Virgin Media's response to Ofcom’s Business Connectivity Market Review and Leased Line Charge Control consultations

30th August 2012

Non-Confidential Version

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Introduction

Virgin Media is a leading communications provider to businesses in the UK. We deliver a complete portfolio of voice and data solutions nationwide and are pleased to have the opportunity to respond to Ofcom's proposals in relation to the Business Connectivity Markets.

Business connectivity, particularly through the continuing development of Ethernet services, is a key market to the UK's communications industry. The need for higher bandwidths to keep pace with the advances in technology has driven considerable investment and innovation within the market place, which in itself is aiding competition and benefitting end users. However, the ubiquity of BT's national network means that an appropriate level of regulation must remain in order to ensure that they are not able to exercise the dominance that they continue to possess in most markets. Ofcom must therefore carefully balance the competing needs of regulating the incumbent provider whilst providing an environment that encourages continued investment and innovation by alternative network providers.

Structure of Response

Ofcom has published two separate consultations in relation to its proposals for the business connectivity markets; the Business Connectivity Market Review (BCMR) on 24 June 2012 and the Leased Lines Charge Control Review (LLCC) on 1 July 2012 (together, "the Consultations"). Essentially, the BCMR reviews the markets, and proposes remedies, including a proposal for certain price controls to be applied to relevant markets, and the LLCC sets out detailed proposals for those price controls. Ofcom have now confirmed[1] that they will accept combined responses to the Consultations by a single deadline of 30 August 2012.

Virgin Media, therefore addresses both Consultations in this single response. Overall, Virgin Media recognises the evolutionary nature of the review, retaining market definitions and approaches from the 2008 review. Whilst we broadly welcome the certainty that this approach provides in these markets, we have two key concerns with the proposals which we outline in Sections 1 and 2 below, before addressing the individual questions asked in the Consultations in Sections 3 and 4.

[1] Email from Gideon Senensieb dated 7 Aug 12 detailing alignment of consultation response deadlines to allow for combined responses.

Executive Summary

Although Virgin Media is broadly supportive of the proposed market definitions and SMP determinations, we have concerns in relation to some of the proposed remedies, and in particular, remedies relating to pricing.

We have identified two critical issues that we believe have failed to be addressed by Ofcom in the Consultations:

1. Failure to impose cost orientation as an appropriate remedy; and
2. Failure to consider the need to encourage investment by alternative network providers.

Cost Orientation

Ofcom have proposed not to impose a cost orientation obligation in any market. This represents a wholesale change in policy, and marked shift from the position adopted in the previous market review.

Virgin Media notes that Ofcom's forthcoming review of cost orientation may well seek to address a wider policy of when and how a cost orientation remedy should be applied to a market, but such proposals are in the future and preliminary internal thinking relating to that project should not influence the proposals here.

Virgin Media considers that Ofcom's reasons for this apparent change of policy are insufficiently articulated in this consultation, and reasons that are provided, are themselves flawed.

Fundamentally, Ofcom have identified key competition concerns in the market, which previously have been addressed by the appropriate imposition of a cost orientation remedy, but in this review have been entirely overlooked.

Cost Orientation, as currently imposed in the majority of regulated markets where pricing issues are a concern, is a valuable remedy that provides an effective constraint on the dominant provider. Recent decisions in the CAT and the Court of Appeal in relation to the application of the obligation in PPC markets, have clarified the application of the obligation, and to abandon this approach would leave stakeholders significantly exposed to pricing distortions.

Failure to consider the need to encourage investment

Ofcom has a vital role in ensuring that the UK telecoms industry continues to develop through effective competition. Where a market is not effectively competitive, appropriate regulation should be imposed in order that competition can be promoted at the deepest level of the infrastructure at which it is likely to be efficient and sustainable.

Whilst Ofcom have proposed to continue regulating markets in which BT is dominant, we are concerned that some of the price control proposals will have the effect of diminishing infrastructure based competition and artificially incentivising the purchase of wholesale inputs to compete against BT's retail divisions.

Having established conditions that have increased the potential for infrastructure based competition, it is vital that this work is not undone. The Ethernet markets concerned continue to develop and, whilst we recognise that forecasting is not a precise science, the effect of getting regulation wrong could be severe. Virgin Media considers that there is an asymmetric risk between over over-regulation and under-regulation.

Even “slightly too low” regulated wholesale prices have the potential to significantly damage infrastructure based competition, leading to artificial incentives in the market, entrenching BT’s position as a wholesale supplier, reducing the prospects of alternative network investment, all of which will result in negative long term outcome for industry and consumers.

Conversely, whilst slightly too high wholesale prices could be passed through and lead to higher prices to consumers, the overall level of infrastructure competition would not be dampened, and the market should continue its trend to becoming more competitive.

We would encourage Ofcom to set the right price, but, there is a need to re-examine the assumptions used in modelling the proposed control, and also to bear in mind the need to be cautious when forecasting, over a five year period, trends in Ethernet products and services.

Virgin Media consider that the currently proposed control for the Ethernet basket should be adjusted so as to reduce the depth of the proposed cuts, and at the least a figure at the top of the consulted range should be adopted.

SECTION 1 : Cost Orientation

1. Ofcom have proposed not to impose a cost orientation obligation in any of the wholesale markets in which it is proposed BT has SMP. This is a significant break with prior practice where cost orientation has usually been imposed as a complementary remedy alongside a charge control.

2. Virgin Media has four specific concerns regarding the approach taken to the issue of cost orientation as a complementary remedy to a charge control.

- Failure to address all identified pricing concerns;
- Failure to provide adequate protection in relation to pricing of new services;
- Lack of adequate reasoning in the BCMR; and
- Flawed reasoning in the Consultations to justify not imposing the remedy.

Failure to address all identified pricing concerns

3. We consider that none of the reasons set out by Ofcom, in either of the Consultations, actually address the identified competition concern relating to excessively low pricing, and even though the proposed charge control seeks to address excessive pricing, there remain concerns that are not covered.

4. Cost Orientation, as a remedy, has a number of functions; it provides:

- Protection from excessive pricing.
- Protection from predatory pricing / price squeeze.
- Protection from exploitation of new services entering the market
- In combination with a charge control, protection from charge control failure due to forecasting errors, especially where market is unstable / not well established
- In combination with a charge control, protection in relation to the pricing of individual services within the wider defined basket
- As an alternative to a charge control, a “lighter touch” form of price regulation

5. In its market analysis Ofcom have identified market failures and competition concerns common to the TISBO, AISBO markets. These include:

- TISBO - “Charg[ing] excessively high prices, margin squeeze, engage in predatory pricing and/or anti-competitive cross subsidisation”[2]

- AISBO - “we consider BT [could] engage in, charging excessively high prices, margin squeeze, engage in predatory pricing and/or anti-competitive cross subsidisation”[3]

6. However, in relation to all TISBO and AISBO markets, Ofcom then dismisses the need for any other form of pricing control other than an RPI-X charge control on the basis that such a control protects against excessive pricing[4]. Further explanation

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[2] Paragraph 10.12 BCMR
[3] Paragraph 11.16 BCMR
[4] See paragraph 10.42 BCMR re TISBO, “we consider that in these markets we can provide adequate protection against excessive pricing with a charge control and are therefore not proposing a cost orientation obligation for these markets.”; see paragraph 11.176-7 re AISBO “we can address the risk of

is promised within the LLCC consultation. No mention is made of how an RPI-X control would address the other identified competition problems of margin squeeze, predatory pricing or anti-competitive cross subsidy.

7. It is of note that in relation to the MISBO market, in contrast to its assessment of the TISBO and AISBO markets, Ofcom identifies only two specific competition concerns relating to pricing, charging excessively high prices and/or engaging in anti-competitive cross subsidisation[5]. However, when analysing the appropriate remedies to put in place for the MISBO market, Ofcom does note that "price control conditions can also be used to prevent anti-competitively low prices"[6]. Whilst the need for pricing remedies is substantially less in the MISBO market, it is notable that excessively low pricing is at least considered in this market.

8. An RPI-X control (with an all service sub-cap) provides a pricing ceiling, but does nothing to constrain BT choosing to price its controlled products and services at excessively low prices. Indeed, the nature of a price control is such that discretion is afforded to the Dominant Provider in how they set individual in-basket prices, with lower pricing on some products being able to off-set higher pricing on other products in order to meet the overall price cap. The broad baskets proposed in this consultation provide considerable pricing flexibility for BT could increase the incentive to price some services at excessively low levels in order to off-set higher prices elsewhere in the basket in order to meet the overall target. Combined with Ofcom's relatively steep proposed control on Ethernet services of RPI-12% (range midpoint), a substantial increase from the current control of RPI-7%, means that such incentives are very real.

9. Ofcom also assesses that some Ethernet prices are substantially closer to DLRIC than DSAC (some services being around 10% above DLRIC)[7]. Whilst Ofcom considers that as unit costs fall then this gap may increase, there is a current trend of falling prices, which would continue under the proposed charge control, and therefore we consider that excessively low pricing (ie pricing below cost) is a real concern. This may be of particular concern where the underlying cost of supply varies little with increasing bandwidth, yet, commercially pricing increments continue to be bandwidth driven.

10. The issue of forecast accuracy is also important, as if, in the case of the Ethernet basket, sales do not increase as Ofcom have predicted, the actual cost base will not reduce and, in effect, the glidepath will be too steep relative to cost. We consider that there is a real risk that Ofcom's forecasts could well be too ambitious (see our answer to Q11 LLCC below for a full discussion), and therefore, should this prove to be the case the risk of prices falling below DLRIC is increased further.

11. We also consider that the wide baskets and product mix also incentivise BT to price different generational products differently within baskets. This may well produce larger price reductions on some products, and therefore make some form of regulation to guard against low pricing necessary. For example, in the Ethernet basket, BT provides both WES services (not available for new connection) and EAD services. Broadly, BT supply 60% of WES (10, 100 and 1000 Mbit/s) services to

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BT engaging in excessive pricing practices with a charge control……we therefore propose not to apply a cost orientation obligation"

[5] Paragraph 12.7 BCMR

[6] Paragraph 12.151 BCMR

[7] Paragraph A5.164 LLCC

downstream businesses against 40% external supply. In the case of EAD the split is broadly 75% internal and 25% external[8]. The proportionately greater supply of EAD to internal customers provides an incentive on BT to make higher price reductions on EAD services than the equivalent WES service. It is of note that BT's recent price reductions for 1Gbit/s services included reductions to the basic EAD product that were twice as big (in percentage terms) as reductions applied to the equivalent WES product[9].

12. BT have also displayed a tendency to tactically price to maximise their profit within the terms of the imposed regulation. In some instances, this has resulted in BT being found to have overstepped the imposed regulatory control[10] or has resulted in an immediate shift of pricing practise in response to an imposed control / price ceiling[11].

13. It is significant that in the ISDN30 CC review, when Ofcom decided, exceptionally, not to impose cost orientation alongside a new charge control (this was the first time any price control had been applied, and not a situation where cost orientation had previously been imposed on the market), the narrowness of the baskets was cited as a specific reason to justify not applying an additional complementary cost orientation condition:

> "*We are not proposing to impose a cost orientation obligation on core wholesale ISDN30 services. This is because we consider that the **low number of services in the charge control baskets** and the presence of safe-guard caps where appropriate, together with the requirements for charges to be fair and reasonable and not unduly discriminatory, will be more effective at constraining the level of prices.*"[12] (emphasis added)

14. [Redacted – Confidential]

Failure to provide adequate protection in relation to pricing of new services

15. Although Ofcom propose that their RPI-X control is, on its own, sufficient to address identified excessive pricing concerns, Virgin Media considers that the pricing of new services will not have adequate protection.

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[8] Figures derived from page 51/52 BT's published RFS for 11/12. (WES10 58% internal / 42% external; WES100 60%/40%; WES1000 60%/40%; EAD10 75%/25%; EAD100 75%/25%; EAD1000 82%/18%)
[9] See BT price briefing ETH034/12 (explaining ACCNOR298) at http://www.openreach.co.uk/orpg/home/updates/briefings/ethernetservicesbriefings/ethernetservicesbriefingsarticles/eth03412.do
[10] For example, the PPC disputes, recently determined by the Court of Appeal, when BT sought to apply a cost orientation obligation in aggregate to PPC trunk elements to offset a low regulated terminating segment charge control.
[11] For example, following Ofcom's 2011 Statement on Wholesale Charge for Number Translation Services and Premium Rate Services, BT raised the price of chargeable calls to the imposed basket cap.
[12] Ofcom (2011), Price controls for wholesale ISDN30 services, Consultation on the form and level of price controls on Openreach wholesale ISDN30 services, 1 April.

16. Ofcom's proposal to introduce a charge control as the sole form of pricing regulation means that it will only apply to a set of defined products as set out in the Annex to the draft legal instrument in Annex 8 of the LLCC. Although Ofcom suggests that the proposed charge control does adequately contemplate new services being introduced, Virgin Media considers that the proposed condition fails to provide sufficient safeguards to address the identified risk that BT can price new services independently of other providers.

17. Ofcom discuss the inclusion of new services within the control at paragraph 10.18 LLCC et seq. Ofcom recognises that telecom markets are generally subject to ongoing product development and review and there is a need, when imposing pricing regulation, to anticipate the development of new and replacement services by BT.

18. This is particularly true of the markets in this review. Ofcom already acknowledge the need for SyncE to be included within the control, but do not have sufficient sight of product charges or the cost of provision relative to existing Ethernet services[13] to propose, at this stage, any specific regulation for this product.

19. By way of two further examples of how products may change during the control, Virgin Media understands that:

- BT is considering the withdrawal of high bandwidth WES variants that are currently proposed to be controlled in the Ethernet basket;
- a replacement product for EAD, is likely to be introduced within the control period;

20. Aside from those potential changes, which are visible and being discussed within industry now, some six months before the start of the control period, it is inevitable that as data consumption increases, the development of new and additional higher bandwidth products will occur, changing the product set further.

21. Ofcom suggest that the draft condition deals with this issue by including a "material change" condition (e.g. Condition 5.3(j) in the Ethernet Services Basket). It is said that "this provision would ensure…that…the replacement service would fall within the scope of the proposed charge control"[14]. Virgin Media has two concerns with the provision, as drafted.

22. Firstly, the provision requires Ofcom to go through a formal direction making process under section 49 of the Act[15]. This will mean that Ofcom will have to propose a direction to include a replacement service within the charge control list (and the setting of any service specific sub-caps if appropriate). This direction will be potentially consulted on domestically under s49A and within Europe under s49B, each of which will take a minimum of one month aside from any time to understand the pricing and cost base of a replacement product, the time to draft the consultation and time to consider responses to it. Virgin Media is concerned that this process will take a significant amount of time within the context of a three year control, and its lack of immediate effect significantly reduces the effectiveness of the control.

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[13] Paragraph 10.27 LLCC
[14] Paragraph 10.22 LLCC
[15] Communications Act 2003 (as amended)

23. Secondly, the "material change" provision within the draft Conditions does not extend to new services that are not "wholly or substantially in substitution" for a controlled service. Should BT launch a new service, then this service will not be price controlled, nor will Ofcom be able to direct that the service be price controlled. Ofcom states in the BCMR that "If, however, BT were to introduce new services that fall outside the scope of the proposed charge control (ie services that do not wholly or substantially replace existing services) we would consider whether a price control obligation would be appropriate for those services" [16]. Therefore, any new service would have to be the subject of a new SMP condition, or Ofcom would have to modify the existing condition. Either process would be much more involved than the direction making process described above, as it would require a market assessment to determine whether there had been a material change to the market since the market power determination in addition to proposing how the new / modified SMP condition should be structured, all of which would require domestic and European consultation. Again, the ability of a service to remain uncontrolled for a significant period of the control is concerning.

24. This concern is very real, as this appears to be the approach that Ofcom will have to take in relation to BT's anticipated launch of SyncE. Ofcom have confirmed in the LLCC that they intend to apply the control to SyncE. Ofcom have not, however included it within the proposed list of controlled services as they are not able assess charges relative to cost. Ofcom therefore states "We will consider the need for a formal consultation on the introduction of SyncE into the charge control…..when we have further data around pricing and costs for the service."[17] It would appear that as SyncE does not "wholly or substantially" substitute an existing EAD product, but adds a new functionality by supporting accurate network timing over Ethernet, that it would not fall within the Direction making remit contained with SMP Condition 5.3(j). Therefore, a full consultation to amend the SMP Condition will be required. It is particularly of note that Ofcom identifies that a failure to charge control this product could "impact the effectiveness of the basket"[18].

25. Given that there is a risk that the control itself could be rendered ineffective by the introduction of a new product, and the potential delay[19] in the process to amend the control, Virgin Media is concerned that a stand alone RPI-X control is not sufficient to address excessive pricing in an market where technology and products are likely to evolve, and that a complementary control of cost orientation is required which would apply immediately to each and every service within a market, and would capture new and replacement services at the time of their launch.

26. Adopting cost orientation may also lessen the need for mid-control intervention in the event of a new service launch. Given that a stand alone cost orientation obligation provides some control against excessively high and low pricing, a new service may not need to be subject to a full charge control.

Lack of adequate reasoning

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[16] See, for example, paragraph 11.171 BCMR Consultation
[17] Paragraph 10.28 LLCC
[18] Paragraph 10.25 LLCC
[19] Virgin Media considers that, based on experience of Ofcom consultation practice, a period of a year would not be unexpected to cover an information gathering phase to understand the product and undertake a no material change review of the market; drafting a consultation document; consulting; assessing responses to the consultation; updating information on the product and the market; and consulting on a draft statement with Europe, all of which would have to precede any final statement being published to give effect to a change of condition.

27. Virgin Media considers that there is insufficient and inadequate reasoning contained within the BCMR to justify the both the non-implementation of cost orientation and change of practice from the approach taken in previous reviews both in these markets and more generally. To the extent that the BCMR seeks to address why it is not appropriate to impose cost orientation, it does so superficially and notes that the reasoning would be set out in the LLCC in "more detail"[20]. Virgin Media considers that the LLCC is not the place in which to judge whether cost orientation is an appropriate remedy; this is an assessment that should be made in the Market Review document, proposing appropriate remedies to address competition concerns identified in its market power analysis. Indeed the LLCC document assesses its options only in light of the competition problem of excessive pricing, and therefore the reasons for non-imposition of cost orientation are inherently flawed.

28. There is no discussion or explanation as to why Ofcom has decided to change its approach to price regulation in this market. cost orientation was imposed in previous BCMR reviews, and indeed, it is often imposed as an appropriate complementary remedy to a charge control, only not being imposed where there are specific circumstances which justify a different approach. Ofcom is obliged to have regard to the principle of consistency when performing their duties[21], and an apparent abandonment of an approach to price regulation that has been followed since the introduction of the general authorisation regime, deserves a full explanation. It is of particular note that the underlying market failures identified in this review that relate to pricing are substantially the same failures identified in 2008 when cost orientation was imposed as an appropriate remedy.

Flawed Reasoning

29. Although substantive reasons for not imposing cost orientation were promised in the LLCC, not only do they fail to address low pricing concerns, Virgin Media considers that they are flawed in any event.

30. The LLCC consultation specifically states "the competition problems we are seeking to address with regarding pricing - ie excessive pricing – can be effectively addressed by sub baskets and sub caps"[22], additionally noting that:

- the proposed charge control provides a greater degree of certainty for stakeholders that Cost Orientation;
- that DSAC is difficult to predict given a changing market;
- that cost orientation would not bring prices in line with costs; and
- that it would be disproportionate to impose cost orientation if excessive pricing is dealt with by the proposed sub caps.

31. Each of the four reasons provided for not imposing a cost orientation obligation are neither fully considered by Ofcom in their Consultation, nor persuasive. We address each issue in turn:

Certainty

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[20] For example, paragraph 10.118 BCMR (re LB TISBO)
[21] Section 3(3) Communications Act 2003
[22] Paragraphs 5.69 LLCC (for TI basket); 6.110 LLCC (for Ethernet basket)

32. We consider that the suggestion that there is a greater degree of certainty for stakeholders from a charge control is an oversimplification of the position. The two remedies, although aimed at addressing a relevant risk of adverse pricing effects, are different in their effect and application. They are, as Ofcom states in the BCMR[23], complementary remedies. Whilst the proposed charge control offers certainty in some areas, by providing a list of regulated products and a sub-cap to ensure that each of those listed products cannot be priced at more than a specified level, it cannot be said that it offers more certainty than cost orientation. Cost orientation provides an obligation that applies across the entire market (not limited to a pre-defined list of products) and therefore provides significantly more certainty over the regulation of new products or services introduced during the life of the market review. Additionally, there is ample guidance as to how a cost orientation obligation (drafted in terms of the current condition) should be applied, following judgements in the PPC Appeal from the CAT and the Court of Appeal; it has never been clearer as to how the obligation should apply.

DSAC is difficult to predict

33. Cost orientation is not subject to forecasting, as it obliges the Dominant Provider to ensure that its prices are related to the cost of the product / services supplied. Ofcom notes that the market is likely to evolve over the forward look period, and cites this as a reason that cost orientation may not be suitable as DSACs are likely to vary through the period. In fact, as DSAC is not applied mechanistically as the definitive test for cost orientation, its predictability should not be considered determinative as to the efficacy of the remedy.

34. A charge control is equally subject to market variability. In proposing a charge control, Ofcom have had to forecast costs and volumes for the forward look period, and the changing nature of the market identified means that there is a risk that those forecasts could be inaccurate[24]. Whilst forecast inaccuracies can be corrected in the next control period (assuming a further price control is required in 2016), it means that market uncertainties affect both forms of price control, and rather than this being a reason not to impose cost orientation it provides a cogent argument for a complementary cost orientation obligation that is based on actual not forecasted costs to sit alongside a forecast based charge control. This is particularly the case in the control proposed for these markets which are based on data from 2010/11, and involve two years of forecasting before the commencement of the proposed control itself, which risks exacerbating the effect of any forecast error over the life of the control.

Failure to bring charges in line with costs

35. Virgin Media accepts that a cost orientation obligation may not be as effective as a charge control at reducing the charges for an overall basket of services to the level of their efficiently incurred aggregate costs. However, Ofcom appears to miss the point of a cost orientation obligation applied in tandem with a charge control as complementary regulation. Indeed, as a charge control is set on a basket approach covering a range of services, it does not ensure that individual services are cost

[23] Paragraph 10.42 BCMR
[24] Indeed, Virgin Media has specific concerns over the volume forecasting in the consultations: see our response to Q11 LLCC below.

based, and the additional control afforded by cost orientation provides valuable protection from excessively high or low charges within the basket.

Proportionality

36. Ofcom suggest that as excessive pricing has been dealt with by the imposition of a charge control, there is no reason to apply an additional pricing remedy such as cost orientation. Ofcom has failed to address the additional identified competition concerns such as predatory pricing, margin squeeze and anti-competitive cross-subsidisation, and therefore their statement on proportionality is fundamentally flawed. However, even if the only competition concern was one of excessive pricing, it would still not be disproportionate to impose a cost orientation remedy for the following reasons:

- The charge control only applies to scheduled products. Cost orientation would apply to any product or service launched into the market, providing important protection to stakeholder, and potentially avoiding the need to re-open the control to amend the list of controlled products through a condition modification (in the case of a new product) or direction in the case of a substitute product;

- The charge control provides a check against actual, rather than forecast costs;

- BT is already set to comply with cost orientation, as the remedy has been applied in previous market reviews. It therefore, does not need to apply new systems to comply with any related cost accounting obligation[25].

[25] Virgin Media consider that cost accounting obligations that are imposed with cost orientation provide a valuable information tool to other CPs in assessing the underlying costs of services offered by BT. We consider that these reporting requirements should continue in any event.

SECTION 2 : Failure to consider the need to encourage investment by alternative network providers

1. In the Consultations, Ofcom confirm the principle of the TSR that regulation should promote competition at the deepest level of the infrastructure at which it is likely to be efficient and sustainable.[26]

2. Virgin Media wholly agrees with this principle, but is concerned that Ofcom, in its proposals have failed to propose regulation that follows that principle in two key markets, the Low Bandwidth AISBO market and MISBO market. In both cases Ofcom have proposed regulation that appears to encourage competition based upon wholesale supply, rather than infrastructure competition. We consider that this approach could detrimentally affect competition in those markets, which we now consider in turn.

Low Bandwidth AISBO

3. Currently, a key area in which infrastructure competition is developing is for 1Gbit/s circuits. This is beneficial for the end user, as competition, supported by regulatory intervention to address BT's SMP, is delivering alternative supply points, innovation within the industry and driving down prices to an efficient level.

4. Ofcom discuss the prospects for competition in the LB AISBO market (UK excluding Hull and WECLA) in Section 7 of the BCMR[27]. They propose that demand will continue to grow within the market, citing demand from MNOs; increasing bandwidth requirements; high value contracts and long term contracts. Ofcom suggest that these circumstances provide a good opportunity to invest in networks and cite Virgin Media's contract with MBNL as evidence of this having occurred already. It is also noted that the market is substantially expanding, especially at higher bandwidths[28], and will continue to do so over the forward look period.

5. Ofcom assess that BT has a stable market share, with it sharing the considerable market growth since the last market review with Virgin Media[29].

6. Whilst Virgin Media agrees with Ofcom's provisional market power analysis of this market, to the extent that BT continues to have SMP, it also considers that the regulatory regime currently supports effective efficient network competition as evidenced by Virgin Media's increasing market share since the last review. As Ofcom itself states the market is "more susceptible to competition", compared to markets where BT has entrenched SMP (e.g. some of the TI markets in this review).

7. Given Ofcom's analysis it is clear that infrastructure based competition can be effective when supported by regulation. In accordance with the TSR principle, Ofcom must not regulate in a manner that diminishes this competition.

8. Ofcom have proposed to charge control BT's supply of low bandwidth AI products, designing a control that reduces prices to an MEA cost base over the course of the control. The MEA is assessed to be the EAD generation of products.

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[26] Paragraph 12.33 and FN81 BCMR
[27] Specifically, Paragraphs 7.204 to 7.207 BCMR
[28] Paragraph 7.208 BCMR
[29] Paragraph 7.183 and Table 64 BCMR

This combined with a number of other assumptions results in a proposed basket control of between RPI-8% to RPI-16%. This, by any standards, would impose a significant price reduction on BT, and effectively constrains the price charged by alternative providers using their own network. Whilst Virgin Media does not disagree with the overall principle that EAD is the MEA (indeed, WES products have been or are being withdrawn from new supply), it is imperative that when moving to a new cost base (the last control having been designed to align prices with the cost of WES/BES supply), the full consequences of the shift are considered. We consider that the migration credit is an important adjustment in this regard to reflect the existence of undepreciated legacy assets and the costs of migration during the course of the control.

9. Virgin Media considers that Ofcom should re-examine a number of its inputs to the control, and undertake a fuller impact assessment on the already identified level of infrastructure based competition within the market. In particular, we consider that Ofcom needs to re-assess, its volume forecasts and efficiency target for AI services in order to set an appropriate level of control.

10. We address Ofcom's volume forecasts in our specific response to Question 11 of the LLCC below, but consider that there is a risk that, in light of the latest available evidence in BT's RFS, that Ofcom has predicted too great an increase in AI volumes over the course of the control, which, if adjusted, should, at the very least, lead to the an increase in the value of X (i.e. that it becomes less negative).

11. In relation to efficiency, we feel that it is appropriate for Ofcom to adopt a more cautious approach in this control to ensure that the control is not set too tightly. This is especially relevant when Ofcom are proposing a change in modelling approach to base costs on the MEA. We discuss our specific comments in relation to efficiency in our answer to Question 12 of the LLCC below, but consider that an efficiency target towards the bottom of the consulted range would be appropriate to adopt in this case. From the sensitivities set out in Table 6.11 this would increase the X by less than 1%.

12. We consider that if Ofcom re-examine these factors, it would be appropriate to set the X at no less than the top of the consulted range (-8%), which would far better balance CPs' incentives to invest in network infrastructure to deliver services without reliance on BT inputs, whilst still ensuring that access to BT's wholesale services is still available where efficient and sustainable investment opportunities are limited or unavailable. This dynamic is specifically considered by Ofcom in their discussion of remedies applied to the MISBO market[30], yet appears to be absent from the consideration of how the AISBO market should be regulated.

13. Virgin Media is committed to investing in a network that is able to offer efficient competition to BT in the provision of business connectivity services, and therefore it is vital that Ofcom regulate in a manner that does not diminish this incentive.

MISBO Market

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[30] Paragraph 12.14 BCMR

14. Ofcom has identified that the Ethernet market is continuing to develop particularly at high bandwidths. Ofcom propose to charge control a sub-set of MISBO products (single service Ethernet), but not to impose any form of price regulation over other MISBO products.

15. Ofcom identify that one consideration in imposing regulation is to maintain CPs incentives to invest in infrastructure where it is effective and sustainable for them to deliver services without any reliance on BT's network[31], and discusses four models of competition that could occur within the market, with Models A and B describing two variations of "own infrastructure" models. Ofcom state "*We promote competition at the deepest level at which it is economic, and therefore consider that any remedies we impose in the MISBO market should not diminish CPs' incentives to invest in infrastructure using Models A and B) to provide MISBO services outside the WECLA where it is efficient*."[32]

16. Whilst a balance has to be struck to ensure that wholesale supply is available on fair and reasonable terms, it is vital that this high level investment is not discouraged, otherwise regulation has the potential to close the market, and entrench BT existing SMP (derived from an infrastructure advantage) in this market.

17. Ofcom identifies a specific concern relating to price controls. They consider that, as the market is still relatively small and that the technology is likely to develop rapidly, there needs to be caution in proposing price controls that could reduce incentives to innovate and invest[33].

18. Virgin Media agrees with Ofcom's assessment in relation to the need to maintain investment incentives, and the need for caution in price controlling services in this market. Virgin Media supplies high bandwidth products and is continuing to invest in its network to ensure that it can provide its customers and potential customers with industry leading services.

19. Virgin Media is therefore concerned that, despite setting out the ground correctly in relation to the MISBO market; identifying BT as having SMP; being concerned that it could price excessively; but identifying the need to be cautious when considering remedies to address that identified concern, it has then erroneously proposed to impose a highly prescriptive RPI-X charge control on services within the market.

20. Ofcom propose to include single service Ethernet products within the Ethernet charge control basket, which is proposed to have an RPI-12% cap and an sub-cap of RPI-RPI applied to each and every service. This level of control is significant, and reflects in part Ofcom's analysis of the more established LB AISBO market, where a charge control already exists. Virgin Media consider that to impose such a strict control on services within a new and developing market completely fails to display any caution in proposing a MISBO price control.

21. Ofcom attempt to justify the proposal as a cautious approach by suggesting that as only some MISBO services are controlled, then this represents an appropriate

[31] Paragraph 12.14 BCMR
[32] Paragraph 12.52 BCMR
[33] Paragraph 12.74 BCMR

level of regulatory intervention. Virgin Media consider that this argument is misplaced.

22. Ofcom identify that the effect of a control on single service Ethernet products may impose some constraint on BT's prices for the WDM MISBO products as well, because the two product sets are, to some extent, mutually substitutable by BT's customers[34].

23. Virgin Media certainly considers that there is a significant risk of the controlled services constraining the prices of WDM services, and given the level of the control applied, this would have a significantly adverse effect on the ability to compete in this market, and therefore on the ability to continue to invest in high bandwidth technologies.

24. Ofcom identifies a number of other constraints on BT's pricing. It confirms that there is limited competition from other CPs, EOI obligations and proposed obligations requiring publication of a reference offer[35]. All of these factors point to BT not being able to charge excessive prices for MISBO products.

25. It is also of note that the proposed suite of general remedies will apply to this market for the first time and represents a considerable increase in regulation, which will constrain the manner in which BT can wholesale its products and services. Virgin Media considers that the proportionate approach to regulation in this developing market, especially in light of the very real identified concern that excessive pricing regulation could adversely affect infrastructure competition, would be not to impose a steep RPI-X based charge control alongside a raft of new regulation, but to take a more cautious approach and see how the additional regulation affects the pricing trends within the market, so as to allow competition to continue to develop.

26. As discussed in our response to Q15 BCMR, below, we consider that Ofcom have failed to draft Condition 1 (network access) to appropriately reflect the identified concern. At paragraph 12.91 BCMR Ofcom states that it is appropriate, within the MISBO market, to impose and access obligation to meet reasonable requests for network access on fair and reasonable terms, conditions and charges. Condition 1, as proposed, is drafted to exclude charges. Virgin Media considers that Condition 1 be amended to reflect the intention expressed in paragraph 12.91, and if the condition is so amended, there will be a valuable additional constraint against BT excessively pricing within the MISBO market. We consider that this "light touch" regulation of charges is the appropriate level of constraint that should be applied in the circumstances of this market, and to introduce deeper regulation would be inappropriate.

27. An additional concern relates to the incentives created by charge controlling only some services within a market. BT may seek to manage its MISBO services in such a way that seeks to push non-controlled services over the controlled services so that the effect of the control is diminished. This could artificially distort the market by reducing demand and/or supply of single service high bandwidth Ethernet in favour of WDM alternatives, which could work against the best interest of both competing network providers and consumers (both wholesale consumers and end users). By

[34] Paragraph 12.81 BCMR
[35] Paragraph 12.81 BCMR

not imposing a control on select products there is no risk that such a distortion will occur.

28. In summary, Virgin Media considers that the proposed price control on high bandwidth Ethernet services is wholly disproportionate and the services should be removed from the condition. In particular, should the services remain within the control there is likely to be a significant adverse effect on competition within the fledgling MISBO market, and we do not consider that such a control would be consistent with the requirements under section 88[36] of the Act. In particular, we do not consider that Ofcom has explained how this control (certainly in relation to included MISBO products) adequately satisfies the statutory test. Further, we consider that given the identified need to encourage infrastructure based competition, and the need to be cautious when assessing how to address the identified “excessive pricing risk”, it would be entirely appropriate to rely upon the general remedies proposed for the MISBO market, especially if the obligation to provide Network Access was re-drafted to extend the obligation to cover charges.

[36] In particular, 88(1)(b)(ii), the control is required to be appropriate for the purposes of promoting sustainable competition.

SECTION 3 : BCMR Consultation Questions

Question 1: Do you agree with our approach to retail market definition and our proposed retail product market definition?

Virgin Media has no comment in relation to Ofcom's approach to retail market definition

Question 2: Do you agree with our approach to wholesale product market definition and our proposed wholesale product market definitions? In particular, do you agree with our proposal to define a Multiple Interface Symmetric Broadband Origination (MISBO) market?

Virgin Media agrees with a need to introduce a market to deal with leased line products that have emerged during the course of the last market review period from fringe technologies to more mainstream in their adoption. Although the introduction of MISBO moves away from a strict "by bandwidth" definition, we agree that there is substitutability between Ethernet and WDM products above 1Gbit/s and therefore this points to the products being in the same market. We also note that the scalability of WDM services does not fit well with a rigid bandwidth based market definition, so can understand Ofcom's approach in this review to include all bandwidth services in the market, despite the availability of 1Gbit/s WDM. We agree with Ofcom's proposal that a single access / backhaul market exists.

Question 3: Do you agree with our approach to geographic market definition and our proposed geographic market definitions? In particular do you agree with our proposal to define a larger geographic market in London (the WECLA)?

Virgin Media agrees with Ofcom's proposal not to create new sub-national geographic markets to any area outside of London.

Virgin Media does have some reservations regarding Ofcom's approach to the definition of the WECLA. Whilst it is understandable that Ofcom has approached its definition of the WECLA on principles that it used in defining the CELA in the last BCMR, we consider that a number of concerns remain in the applied methodology, and in particular the network reach analysis.

The network reach analysis assesses the level of competition based upon a theoretical dig distance of 200m. The assumption is made that a CP would be willing to invest in digging to extend its network to connect its network from an existing flex point to a potential new customer. Whilst the overall concept may be appropriate the use of a 200m assumption may lead to the overstatement of competition within an area. Virgin Media has two primary concerns:

- A 200m dig distance is too long based upon actual dig distances; and
- A linear buffer zone assumes a straight line dig, which is unrealistic.

Whilst Ofcom has said that 200m represents the maximum distance which a CP would generally be likely to extend its network in the absence of regulation, and that in 5.5% of cases dig distances of longer than 200m were undertaken[37], Virgin Media considers that it still too long a distance for the purpose of the analysis.

It is of note that Virgin Media seeks to compete with BT by utilising our own network, and therefore extending it to new customers where appropriate.

We also note that Ofcom states that it has taken account of the inability to dig in a perfect straight line, in that it states that "*an operators ability to serve a particular customer may be affected by natural obstacles such as rivers, which are not reflected in the network reach analysis*"[38] and that a cross check against service share is performed. However, this assumes that there is generally an ability to dig straight, which is not the case. Very few, if any, digs will be unimpeded, and it is not appropriate to consider obstructions to serve as the exception rather than the rule.

Whilst the assumption was used in 2008 to define the CELA, and therefore may be considered an established tool, it is significant that the majority of industry has a concern regarding this assumption. In proposing to extend the London based geographic market from the CELA to the WECLA, Ofcom have not examined in detail the "expansion area" (ie the 87 additional post codes proposed to be included within the WECLA) and have, instead, analysed the CELA and the WECLA as a whole. Virgin Media consider, especially when the assumptions used are contentious, that a full analysis to determine the level of potential competition in the expansion area is important, otherwise the additional post codes could ride on the back of conditions already established within the CELA.

Question 4: Do you agree with our approach to product and geographic market definition for wholesale trunk and do you agree with our proposed market definitions for wholesale trunk?

Regulation should only be targeted at cases where it is needed, it should be transparent and it should be consistent[39], further any condition imposed needs to be objectively justifiable. Ofcom are proposing to regulate a separate "short-distance regional trunk market" by subdividing the previously defined trunk market. In summary, Virgin Media consider that the analysis of Trunk does not justify this division and the proposed regulation unnecessarily overly complicates an area, which had already been made complex by the introduction of the TAN concept in the 2008 review. Virgin Media consider that a single Trunk market should be maintained, and that BT continues to have SMP in this market (with an assessed market share of 49%[40]).

Ofcom rely on pricing discounts as support for a proposal to define National as circuits between non-adjacent TANs across the UK, however these discounts apply only on two routes from London, so cannot be said to be representative of non-adjacent TAN circuits more generally. Ofcom also dismiss the fact that competition "may have emerged in certain locations beyond the national trunk routes"[41]. Both of these factors, in fact, suggest a more mixed level of competition between routes than can be categorised by a simplistic regional / national split.

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[37] Paragraph 5.111 – 5.112 BCMR
[38] For example, paragraph 5.198 BCMR
[39] Section 3(3) Communications Act 2003
[40] Paragraph 6.127 BCMR
[41] Paragrpah 6.131 BCMR

We consider that this is actually recognised by Ofcom who confirm that if they had applied a standard approach to market definition, due to the availability of alternate routes and through a chain of substitution all national routes would fall within a single national trunk market[42].

Virgin Media considers that Ofcom have overcomplicated their analysis of TI Trunk, and the proposed market definitions risk confusion over boundaries, charging practises and related issues increasing within the market. We do not consider that the evidence leads naturally to a split definition, and would suggest that, at the very least, it equally supports retaining the current single market definition which would retain certainty of application for industry, be transparent and justifiable. It would be simply counter-productive to attempt to lessen regulation in this area as proposed, as this would have the opposite effect of failing to further the interests of consumers in the Trunk market in accordance with Ofcom's principle duty.

Question 5: Do you agree with our approach to SMP assessment?

Virgin Media broadly agrees with the approach taken to SMP assessment. It is noted that market share assessment needs to be treated with a degree of caution due to mis-reporting of data in previous reviews. For example, it is noted by Ofcom that revisions to BT's circuit count in the low bandwidth AISBO market resulted in a drop in assessed market share from 59% to 41%. Virgin Media welcomes Ofcom's attempts to correct this figure (a proposed market share of between 45 and 50% has been assessed), but notes that it remains a reasonably broad assessment. Ofcom should ensure that it makes its SMP assessment in the round (not just relying on market share), consistent with Commission guidelines.

Question 6: Do you agree with our assessment of SMP for the retail low bandwidth TI market in the UK excluding the Hull area?

Virgin Media has no comment in relation to this question.

Question 7: Do you agree with our assessment of SMP for the wholesale TISBO markets in the UK excluding the Hull area?

Virgin Media broadly agrees with the SMP assessment in the wholesale TISBO markets. It is of note that specific competition concerns are identified by Ofcom in relation to BT's proposed SMP, including excessive pricing, predatory pricing, margin squeeze and cross subsidisation[43]. Virgin Media considers that these are all problems that are present in markets which are not competitive, and therefore remedies should be imposed to address these concerns. We address the issue of remedies below.

Question 8: Do you agree with our assessment of SMP for the wholesale AISBO markets in the UK excluding the Hull area?

As per our answer to Q7, whilst we broadly agree with Ofcom's SMP assessment, we highlight the identified competition concerns relating to predatory pricing, margin

[42] Paragraph 6.120 BCMR
[43] See summary of identified competition problems in Table 84 BCMR

squeeze and cross subsidisation, with which we agree, and consider that appropriate remedies should be applied to address these concerns.

Question 9: Do you agree with our assessment of SMP for the wholesale MISBO markets in the UK excluding the Hull area?

Virgin Media agrees that BT holds SMP in this market on a forward looking basis for the review period. Virgin Media also agrees with Ofcom that competition will increase within this market[44]. Given that there is some degree of network infrastructure based competition, and that this is set to increase as this developing market evolves, any remedies imposed must not act in a way that would be detrimental to this trend.

Question 10: Do you agree with our assessment of SMP for the wholesale TI regional trunk market and the wholesale TI national trunk markets?

Virgin Media considers that there should be a single TI Trunk market (see our answer to Q4, and that BT would hold SMP in this market.

Question 11: Do you agree with our assessment of SMP for the retail low bandwidth TI market and the retail low bandwidth AI market in the Hull area?

Virgin Media has no comment in relation to this question

Question 12: Do you agree with our assessment of SMP for the wholesale TISBO and AISBO markets in the Hull area?

Virgin Media has no comment in relation to this question

Question 13: Do you agree with our approach to remedies and in particular our consideration of the case for imposing passive remedies?

Virgin Media considers that there is a significant failing on the part of Ofcom in its consideration of pricing remedies. We have set out our comments in relation to cost orientation in Section 1 of our response.

Virgin Media agrees with Ofcom's proposal that passive remedies are not appropriate for imposition in the markets under review. Ofcom noted, for example, in relation to mobile backhaul, Virgin Media's ability to compete successfully against BT. It is also open to other network owners to compete on this basis, and with the availability of active remedies to address identified competition concerns, it would neither be necessary or appropriate to seek to impose passive remedies within this market.

Question 14: Do you agree with the remedies that we propose for BT in the low bandwidth TI retail market in the UK excluding the Hull area?

Virgin Media has no comment in relation to this question

[44] Paragraph 7.286 BCMR

Question 15: Do you agree with the remedies that we propose for BT in the wholesale TISBO markets in the UK excluding the Hull area and the wholesale TI regional trunk market?

Condition 1

We are concerned that Ofcom has incorrectly proposed its network access obligation (Condition 1) for BT and KCOM. At paragraph 10.65 BCMR Ofcom states "*We consider that it is appropriate in cases where a CP has SMP to impose an access obligation on that provider requiring it to meet all reasonable requests for network access within the relevant wholesale market, irrespective of the technology required, on fair and reasonable terms, conditions and* ***charges***."[emphasis added]. However, the condition proposed[45] specifically excludes charges from the obligation to provide access ("*provided on fair and reasonable terms and conditions (*__excluding charges__*)*") [emphasis added]. The SMP Condition, as drafted, therefore fails to implement the remedy identified as required to address the competition problem. Ofcom should ensure that the final Condition 1 is drafted in a manner consistent with intent in paragraph 10.64, and consistently with other Network Access obligations imposed on other markets.

This is particularly important as other SMP Conditions (eg Condition 2, no undue discrimination) only apply to Access that is regulated under Condition 1.

This matter was raised with Ofcom in the context of an UKCTA meeting on 25 July 2012. Ofcom undertook to respond subsequently with their comments, and by an email dated 21 August 2012 implied that the wording of proposed Condition 1 as drafted was intentional. Ofcom stated "*As we have explained in the LLCC consultation we consider that we can address the competition concerns about pricing with the proposed charge control. We do not consider that an obligation for charges to be fair and reasonable is also necessary*."[46]

Virgin Media is concerned that the response runs directly counter to the position that was consulted upon in the consultation document at paragraph 10.85 BCMR. Given that the legal instruments should be drafted to give effect to the substantive analysis undertaken, and explained in the main body of the document, we consider that Ofcom is obliged to correct the wording of the legal instrument. If Ofcom really considered that a "fair and reasonable charge" provision was inappropriate for these markets, this would be a position that had not been exposed to stakeholders or consulted upon, and Ofcom may well need to undertake a further consultation on this issue in order to fully set out the reasons for its change of position.

Additionally, it is of particular note that the BCMR markets are alone in proposing to apply this modified wholesale access condition which explicitly excludes charges from being set on a fair and reasonable basis. Ofcom are required to regulate in a consistent manner in order that all stakeholders can have the best idea of what and how each remedy is designed to regulate. There is no explanation in the document as to why market conditions in the BCMR markets differ from each of the other regulated markets which would justify this difference of approach.

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[45] SMP Condition 1 – Network access on reasonable request; clause 1.2(b). Part 3 of Schedule 2 to Draft Legal Instrument at page 726 of Annex 14
[46] Email Clive Hillier to Towerhouse Consulting dated 21 August 2012

The potential effect of the different wording is also significant. As other conditions (such as Condition 2) apply to access as regulated under Condition 1, then it could be argued there is no obligation constraining potentially discriminatory pricing even where the "general" SMP Conditions are held to apply. This level of uncertainty is not acceptable, and should be resolved by aligning the wording of the Condition to that imposed in other markets, which would also address the competition concern identified by Ofcom.

Virgin Media also considers that cost orientation would be an appropriate remedy to apply to these markets, for the reasons set out in section 1. It is worth noting that, if Ofcom chose not to amend the proposed wording of Condition 1 in relation to fair and reasonable charges, aside from any re-consultation issues, then there is an even greater imperative to impose cost orientation. Where, exceptionally, Ofcom has previously decided not to implement cost orientation alongside a charge control, it has relied upon the alternate protection afforded by a "fair and reasonable charges" obligation. In the ISDN30 Charge Control Ofcom stated:

> "*We are not proposing to impose a cost orientation obligation on core wholesale ISDN30 services. This is because we consider that the low number of services in the charge control baskets and the presence of safe-guard caps where appropriate, **together with the requirements for charges to be fair and reasonable and not unduly discriminatory**, will be more effective at constraining the level of prices.*"[47] (emphasis added)

Without such a condition, the proposal not to implement cost orientation becomes even more stark and less justifiable.

Cost Accounting

For the reasons set out in Section 1, above, Virgin Media considers that cost orientation ought to be applied to this market. In tandem Virgin Media also considered that cost accounting obligations should be imposed in order to ensure that LRIC data continue to be published by BT. Whilst such an obligation would be essential in combination with a cost orientation obligation, we consider that the requirement to produce relevant cost accounting data should remain in any event.

The ability of competing CPs to understand the cost base of each connectivity product is essential when making decisions as to whether to invest in developing own infrastructure, or considering whether to compete using wholesale inputs. Further, as the charge control is vulnerable to deviations from actual cost, published LRIC data will provide a valuable check to ensure that the control is "on track". Indeed, Ofcom itself has previously stated in the last LLCC review, the importance of regulatory accounting obligations to monitor not just cost orientation obligations but also compliance with charge controls.[48]

Virgin Media submits that some cost accounting data should continue to be published, and at this stage Ofcom should confirm that a general obligation will

[47] Ofcom (2011), Price controls for wholesale ISDN30 services, Consultation on the form and level of price controls on Openreach wholesale ISDN30 services, 1 April.
[48] See paragraph 2.24 of the 2009 LLCC.

continue to apply to BT as a result of this market review. This would not translate into any immediate obligation on BT, as the specifics of what cost accounting data would be required would be consulted upon separately in Ofcom's annual review of the RFS Direction. It is at this point that the outcome of the market review may well be known, specific obligations could be proposed and consulted upon, but it is vital that Ofcom leave this door open by making a finding in this review that cost accounting reporting (of some form) is a requirement for these markets.

Cost Orientation

For the reasons set out in Section 1, above, we consider that cost orientation should be applied to these markets.

Question 16: Do you agree with the remedies that we propose for BT in the wholesale AISBO markets in the UK excluding the Hull area?

Virgin Media have the same concerns relating to AISBO remedies as set out in our response to Q17 in relation to TISBO remedies, namely that:

- the Network Access condition (Condition 1) should be re-worded to include charges;
- cost accounting should be retained; and
- cost orientation should be imposed as an appropriate remedy for these markets.

Question 17: Do you agree with the remedies that we propose for BT in the wholesale MISBO markets?

Virgin Media have some of the same concerns relating to MISBO remedies as set out in our response to Q17 in relation to TISBO remedies, namely that:

- the Network Access condition (Condition 1) should be re-worded to include charges.

Question 18: Do you agree with the remedies that we propose for KCOM in the retail TI and AI markets? In particular, do you agree with our proposal that KCOM should be required only to publish maximum prices and to be permitted to offer bespoke discounts?

Virgin Media has no comment in relation to this question

Question 19: Do you agree with the remedies that we propose for KCOM in the wholesale TISBO and AISBO markets? In particular, do you agree with our proposal that KCOM should be required only to publish maximum prices and to be permitted to offer bespoke discounts?

Virgin Media has no comment in relation to this question

SECTION 4 : Answers to LLCC Questions

Question 1: Do you agree with our proposal to use an RPI-X form of charge control? If not, please explain why and propose an alternative approach with supporting information.

We agree the market analysis finding that justifies regulatory intervention to address the risk of adverse effects relating to price distortion. We also accept that an RPI-X control is an appropriate form of control where there is a need to align prices with efficiently incurred cost.

We have two key concerns in relation to Ofcom's proposal as a whole, which we detail in Sections 1 and 2 above. We have explained that we consider that a more effective approach would be the application of an appropriately targeted RPI-X control in tandem with a complementary cost orientation obligation.

Question 2: Do you agree with our proposal for the charge control to run for a maximum of three years from the date of implementation? If not, please explain why and propose an alternative approach with supporting information.

Virgin Media agrees in principle that controls are best suited to running in parallel with the market reviews which determine the need for any remedy to be imposed. As market reviews are now required to be conducted every three years, Virgin Media agrees that this is a natural starting point for the length of a control.

We do, however, have concerns over the apparently increasing gaps between the end of controls and the start of the next control. Given that the shorter period between reviews may exacerbate this problem, we consider that there is a need to consider ways in which the effect of such gaps can be mitigated, including by the imposition of more generic pricing obligations such as including charges within the fair and reasonable access condition and applying a cost orientation obligation to all services within a market.

Question 3: Do you agree with our overall proposal for the design of the charge control? If not, please explain why and propose an alternative approach with supporting information.

Virgin Media notes Ofcom's preference for wider baskets giving the Dominant Provider more flexibility in which it may meet a control. We are concerned that, on this occasion, the current proposals afford too much discretion to BT. In particular, there are a number of substitutable services within a basket (for example WES / EAD Ethernet services), where BT may have incentives to set in-basket pricing to advantage its own downstream businesses.

We note that sub-caps have been proposed to ensure that no individual service can be priced above a particular level, however, this does not address potentially low pricing of services, nor does it address concerns if the cost of provision of services is not in line with forecasts.

This concern could be mitigated in a number of ways;

- The creation of a larger number of narrower baskets;

- The imposition of more in-basket controls such as sub-caps or inertia clauses; and/or
- The imposition of a complementary cost orientation obligation.

We acknowledge that the control is a complicated one designed to control the pricing of multiple products offered within relevant markets (with the Ethernet baskets currently proposed to include services/products from more than one market). We consider that to increase the complexity of the control may give rise to transparency concerns, and create additional confusion regarding the manner in which prices were controlled. We therefore consider that the imposition of a complementary cost orientation obligation would provide additional protection in relation to the pricing of each service without adding to the complexity of the control. We also consider, that, contrary to Ofcom's assertion that such an obligation would be disproportionate, it would be an appropriate and necessary remedy to impose in these markets.

Question 4: Do you agree with our proposals for TI, specifically: basket design; anchor pricing approach; base year adjustments; and forecasting assumptions? If not, please explain why and propose alternative approaches with supporting information.

We have no additional comments to make beyond our answer to Q3.

Question 5: Do you agree with our proposal for Ethernet, specifically: basket design; modern equivalent asset approach; base year adjustments; and forecasting assumptions? If not, please explain why and propose alternative approaches with supporting information.

As set out in Section 2 above, Virgin Media does not disagree with the overall principle that EAD is the MEA (indeed, WES products within this market have been withdrawn from new supply). However, it is imperative that when moving to a new cost base (the last control having been designed to align prices with the cost of WES/BES supply), the full consequences of the shift are considered. We consider that the migration credit is an important adjustment in this regard to reflect the existence of undepreciated legacy assets and the costs of migration during the course of the control.

We address the issue of volume forecast and efficiency assumptions in our answer to Q11 and Q12 below.

Question 6: Do you agree with our approach and proposals for controls for excess construction charges? If not, please explain why and propose an alternative approach with supporting information.

Virgin Media broadly agrees that it is desirable to control Excess Construction Charges as proposed. It has become apparent that BT routinely imposes these "excess" charges as part of the provision of a new circuit. This significantly increases the cost of provision whilst allowing "connection" charges to remain apparently modest (and within their charge control).

Question 7: Do you agree with our approach and proposals for charge controls for accommodation? If not, please explain why and propose an alternative approach with supporting information.

Accommodation is aligned with LLU Co-Mingling basket, therefore Virgin Media is concerned that there is an uncertainty over the second half of the proposed control period. This would be in some way mitigated by the presence of back stop regulation applied to all services in a market such as cost orientation.

Question 8: Do you agree with our proposal for charge controls for AI services in the WECLA? If not, please explain why and propose an alternative approach with supporting information.

We have addressed our concerns in relation to the definition of the WECLA area above in our response to Q3 BCMR above, however, to the extent that we consider that the control proposed for the UK excluding the WECLA is too tight, we consider that the proposed looser control within the WECLA area is not inappropriate.

Question 9: Do you agree with our proposal for charge controls for retail analogue services? If not, please explain why and propose an alternative approach with supporting information.

Virgin Media has no comment in relation to this question

Question 10: Do you agree with our proposals for the implementation of the new charge controls? If not, please explain why and propose alternative approaches with supporting information.

Virgin Media are concerned about two aspects of the proposed controls:

- New / Replacement Services; and
- Interaction with Other Remedies

We discuss our concern that Ofcom has failed to make sufficient provision for the control of the pricing of new / replacement services in Section 1 above.

At paragraph 10.44 LLCC Ofcom explains how the proposed controls work alongside the proposed obligation not to discriminate unduly in the provision of SMP wholesale services.

It is said that in meeting its charge control obligations "BT would still be require to ensure that each and every charge does not discriminate unduly in favour of particular companies or parties".

Virgin Media welcomes the intent of the provision, but is concerned that it is not drafted in a manner that achieves the intent. We discuss in our response to Q15 BCMR the drafting of Condition 1 (Network Access) which, contrary to access conditions applied to other markets specifically excludes the condition applying to charges. Condition 2 (no undue discrimination) only applies to in relation to matters concerned with Network Access, thus referring back to Condition 1 and apparently excluding charges from regulation.

Virgin Media would request that Ofcom modifies the wording of Condition 1 to align it with Network Access obligation applied in other markets to not exclude charges from the obligation, which would then allow the intent described in paragraph 10.44 LLCC to be enacted.

In the event that Ofcom declines to modify Condition 1, it should modify Condition 2 to ensure that it is clear that price discrimination is within the remit of the provision.

Question 11: Do you agree with our approach to cost forecast modelling? If not, please explain why and propose an alternative approach with supporting information.

Volume Forecasts

Virgin Media is concerned that the volume forecasts in relation to reduction of TI circuits (and in particular, the relative shift of volumes from TI to AI services) may be overstated, and that this could have a significant impact on the control.

Ofcom propose that controlled TI services will reduce from c450,000 circuits based on 10/11 data to c120,000 circuits by the end of the control (15/16)[49] a (negative) CAGR of -25%. This decline incorporates a marked decline in volumes in the first year of the forecast to c280,000 circuits. BT's RFS for 11/12 have now been published, and the volume figures disclosed do not support the forecasted first year decline by Ofcom.

Virgin Media notes that in the 2008/9 LLCC Ofcom forecasted substantial migration from TI to AI services when setting the control. A number of stakeholders cautioned Ofcom about the level for forecasted migration, suggesting that actual migration may be significantly less; Ofcom chose not to modify its volume forecast when setting the control. In the event, the forecast decline of TI services was overstated, and, significantly, the effect on the current control is notable. If there was no cost reallocation made between the TI and AI baskets (and, for the avoidance of doubt, Virgin Media agrees that a cost re-allocation between legacy and Ethernet services is appropriate), then, other assumptions remaining as proposed, a control of RPI+18.75 would be required to restore TI pricing to a cost based level[50]. This suggests that a considerable adjustment is required to compensate for the previous control "overshooting" its target, which we consider is, in most part, attributable to volume mis-forecast.

The extent of the forecasting error in the 2009 control was not insignificant, predicting a (negative) CAGR of -20%, against an actual (negative) CAGR of -13%[51], based upon published volumes in the RFS.

The current control proposes a forecast giving -25% CAGR to the end of the control period, with sharper declines in earlier years. In particular, the forecast included an assessment for volume declines in 11/12. This year has now been reported by BT in its RFS. The RFS show that TI volumes declined by 10% between 10/11 and 11/12, compared to a predicted 27% reduction proposed in the LLCC consultation.

Virgin Media accepts that volume forecasting is an imprecise science, and that the proposed forecasts have been informed by industry (BT and other CPs) and analyst views. However, especially in light of the RFS11/12 data, Virgin urges Ofcom to take

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[49] Approximate values derived from figure A5.2
[50] Paragraph A5.268
[51] See Annex 1 to our response showing our methodology for deriving these figures

a more cautious approach to the assessment of volume trends in this control. It is particularly important to ensure that forecasting remains realistic when the base year actuals (10/11) require two additional years of forecasting before the start of the control period (13/14), which means that any errors will be compounded, and discrepancy between prices and target cost at the end of the period would be magnified.

Ofcom confirms that volumes are the single most significant variable to affect the level of the proposed control[52]. Therefore a small error in volume forecasting can have a significant effect on the "X". It is noted that a 10% over forecast of TI volumes would affect the X by reducing it to RPI+1.5%.

Similarly the forecast in relation to AI services is also vulnerable to error. Ofcom identifies that most of the diminishing TI volumes can be attributed to migration to AI products. Ofcom's AI and TI volume forecasts are therefore intrinsically linked.

Ofcom sets out that a 10% forecast error for AI volumes (assuming 10% lower volumes) would affect the X by reducing it to 9.5%.

The nature of an RPI-X control is that it can produce asymmetric effects on the market depending upon whether it is too tight or too loose. If a control is set too tightly, so that prices are driven down too steeply, then this will diminish the investment incentives for competing CPs to invest in their own networks. As set out in the TSR, regulation should promote competition at the deepest level of the infrastructure at which it is likely to be efficient and sustainable.

As Ofcom notes there is increasing infrastructure based competition in the provision of Ethernet services, as discussed in the following terms:

- "circumstances give CPs a very good opportunity to invest in extending their networks"[53] and "the rapid growth in demand…..does make this market more susceptible to competition"[54] - AISBO market (UK excluding Hull and WECLA);

- the market is assessed as "prospectively competitive"[55] AISBO in the WECLA;

- although proposed not to be effectively competitive it is noted that "competition will increase in this market"[56]. MISBO market (UK excluding Hull and WECLA)

It is clear that there is, within the context of the current regulatory regime, a degree of network based efficient and sustainable competition, and based upon the current market conditions, it is set to continue for Ethernet services. In accordance with the TSR, it is vital that Ofcom do not, by the imposition of inappropriate regulation, choke off this competition. Therefore, particular care needs to be taken when imposing cost based price regulation on these markets.

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[52] See Sensitivity Table 5.13, for TI sensitivities and Table 6.11 for AI sensitivities
[53] Paragraph 7.205 BCMR Consultation
[54] Paragraph 7.209 BCMR Consultation
[55] Paragraph 8.15 LLCC Consultation
[56] Paragraph 7.286 BCMR Consultation

The effect of setting a looser X would mean that higher wholesale charges could be passed through to end users, but, ultimately, if lower prices generated by an overly tight X were to lead to a reduction in infrastructure based competition, then end users would lose out in the long term.

Virgin Media consider that, in light of all of the available evidence including the recently reported RFS, a more cautious approach should be taken to the volume forecasts proposed by Ofcom, especially in light of the need to preserve the emerging competitive element of the regulated Ethernet markets, and therefore, at the very least, this would justify setting the Xs to the top (least negative) of the proposed ranges.

Question 12: Do you agree with our assumptions of key inputs? If not, please explain why and propose an alternative approach with supporting information.

Ofcom assess that efficiency for the TI basket should be set between 0 and 3% and that efficiency for the Ethernet basket should be set between 2 and 5 %. These proposed ranges are derived from a variety of inputs.

Ofcom has taken account of various studies and assessments which broadly suggest an efficiency range of between 2 and 2.6%[57]. Ofcom has also looked at TI trends and, in respect of the Ethernet basket, trends across Openreach as a whole. It is these trends that are weighted most heavily in determining the proposed ranges.

Whilst Ofcom recognise that as TI services are a mature and declining set of markets and there is no reason that would justify making a stronger efficiency assumption, there is a notable disparity between the efficiency applied to the TI basket and the Ethernet basket.

Although Ethernet is a developing product, and in one sense costs of providing an Ethernet service can be expected to reduce over the forward look period, it is significant that Ofcom have chosen to model costs on an MEA basis, with EAD as identified as the MEA. The actual cost of providing Ethernet services over the life of the control will be a combination of the costs of EAD and legacy WES/BES technology. Whilst migration has been forecast, there will still be a sizable WES estate present by the end of the control period. Therefore, efficiency gains when the cost of provision is modelled on an efficient asset basis will necessarily be limited.

We do not consider that Openreach as a whole provides a wholly appropriate benchmark to set the efficiency assumption for this charge control basket, nor can the WLR/LLU efficiency input be regarded as a good benchmark for this market. Whilst Openreach's potential efficiency may be useful to inform the decision, Virgin Media consider that greater weight should be given to the other sources of available evidence.

Virgin Media also set out in Section 1 that it would be appropriate for Ofcom to adopt a more cautious approach in this control to ensure that it is not set too tightly, given the potential adverse effect on infrastructure based competition should an overly tight control be set. Therefore, it is suggested that an efficiency target towards the bottom

[57] Deloitte, NERA, KPMG studies as set out in Tables A5.7 and A5.8 LLCC

of the consulted range would be appropriate to adopt in this case. From the sensitivities set out in Table 6.11 LLCC this would increase the X by less than 1%.

Question 13: Do you agree with our approach in relation to POH charges? If not, please explain why and propose an alternative approach with supporting information.

Virgin Media has no comment on this question.

Question 14: Do you agree with our proposals for the treatment of cost of capital? If not, please explain why and propose an alternative approach with supporting information.

Virgin Media agrees that the “rest of BT” WACC is appropriate for the setting of the control.

ANNEX – VOLUME FORECAST ANALYSIS
(to be read with attached Excel Workbook)

Introduction

Virgin Media considers that the volume forecast undertaken by Ofcom and relied upon to set the proposed charge control overstates the volume reduction in TI circuits and growth in AI circuits during the course of the control.

Virgin Media has reviewed Ofcom's assumptions on volume trends for the previous control set in 2009 against data published by BT in its RFS for the control years. Additionally, Virgin Media has considered the volume forecast proposed for this control period and reviewed this against the recently published RFS for 11/12, which was not available at the time Ofcom published its consultation.

Methodology

In its previous LLCC review, Ofcom benchmarked volume forecasts to the base year 07/08 (indexed at 100). In order to compare the reported RFS data we have converted circuits to an index basis with 07/08 indexed at 100. In the current consultation Ofcom have changed their approach to use actual circuits numbers and bandwidth supplied over those circuits. In order to compare, we have converted the 2009 LLCC to actual circuits and bandwidth and have indexed the 2012 LLCC consultation from the 10/11 base year.

For the purposes of this exercise we have focussed on TI circuits.

We have examined each bandwidth separately, and then aggregated the results by calculating the total Gbit/s supplied. When indexed against 07/08, this shows that for TI there was a CAGR of -13% for the period from 07/08 to 11/12.

We have then taken Ofcom's indexed forecast for each year within the control and converted the indexed figure to an implied number of local ends. Following this we have then calculated the total Gbit/s supplied over those local ends. This shows that Ofcom predicted a CAGR of -20% for the period 07/08 to 11/12.

In relation to Ofcom's current forecast, which is expressed in circuit numbers and capacity, Ofcom predict a CAGR of -25% for the period 10/11 to 15/16.

Key Findings

1. Ofcom was far too bullish on how quickly TI capacity would reduce over the last CC, predicting a CAGR of -20% against -13% in reality.

2. In the last year where actuals are available, (i.e. between 2011/12 and 2010/11) the rate of decline was just -10%.

3. Ofcom's prediction of even faster rates of reduction of TI to the end of the next charge control does not appear to follow the trend demonstrated by actual data

4. Ofcom's predicted rate of decline between 10/11 and 11/12 is a CAGR of -27%. Based on reported RFS the decline for this period is just -10%

Conclusion

Ofcom have been too aggressive in their volume forecasts. This applies to both TI and AI forecasts (which are intrinsically linked due to migration). Forecasts should be reconsidered in light of both historic trend data and the most recent RFS.