case has failed to take account on competition or of a contestable market from the model that it puts forward.

Market share

The way in which the Wholesale Call Termination LRIC is set is of key concern as indicated by Figure A14.8. A market share of 25% produces a Termination LRIC of 0.032ppm, while a 50% market share produces a Termination LRIC if 0.040ppm, and, an even higher market share of 65% produces an even higher Termination LRIC of 0.044ppm. This finding is completely counter intuitive as prima facie a higher market share should result in a lower Termination LRIC – all other things being equal.

Whilst we acknowledge Ofcom's explanation that more asset capacity boundaries are reached - we are left with an unsatisfactory treatment of Termination LRIC as the model output is inconsistent with real world efficiencies of scale. What it serves to highlight is how sensitive the NGN model is to its assumptions – and that there is a large degree of uncertainty regarding the results. The NGN model with its current finding of increased Termination LRIC with increased market share is simply not satisfactory.

Notwithstanding our concerns as outlined above, Figure A12.102 Ofcom originally used a market share of 25% based upon a 'competitively neutral market share for a national NGN operator'. This approach was supported by the fact this reflects that there are 4 key players in the fixed voice market (i.e. Virgin Media, BT, Sky, TalkTalk).

We do not accept that a market share of 50% which is based upon an operator with SMP is compatible with a longer term efficient entry and so in this respect ignores the EC recommendation which offers the following guidance: 'when defining the single efficient scale for the modelled operators, NRAs should therefore take into account the need to promote efficient entry while also recognising that under certain conditions smaller operators can produce at low unit costs in smaller geographic areas.'

Ofcom's justification for moving to a 50% in termination is that it has been selected to reflect the need to be consistent with SMP in origination. Virgin Media consider that this explanation is flawed; it is entirely reasonable to have a 25% market share for termination, combined with a 50% market share for origination. Ofcom has overlooked this at the expense of promoting efficiency – and therefore potential investment. The approach set forward is therefore not reasonable.

Assumptions driven Hypothetical NGN Model

The wide range in LRIC Termination values indicate that there is a measure of uncertainty in respect to the results where the Termination LRIC high case is 0.077ppm and the low case is 0.002ppm[25]. Under normal circumstances the medium case (estimated at 0.040ppm) might be acceptable middle path to adopt, but under the 'pure LRIC' approach picking the medium case is risky as it could easily lead to under investment in the networks and is a serious consequence of 'under-estimating' LRIC Termination. The range represents a *limited* measure of the degree of 'uncertainty' or 'error' in estimating LRIC Termination and that there is a danger that ignoring the range when setting the charge control runs the risk foreclosing certain types competition.

In practice the range could be significantly bigger as the scenarios only take account of a limited set of sensitivities in the high and low cases (as set out in Figure A14.23). The high and low scenario does not include the sensitivity to a different network start date – and it completely ignores the vast majority of inputs that have been used to derive the result. Virgin Media's count of inputs is 100+ required by the NGN model[26]. An insight into the complexity of Ofcom's model is demonstrated by our counting of only a subset of the number of inputs as set out in this worksheet that the model is structured upon:

- Over 100 different network elements – each with a traffic dimensioning, unit cost and operational expenditure;
- 13 cost trends;
- 8 lifetimes.

Virgin Media's conclusion is that there is a sizable margin for 'uncertainty/error' that such a model can produce – of which just a limited set of inputs have been changed to generate the high and low cases.

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[25] Paragraph A14.25 and Figure A14.25
[26] as set out in the worksheet entitled 'Input_Lists' of workbook 3.Economic.xlsm

From this perspective, adopting the high case for the glide path[27] might go some way to addressing the limitations of modelling a hypothetical NGN operators without being able to conduct sufficient real world cross-checks (this problem didn't arise in the MTR because top-down costs were available).

The combination of these findings highlights the limitation of the hypothetical NGN model that has been developed and its sensitivity to a multitude of assumptions that haven't been cross-checked. It underlines VM's key concern that accurately estimating pure LRIC with a 'hypothetical' NGN model remains too uncertain and therefore a more conservative approach is justified, which can be achieved by adopting a glide path approach as discussed in the first part of this section and flexing some of the inputs to, or towards the "high case" values.

The danger of setting a Termination LRIC too low is that operators that are overly reliant upon termination revenue will not even be allowed to recover their 'efficient incremental' costs of terminating traffic despite operating a newly built NGN network. This is of particular relevance as it forecloses on competitive entry and/or on a telecoms business model that seeks to rely upon call termination revenues – as such it cannot be considered to be competitively neutral or encourage efficient competitive market entry.

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[27] Glide path in this context refers to the ongoing cost reduction proposed through the control period to keep costs at LRIC throughout, and does not relate to any glide from current charges.

Section 2 : Consultation Questions :

Market developments in retail services excluding the Hull Area

Question 3.1: *Do you agree with our assessment that both the business and residential retail fixed narrowband calls markets in the United Kingdom have remained competitive since 2009 and that we expect the same competitive conditions to continue during the period of this review as long as appropriate wholesale regulations remain in place? If not, please explain why.*

Virgin Media agrees

Market developments in retail services in the Hull Area

Question 4.1: *Do you agree with our assessment that no material changes have occurred in the retail markets in the Hull Area since the last review in 2009? If not, please explain why.*

No Comment

Question 4.2: *Do you agree with our assessment that ex post competition law remedies would now be sufficient to address any competition concerns identified during the period covered by this review and that it would no longer be appropriate to maintain regulation for retail narrowband call services in the Hull Area? If not, please explain why.*

No Comment

Wholesale call origination

Question 5.1: *Do you agree with our assessment that the relevant service market is "Wholesale call origination on a fixed narrowband network"? If not, please explain why.*

Virgin Media agrees.

Question 5.2: *Do you agree with our assessment that there are two relevant geographic markets: "The United Kingdom excluding the Hull Area" and "The Hull Area"? If not, please explain why.*

Virgin Media agrees.

Question 5.3: *Do you agree with our assessment that BT has SMP in the market for "Wholesale call origination on a fixed narrowband network" in the United Kingdom excluding the Hull Area? If not, please explain why.*

Virgin Media agrees.

Question 5.4: *Do you agree with our assessment that KCOM has SMP in the market for "Wholesale call origination on a fixed narrowband network" in the Hull Area? If not, please explain why.*

Virgin Media agrees.

Question 5.5: *Do you agree with the remedies imposed on BT in the market for "Wholesale call origination on a fixed narrowband network" in the United Kingdom excluding the Hull Area? If not, please explain why.*

Virgin Media agrees that BT should be subject to general remedies and a charge control, but would additionally comment on the following proposals:

1. Proposing an access conditions that does not include a requirement for charges to be fair and reasonable;
2. Not proposing a cost orientation remedy; and
3. The proposal to remove LRIC reporting from financial reporting obligations.

These issues are interlinked and relate more generally to Ofcom's approach to cost orientation, which appears to be a policy shift in the approach taken to regulation of markets where the market analysis reveals potentially adverse effects on pricing. Ofcom have repeated stated that they will be publishing a document to set out their views on cost orientation remedy, although the exact nature of the document has not been confirmed. This document has now been delayed several times over, and we are seeing a potential change in policy acted out in individual market reviews without sufficient justification as to why a change of view has been adopted.

Additional confusion appears to have been created in relation to the status of any policy review of cost orientation, in that Ofcom's Annual Plan, published 28 March 2013, stated:

> "*We can confirm that we plan to publish a consultation and statement in 2013/14 on the regulatory reporting framework. <u>We will also start the cost orientation project</u>. We welcome stakeholder views on this issue as part of the forthcoming consultation process*"[28] [emphasis added]

This suggests that any substantive project work has not yet commenced, and that Ofcom still need to engage with stakeholders on this issue. Virgin Media fully agrees that stakeholder engagement is key, and that, to date, is has been wholly lacking. There were considerable concerns over the approach taken to cost orientation within the Business Connectivity Market Review (now concluded), which appeared to be predicated on the basis of on going policy decisions. The approach being proposed in this review would hugely benefit from transparency of Ofcom's wider thinking as to cost orientation as a remedy, and the manner in which the approach to cost orientation has been handled to date is positively opaque and entirely contrary to the manner in which Ofcom is required to regulate under section 3 of the Act.

In relation to this market, wholesale call origination, it is proposed that a charge control should be applied, and therefore any excessive pricing concerns will be addressed. Further the proposed control will regulate rates in a very specific manner, allowing for recovery of an amount in excess of the costs of provision of the service, by allowing the recovery of common costs associated with the provision of call termination. In the very specific circumstances of the setting of this control Virgin Media understands that Ofcom's traditional "basis of charges" conditions (as

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[28] *Ofcom Annual Plan paragraph A1.34*

currently imposed on the call origination market) would not be appropriate as the charges allowed under the control would not be based on the long run incremental costs of the provision of the service. Therefore, in this specific case, Virgin Media can understand the decision not to impose cost orientation.

Ofcom have proposed to modify the access condition to exclude an obligation to set charges on a fair and reasonable basis. Again, this would appear to be a change of policy, and we would re-iterate the need for transparency on Ofcom's approach to setting conditions.

An access condition that requires charges to be set on a fair and reasonable basis can provide additional and important protection above and beyond that offered by a charge control. In particular, where a control covers specified service, a generic condition applying across a market will provide reassurance across all services, including new services introduced to the market. Additionally, when there is a gap between charge controls it provide a regulatory hook on which to hang transitional or bridging guidance, and an important additional safeguard above and beyond any voluntary commitments.

Therefore, where pricing issues are identified in the market analysis as needing to be addressed, it is preferable, in Virgin Media's submission for the access condition not to exclude charges, as is proposed in this case.

There is an additional argument in support on this occasion. Ofcom propose that in relation to the NTS Call Origination condition that it shall only subsist until the NGC Effective Date. Although the proposals for the NTS regime have been set out since April 2012, there has not yet been any statement published detailing the regime, and there remains to be a separate consultation on the legal instruments required to effect the regime. To make a proposal for regulation without stakeholders having had the opportunity to fully consider the effects of the future NTS regulatory regime, provides significant weight to ensure that there is an appropriate safeguard placed upon BT in relation to the wholesale origination of NTS calls to ensure that a loophole between the regimes exist. To leave the obligation to ensure that charges should be fair and reasonable within the access condition applied, is far from onerous and would provide significant reassurance.

Finally, we note that Ofcom propose that it is appropriate to remove LRIC reporting obligations from BT given that it is proposed that cost orientation will no longer be applied. We do not consider that the removal of cost orientation should automatically lead to the removal of cost orientation, and in that regard we consider that Ofcom has not provided sufficient reasoning in this consultation as to why BT should not publish this data for industry given that it still remains an important metric that they are required to continue to report to Ofcom. The incremental effort required by BT to publish LRIC data, which they are already publishing, and are required to maintain in any event, is minimal. It will also provide significant transparency to stakeholders who will be facing a regulated origination charge that will, unusually, contain cost elements that are attributable to a different service. The relative FAC, and DSAC costs in this case will have a raised importance to ensure that, aside from the charge control being complied with, the effect of the new regulatory regime can remain fully transparent. Stakeholders will be engaging with Ofcom within 18 months of the new control starting in relation to the next market review, and it is likely that views on how the approach to the regulation of origination will be a key topic of discussion. In the circumstances, Virgin Media considers that there are significant reasons for maintaining the current level of reporting transparency, and continuing to require BT to publish its LRIC figures.

Question 5.6: *Do you agree with the remedies imposed on KCOM in the market for "Wholesale call origination on a fixed narrowband network" in the Hull Area? If not, please explain why.*

No comment

Wholesale fixed geographic call termination

Question 6.1: *Do you agree with our assessment that the relevant service market is "termination services that are provided by [named fixed communications provider] (CP) to another communications provider, for the termination of voice calls to United Kingdom geographic numbers which that CP has been allocated by Ofcom in the area served by that CP"? If not, please explain why.*

Virgin Media agrees, however, we continue to have concerns that the non-geographic termination market has not been reviewed, and there remains an asymmetry of approach in regulation towards the two different market sectors. Ofcom rely upon its on-going NGCS review (which, as at the date of this response remains unpublished), as a reason not to regulate the termination market, however, the regulation that may or may not be imposed in the NGCS review is not competition based, but based upon the consumer failings perceived within the market.

Question 6.2: *Do you agree with our assessment that the relevant geographic market is determined by reference to the area in which the CP provides termination services and is not wider than the United Kingdom? If not, please explain why.*

Virgin Media agrees.

Question 6.3: *Do you agree with our assessment that each CP has SMP in the market for fixed geographic call termination to their number range? If not, please explain why.*

Virgin Media agrees.

Question 6.4: *Do you agree with the remedies imposed on BT in the market for fixed geographic call termination to its number range? If not, please explain why.*

Virgin Media agrees that BT should be subject to general remedies and a charge control, but would additionally comment on the following proposals:

1. Proposing an access conditions that does not include a requirement for charges to be fair and reasonable;
2. Not proposing a cost orientation remedy; and
3. The proposal to remove LRIC reporting from financial reporting obligations.

We would refer to our comment in relation to Question 5.5, in which we considered the approach taken to the regulation of wholesale call origination. The same approach in relation to the three issues described above has been taken in relation to the call termination market, and our comments apply equally to this market.

As with call origination, although we have significant concerns over the approach Ofcom has taken to these issues, in that they appear to indicate the existence of a wider and as yet, unveiled policy, we understand in the specific circumstances of the termination market, and the proposed charge control, that a cost orientation obligation would not be appropriate, given that Ofcom are proposing that charges should be aligned with LRIC, and therefore not in accordance with the current wording of the basis of charge condition applied to the market.

Question 6.5: *Do you agree with the remedies imposed on other CPs (excluding BT) in the market for fixed geographic call termination to their number range? If not, please explain why.*

Virgin Media agrees that a “fair and reasonable” condition continues to be appropriate, however, please see our response to Question 8.3 below.

Transit and conveyance services

Question 7.1: *Do you agree with our assessment that there have been no material changes in the ST market since the 2009 review? If not, please explain why.*

Virgin Media agrees that there has been no material change within this market.

Question 7.2: *Do you agree with our assessment that ex post competition law remedies would now be sufficient to address the competition concerns identified during the period covered by this review in the ST market and that it would no longer be appropriate to maintain regulation in this market? If not, please explain why.*

Virgin Media disagrees with Ofcom’s analysis as to whether the market should be subject to ex ante regulation. We consider that this market should continue to be reviewed, and given the provisional finding that there has been no material change in the market, this would render BT as having SMP, and we consider that it should remain subject to the ex ante remedies imposed in 2009, which have, to date, been proved to be effective. The deregulation of an uncompetitive transit market noted to have enduring competition problems on its “thin” routes, would lead to adverse consequences in this small but still important market.

In establishing the appropriate manner in which this market should be regulated it is important to look back to the last market review.

In 2009, Ofcom looked at the Single Transit market in some considerable depth. This was in part due to the strength of feeling generated following an initial proposal to define a generic transit market (including ITT/ITC and ST) with a provisional finding that the market was effectively competitive.

Ofcom reviewed its approach to transit and in September 2009, published as revised consultation proposing that BT continued to hold SMP in a separately defined Single Transit market. In making its revised proposals Ofcom was aware of the need to ensure that a market outside of the Commissions list of markets susceptible to *ex ante* regulation satisfied the “three criteria test”.

In particular, Ofcom identified competition problems that could not be deal with by competition law:

"*We have identified that some routes within the ST market are less competitive than other routes. These routes generally relate to the smaller and less well interconnected CPs. There is a risk that BT could abuse its dominant position in the market by raising prices to such CPs . The complexity of the market is such that these routes and therefore the CPs that could be potentially affected are difficult to identify. We do not consider that competition law, on its own, would be sufficient to resolve this issue. We consider that ex ante regulation is required in order to provide legal certainty to CPs. This would ensure that they can obtain supply service from BT and be protected against excessive pricing. Further Ofcom would be able to intervene in a timely manner to deal with any competition concerns that did arise*."[29]

"*We have also considered whether allegations or evidence of discriminatory behaviour could be adequately addressed through competition law. However, Ofcom considers that in order to meet our objective to promote efficient and sustainable competition at the wholesale level, a non undue discrimination condition is necessary. This proposed condition ensures, in particular, that all parties are treated on an equivalent basis in equivalent circumstances, thereby creating the right environment for competition to develop. Our view is that this ex ante obligation is therefore needed to create legal certainty and to ensure that Ofcom could intervene in a timely manner to deal with these competition concerns*.[30]

Ofcom confirmed its view in its 2010 Statement[31]. Additionally, it also responded to queries from the Commission in relation to BT's incentive to price discriminate[32]. In essence, Ofcom argued that it was appropriate to apply an unusually light touch approach against price discrimination given the nature of the market and BT's billing systems being historically less than flexible to allow for route by route charging. Ofcom identified that there was a possibility of BT setting a universal high price, and then offering manual discounts, thus favouring individual customers. It noted that this approach had already been applied to other deregulated transit markets.

Again Ofcom stressed that they had considered whether competition law, on its own, would be sufficient to address the identified concerns within the market. At paragraph 5.35 of the statement Ofcom concluded:

"*We have also considered whether allegations or evidence of discriminatory behaviour could be adequately addressed through competition law. However, Ofcom considers that in order to meet our objective to promote efficient and sustainable competition at the wholesale level, a no undue discrimination condition is necessary. This condition ensures, in particular, that all parties are treated on an equivalent basis in equivalent circumstances, thereby creating the right environment for competition to develop. Our view is that this ex ante obligation is therefore needed to create legal certainty and to ensure that Ofcom could intervene in a timely manner to deal with these competition concerns*."

[29] Paragraph 19.50 : Single Transit Consultation Sep 2009
[30] Paragraph 19.120 : Single Transit Consultation 2009
[31] See, for example, paragraph 4.63 : Single Transit Statement 2010
[32] See paragraphs 4.81 et seq : Single Transit Statement 2010

Ofcom now propose to take different approach to this market, despite assessing that there is no evidence to suggest that the product market would be differently defined.[33].

Ofcom point to two key reasons as to why a different approach is merited in this review. In paragraph 7.65 they indicate that total demand is down, and continuing to trend down, and that BT have not attempted to increase the price despite having no regulatory constraint on doing so.

The reasons put forward do not support a change in position. In relation to the declining market, Single Transit remains an important element of the ability to ensure end to end connectivity within the UK, and even if direct interconnection can be said to be replacing the need for ST on "thick" routes, the rationale for regulation, as set out in the 2009/2010 review remains; thin routes are needed, there is an enduring lack of competitiveness over these routes, and regulatory intervention remains relevant. Additionally, it is not apparent that the market will continue to decline over the course of the forward look. Indeed, during this time CPs may well become more dependent on a regulated Single Transit product as the volume of transit minutes they must purchase increases through proposed changes to the NGCS market whereby the terminating provider takes over responsibility for all transit costs while not determining the routing path of the call.

The second reason relied upon by Ofcom is entirely circular. In the 2009/2010 review Ofcom carefully examined the market and concluded that some form of pricing regulation was appropriate, and exceptionally, this could be achieved in the ST market through the imposition of a non-discrimination condition[34]. Ofcom explained that BT may be incentivised to raise the price universally, then apply a discount to specific customers. The incentive to raise prices was therefore contingent upon the ability to discount on "thick" routes, thus remaining competitive for those routes, whilst earning greater returns on "thin" routes with captive traffic.

Ofcom now appear to rely on that fact that the lack of a price increase is evidence that no regulation is needed. On the contrary, Virgin Media considers that the lack of a price increase may well be evidence that the regulation has worked and is appropriately constraining the price on thin routes to that of competitive levels.

Ofcom, by their own admission, have no evidence to suggest any movement in the market, or any evidence that thin routes will still cause the same potential competition problem going forward. Therefore, for the same reasons that Ofcom relied upon in the 2009/2010 review, the imposition of ex ante regulation to create the necessary certainty and ability to intervene in a timely manner remain. Virgin Media does not understand how, in the absence of any new evidence, Ofcom can provisionally conclude that a CP not being able to offer termination (if ST services were withdrawn – either by act or effect, for example through pricing changes), will have a negligible effect on competition at the retail level[35]. Additionally, there does not appear to be consideration of the effect at the wholesale level in relation to the CPs who would (in Ofcom's scenario) be denied interconnection.

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[33] Paragraph 7.32 consultation
[34] It is of note that the original proposal in 2009 had proposed the imposition of cost orientation in addition to the non-discrimination condition. This was dropped between the consultation and statement.
[35] Paragraph 7.66 Consultation

Virgin Media considers that the appropriate approach for Ofcom to take in relation to this market is, given the lack of any material change, is to ensure that the regulation, that was applied successfully in 2009/10 is reapplied in this review.

Question 7.3: *Do you agree with our assessment that the LTC/LTT market in the United Kingdom has remained competitive since 2009 and that we expect the same competitive conditions to continue during the period of this review? If not, please explain why.*

Virgin Media agrees.

Price regulation of termination and origination markets

Question 8.1: *Do you agree that we should cap FTRs at LRIC? Please explain your reasons.*

Virgin Media does not agree with the proposal, and would refer to our detailed response in Section 1, above.

Question 8.2: *Do you agree that wholesale call origination should be regulated on a LRIC+ basis where the "+" includes a mark-up to off-set the common cost recovery foregone from externally provided wholesale call termination on a LRIC basis? If not, please explain why.*

Virgin Media agrees with the overall approach that lost termination costs need to be recovered in a transparent manner. We also agree that the wholesale origination charge set alongside the termination rate under the Network Charge Controls presents an appropriate vehicle for this recovery, however, we would refer to our detailed comments in section 1 above in relation to the importance of not skewing incentives by setting saw-toothed regulated rates, and our proposal to ensure that this does not happen.

Question 8.3: *Should the FTRs of CPs other than BT be presumed fair and reasonable where they are no higher than the Benchmark FTR? If not, please explain why*

We discuss Ofcom's approach to fair and reasonable termination rates in our detailed discussion in Section 1, above.

Question 8.4: *Should the FTR set by KCOM in the Hull Area be presumed fair and reasonable where it is no higher than the Benchmark FTR? If not, please explain why.*

No comment

Question 8.5: *Do you agree with our proposed approach to the regulation of wholesale call origination rates in the Hull Area? If not, please explain why.*

No comment

Question 8.6: *Do you agree that LRIC-based FTRs should not be adjusted for APCCs?*

Virgin Media considers that the issue of APPC is one that has not been fully accounted for in Ofcom's current proposals given the magnitude of the impact of the change in FTR rates. Although the regulatory regime regulating APCCs is through General Conditions, and as such, it is not directly under this market review, it is undeniably related to the setting of LRIC based FTRs in practice and further work needs to be undertaken by Ofcom in relation to its position on APCCs to ensure that the two regulatory regimes remain complementary, and do not work against one another. Ofcom may seek to issue guidance or amend the text of GC18 to safeguard against this risk, but by ensuring that there is a degree of "cushioning" by applying a glide path to termination rates, then any risk of perverse consequences is reduced, and any difference in timing between the 2013 narrowband statement and clarification / amendment of GC18 would considerably less significant.

Cost modelling for call conveyance services

Question 9.1: *Do you agree with our proposed approach to modelling the cost of fixed call origination and fixed call termination? If not, please explain why.*

Virgin Media has set out its concerns over the proposed modelling approach in section 1 above.

Interconnection

Question 10.1: *Do you agree with our assessment that BT and KCOM should be required to provide interconnect circuits? If not, please explain why.*

Virgin Media agrees.

Question 10.2: *Do you agree with the obligations we propose to impose on BT in relation to the provision of interconnect circuits? If not, please explain why.*

Virgin Media agrees.

Question 10.3: *Do you agree with the obligations we propose to impose on KCOM in relation to the provision of interconnect circuits? If not, please explain why.*

No Comment.

Charge control specification

Question 11.1: *Do you agree with our proposed glide paths? If not, please explain why.*

Virgin Media disagrees with the proposed approach, and has set out its concerns fully in section 1, above.

Question 11.2: *Do you agree with our proposal to allow a six week implementation period for Fixed Termination Rates to be capped at LRIC? If not please explain why.*

Virgin Media disagrees with an approach that does not apply a glide path and considers that an aggressive implementation of LRIC rates will have significant negative impact as discussed above. We do not therefore agree that a six week implementation period is appropriate.

We also refer to our response in Section 1 above, in relation to the potential for the charge control to start later than 1 October, and therefore avoid an unnecessarily short lead in time.

Question 11.3: Do you agree with our proposals relating to “Charge control design”? If not, please explain why.

Virgin Media does not have any comments to make in relation to the charge control design issues discussed between 11.77 and 11.116 of the consultation document.

Virgin Media
2 April 2013

Virgin Media's response to Ofcom's Narrowband Market Review Consultation

Annex 1 : Virgin Media's Impact Assessment

[✂]

Virgin Media's response to Ofcom's Narrowband Market Review Consultation

Annex 2 [✁]

Virgin Media's response to Ofcom's Narrowband Market Review Consultation

Annex 3: Proposed Glide Path to ensure neutral Call Origination Incentives

Introduction

The current proposal for the regulated charge on BT for wholesale call origination provides for an increase in the charge in year 1 of the control, followed by decreases in year 2 and year 3, such that the end point of the control will be lower than the starting charge.

We described our concerns over this "saw-tooth" effect in our main response and suggested that it would be appropriate to cap the call origination charge in years 1 and 2 of the control to their current level.

However, as the proposed regulated call origination rate contained a mark up for the common costs associated with call termination, it would be important to adjust the termination control to ensure that BT could continue to recover an appropriate level of common costs associated with both call origination and call termination.

Our proposal is that the termination common costs allocated to the regulated call origination charge above the current charge ceiling should remain within the termination charge for those years. Thus termination common costs would be split between the regulated charges for origination and termination for years one and two of the control (in reducing proportions), with termination common costs being recovered exclusively in the call origination cost in year three of the control (and beyond, subject to any future controls).

We consider that the base case proposal would produce the following values:

	13/14	14/15	15/16
Ofcom's Proposed Origination Charge	0.297	0.269	0.244
Ofcom's Proposed Termination Charge	0.04	0.037	0.034
Adjusted Origination Charge based on ceiling set at current charge	0.252	0.252	0.244
Adjusted Regulated Termination Charge	0.095	0.058	0.034

In this Annex we explain how we derived the values for the Adjusted Regulated Termination Charge set out in the above table, and confirm the compatibility of the resultant termination glide path with our assessment of the impact of an immediate reduction to LRIC in the termination market, as set out in our substantive response and Impact Assessment.

Further we also assess the practical impact on timing if a further round of consultation was required.

Overview of Analysis / Methodology

Our analysis determines the amount of common costs allocated to call origination over and above the nominal charge ceiling set at the level of the current regulated charge and then reallocates this back into the regulated termination charge. This process is outlined below.

Step 1	Establish the LRIC+ values for both Call Termination and Call Origination
Step 2	Establish the Common Costs attributed to Call Termination
Step 3	Determine the common costs above the current regulated Call Termination charge (taken as the maximum charge ceiling).
Step 4	Determine the difference between the Common Costs attributed to Call Termination and the mark up on the Call Origination charge.
Step 5	Adjust this figure to reflect the ratio of termination common costs (established at Step 2) and the mark up allocated to call origination (A12.13).
Step 6	Add this figure to the LRIC of termination charge to determine the level of regulated charge for a year within the control.

Applied methodology and sources

Step 1 : Establish LRIC+ costs

LRIC+ termination set out in Fig 9.6
LRIC+ origination can be calculated from deducting the origination mark up (Table 12.13) from the proposed origination charge (Table 1.1)

		13/14	14/15	15/16	Source
A	Total Origination Charge	0.297	0.269	0.244	Table 1.1
B	Origination Mark up	0.123	0.111	0.100	Table 12.13
C	**LRIC+ Origination**	**0.174**	**0.158**	**0.144**	A-B
D	**LRIC+ Termination**	**0.189**	**0.173**	**0.158**	Fig 9.6

Step 2 : Establish Termination Common Costs

Deduct termination LRIC (Table 1.1) from termination LRIC+ (Value D) to establish the common costs assigned to termination.

		13/14	14/15	15/16	Source
D	LRIC+ Termination	0.189	0.173	0.158	Fig 9.6
E	LRIC Termination	0.04	0.037	0.034	Table 1.1.
F	**Termination Common Costs**	**0.149**	**0.136**	**0.124**	D-E

Step 3 : Determine common costs above charge ceiling

Assuming a charge ceiling of the current regulated charge, common costs previously associated with termination can still continue to be recovered in the regulated origination charge up to that level, but costs associated with termination above that level need to be split out.

We derive this from deducting the current charge ceiling from the proposed Origination Charge, where this exceeds the current charge.

		13/14	14/15	15/16	Source
A	Total Origination Charge	0.297	0.269	0.244	Table 1.1
G	Current regulated charge (as ceiling)	0.252	0.252	0.244	Table 1.1
H	**Common costs above ceiling**	**0.045**	**0.017**	**0.000**	A-G

Step 4 : Determine difference between Termination common costs and Origination mark up

It would be inappropriate to simply add the common costs above the ceiling onto the termination charge, as the costs are calculated based on overall termination and origination volumes. Ofcom explain at paragraph A12.210, in relation to calculating the uplift to be applied to call origination that they take the ppm termination common costs, multiply it by total inbound minutes, then divide that by total outbound minutes to derive a ppm value to be assigned to Call Origination Charge.

In order to adjust for this we need to determine the ratio between termination and origination, which we can derive from dividing termination common costs from the mark up actually applied to the origination charge.

		13/14	14/15	15/16	Source
F	Termination Common Cost	0.149	0.136	0.124	Calculated
B	Origination mark up	0.123	0.111	0.100	Table 12.3
I	**Ratio**	**1.211**	**1.225**	n/a	F/B

Step 5 : Determine common cost to remain in Termination

Having derived the ratio to adjust the costs that need to be fed back into termination to compensate for the costs above the call origination ceiling. We multiply the common costs above the Call Origination ceiling (ie those that would not fall to be recovered in that charge), by that ratio.

		13/14	14/15	15/16	Source
H	Common costs above ceiling	0.045	0.017	0.000	Calculated
J	Multiplication Factor	1.211	1.225	n/a	F/B
K	**Termination common costs**	**0.055**	**0.021**	**n/a**	H*J

Step 6 : Determine level of regulated charge

Having established the level of common costs to be fed back into the termination charge we can come up with a proposed glide path by adding the common costs not able to be recovered under the Origination charge back onto the termination LRIC value. This creates a small adjustment to allow for a rational glide path for wholesale call origination.

		13/14	14/15	15/16	Source
E	LRIC Termination	0.04	0.037	0.034	Table 1.1
K	Termination common costs	0.055	0.021	n/a	Calculated
L	**Adjusted Regulated Termination Charge**	**0.095**	**0.058**	**0.034**	E+K

Common costs associated with termination are therefore allocated in the following manner:

Year 1

73% - Termination Common Costs recovered through Origination Charge
27% - Termination Common Costs recovered through Termination Charge

Year 2

87% - Termination Common Costs recovered through Origination Charge
13% - Termination Common Costs recovered through Termination Charge

Year 3

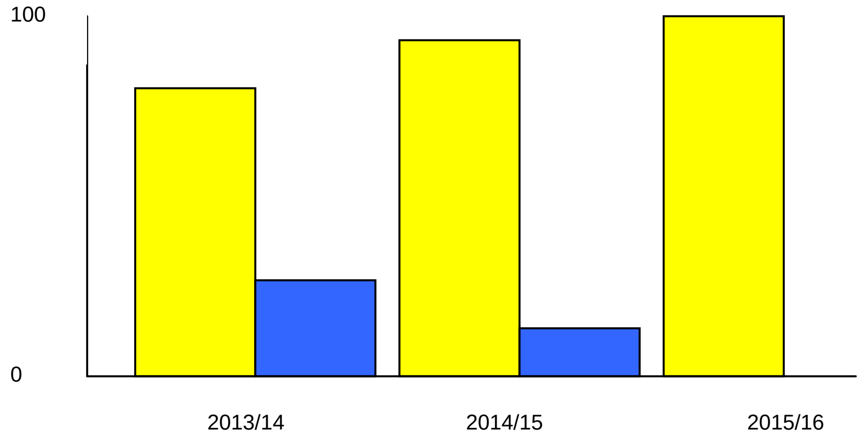
100% - Termination Common Costs recovered through Origination Charge

The relative splits, and reducing allocation to termination can be effectively illustrated as follows, which clearly shows a *de minimis* retention of common costs within termination for years one and two of the control. Thus diverting only marginally from the “goal” of the Recommendation to set rates with no common cost recovery from termination.

Figure 1 : Illustration of Common Cost Allocation between Origination and Termination Charge

Key :

%age common costs associated with termination allocated to call origination charge	
%age common costs associated with termination allocated to call termination charge	



Not to scale : illustrative only

The glide path also remains appropriate to justify an adjusted termination rate based on a glide path down to LRIC, given the objective reasons that an immediate adjustment would cause disruption to industry, leading to consumer detriment and reduced investment incentives (or investment inefficiencies through required strategy changes). Additionally, the differing nature of fixed networks, created in part through legacy regulatory incentives (such as the Reciprocity Agreement, endorsed by previous Narrowband market reviews), also justifies an appropriate period of adjustment through a glide path.

Further, the levels suggested in the above approach would not have any European inter-market impact, given that all lie below the current Euro Average BU-LRIC rate[36].

Effect on Review Timetable

We appreciate that, should a revised approach to the setting of the charge controls be applied, to the extent that this was considered to be a material change to the proposals consulted upon, a further round of consultation may be required to ensure that stakeholders had an opportunity to express their views on any alternate proposal.

Whilst the timeline is tight, we consider that it remains feasible for an additional 4 week consultation period to be inserted into the current timetable. Responses to the consultation have been received, and a further consultation in May/June should not

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[36] 0.1135ppm, as cited by BEREC in its recent opinion on the Commission's Phase II enquiry into Italian Termination Rates

preclude a draft statement being notified to the Commission in July as implied by the desire to publish a statement in mid-August[37].

To the extent that there is any slippage, Virgin Media consider that this could be accommodated by the current NCC rates acting as an effective charge ceiling until new rates could be implemented, subject to an appropriate commitment from BT. In our response to Question 11.2 we disagreed with the proposed implementation of the new control which differs significantly to previous controls that have not required "day 1" adjustments, and remain concerned that Ofcom should not rush the implementation of the control, creating further unnecessary disruption on the market.

In this context we consider that a delay to the statement (in which the substantive market review decisions are taken alongside setting the NCCs)[38], would not affect the three year duration of the control, and as such the control is not required to start on 1 October, providing an appropriate bridging remedy or solution is available. Further, there are no directly linked markets that will be affected by the starting date of the control, indeed it is notable that wholesale exchange lines (previously included in the Narrowband Review), which are subject to charge controls (WLR / ISDN30) are now de-linked from this review and are being reviewed under the Fixed Access review, in order to maintain consistency with LLU controls.

Our overall concern in relation to the impact of a sudden decrease in rates on industry, therefore extends to how the controls should be implemented, and as such an approach that allows for an appropriate lead in before the implementation of an appropriate form glide path should be considered, and in our view proposed as the appropriate regulation for this market.

[37] Paragraph 11.68
[38] There is no issue in relation to a charge control being for a different period than the market review that "parents" it, as has been the case where reviews of charge controls have been conducted separately from the market review.