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5th June 2009

Dear Chris,

Review of BT Network Charge Controls

Virgin Media is pleased to respond to the above consultation. We set out below our views on the proposals made by Ofcom, together with our responses to the specific questions posed.

Despite the decline in fixed voice volumes witnessed over recent years, narrowband services continue to generate significant revenues (and indeed costs) for CPs. It is arguably the case that these services constitute a material component in CPs' financial plans. As such it is critical that Ofcom adopts the correct approach to charge controls relating to narrowband services going forward. This need to take the correct approach is accentuated by the fact that the provision of voice services is undergoing fundamental change, with CPs designing, and deploying, next generation applications, not to mention the changing characteristics of the voice markets as volumes decline and consumers' usage habits evolve. This evolution of technology, services and characteristics creates both uncertainty and opportunity. Ofcom must therefore achieve the right balance of establishing a regulatory environment that is not only stable, but is also sufficiently flexible so as to allow for changes in technology and market characteristics etc to be taken account of in a timely fashion.

Summary

Given the uncertainty that exists around the provision of voice services at the present time, in particular the deployment of BT's 21CN and the continued decline in voice volumes, Virgin Media believes that a shorter control period than that proposed by Ofcom would be more appropriate. In our opinion, a 24 month control would represent a suitable compromise. As we set out below such an approach would, we believe, deliver a number of positive benefits, including an earlier correction to the ongoing under recovery of costs by BT, a reduction to the risk inherent in forecasting volumes over a four year period, an opportunity to revisit the approach to modelling at an earlier point and an opportunity to bring the UK into line with the European Commission's Recommendation on termination prior to the end of the transition period. We note that in its review of the Openreach Financial Framework, as a result of uncertainty beyond a certain period of time, Ofcom has concluded that it is appropriate to prescribe a shorter control duration for metallic path facilities than has previously been the case. We would suggest, therefore, that a deviation from 'traditional' control periods is not without precedent.

We recognise the difficulties posed by the current absence of sufficiently robust information on next generation services and their underlying costs and as such, in the short term at least, we concur with Ofcom's proposed technology neutral approach to modelling using the 'steady state' PSTN cost model as a base. However, we do not agree that this approach will necessarily continue to be appropriate over the entirety of the next four years. Despite the fact that BT's 21CN plans are increasingly unclear, we do expect at least some next generation network deployment by BT between now and 2013. In this respect, we note that Ofcom is proposing not to apply the NCCs directly to 21CN services. While we acknowledge the constraints to which Ofcom is subject as regards inclusion of 21CN services within the control at the present time, we are concerned at the potential loopholes and scope for manipulative or anti-competitive behaviour that their absence from the controls over the forthcoming four year period will constitute. Further, we believe that such a situation creates no incentive for BT to avoid inefficient investment in 21CN. In addition, the absence of any obligation on BT to report on the costing elements of 21CN services to a sufficient level of granularity would result in CPs and Ofcom being unable to assess whether the services were being provided on an efficient basis (or indeed whether they were compliant with the proposed cost orientation obligation). Our proposal to set a shorter control period would therefore afford Ofcom the opportunity to re-assess the situation at an earlier date, if necessary amending its approach to modelling to more accurately reflect the actual circumstances, and potentially resulting in the inclusion of 21CN services within the control.

As outlined above, Virgin Media's preference is for a shorter control period. However, in the event that Ofcom proceeds with the proposed four year duration, we believe that it is critical for Ofcom to adopt a flexible approach to the control. We do not believe, for example, that the current lack of information regarding BT's 21CN should necessarily prevent Ofcom from re-assessing the situation at some intermediate point. Nor should it prevent Ofcom from developing and potentially using a hypothetical fixed NGN costing tool (following, for example, a Bottom-Up approach) well before the end of the proposed four year control period. In this respect, we therefore welcome Ofcom's recognition that it would have the ability to impose additional remedies on 21CN services if appropriate (e.g. new charge controls) and we believe that it is imperative that Ofcom makes a strong statement regarding its willingness to undertake such action. We further believe that Ofcom must subject 21CN developments to rigorous scrutiny on an ongoing basis from the commencement of the new control period.

To the extent that BT's existing reporting obligations as regards 21CN services are not comprehensive, we believe that Ofcom should mandate the provision of costing information to a sufficiently granular level of detail such that both compliance with the cost orientation obligation and the subsequent construction of a 21CN costing model is facilitated. Such a requirement is particularly important given the absence of 21CN services from the charge control. We believe that BT should be required to report on all components of 21CN as it evolves and that BT should not be able to claim that such practice is onerous. 21CN services are at present nascent and as such there should be little or no requirement for BT to 're-engineer' existing accounting and reporting information. Rather, BT's 21CN accounting information can be configured from the outset to incorporate the necessary level of detail on the relevant network costs and components.

Timing and Implementation

As we set out in our response to the Review of the Fixed Narrowband Services Wholesale Markets consultation, we have significant concerns about the situation that could occur post 30th September 2009. Given the broad scope, complexity and closely interlinked nature of the current Ofcom narrowband reviews, Virgin Media believes that there is a significant risk that the overall initiative will not be completed in its entirety by the end of the current NCC period, particularly given that we are urging Ofcom to undertake further analysis. Any hiatus between the expiry of the current NCC and the implementation of a new NCC will cause uncertainty and would be extremely disruptive for the industry. Virgin Media therefore believes it is of fundamental importance to ensure that this does not happen. Whilst we accept that it would be difficult to extend the existing charge control we would urge Ofcom, particularly if it accepts the need to carry out further analysis, to seek voluntary commitments from BT to ensure that market disruption does not occur.

Question 4.1: Do you agree with Ofcom's proposal to set a four year NCC from 1 October 2009 – 30 September 2013?

Virgin Media believes that a shorter control period would be more appropriate in this instance. We note Ofcom's reasons for dismissing an 18 month control and recognise certain of the factors that Ofcom believes mitigate against a control of this duration, in particular the need to commence the assessment and analysis related to the subsequent control period soon after concluding the current exercise. By way of a compromise, we believe that a 24 month control would represent an optimal duration. We believe that a number of factors justify this, as set out below:

1) In the case of a number of the charge controlled services, as the end of the existing control period approaches it is apparent that BT has not been able to recover an appropriate WACC. This is principally as a result of the lower than predicted call volumes. Ofcom's proposed 4 year duration for the next control would result in BT not achieving a ROCE before the end of 2013, during which time it will in effect have been under-charging for fixed call termination and origination since 2006. We believe that it would be more appropriate to set a shorter charge control and to allow BT to recover an appropriate WACC well before the end of 2013.
2) BT's plans as regards deployment of its 21CN are increasingly unclear. This ambiguity has been compounded in recent weeks with BT's announced intention to adopt an evolutionary rather than revolutionary approach to next generation network deployment and, in effect, to 'sweat' its legacy assets well beyond the originally anticipated timeframe. However, we are given to understand that there may be certain areas of the country in which BT will necessarily need to upgrade its network in the shorter term (where, for example, legacy infrastructure is simply unable to sustain ongoing usage requirements or where obsolescence leaves BT with no choice). It is our expectation therefore that there will be at least some usage of 21CN for the provision of voice services during the course of the next four years. An additional complicating factor in this however is BT's indication that it ultimately intends to adopt a derived lines approach to voice, potentially using the GEA product. Given this intention, it is not clear to Virgin Media at what point BT's deployment of 21CN will result in it becoming the prevalent technology or if, for example, 21CN will only ever be a 'stop gap' on the path

to a derived lines approach to voice. We would suggest that the deployment of a derived lines approach to voice would represent a considerable departure from both legacy and 21CN solutions and may well warrant reassessment and re-definition of the relevant markets. A shorter control period would therefore allow Ofcom to reassess the situation at an earlier point and determine, for example, whether a different approach to modelling that takes account of NGN deployment should be factored into its charge control assessment, or whether a different approach altogether might be warranted.

3) The characteristics of the fixed calling markets are rapidly changing and volumes are falling as a result of mobile substitution and economic turbulence. There is a significant risk that volumes will fall at a faster rate and to a greater extent than Ofcom is projecting (see Figure 4.2, page 18) over the future control period. Faced with a high probability of overestimating demand during the next control period, we believe that the control should be much shorter in duration in order for reality to be reflected more closely.
4) The risks of setting a control period that is too long in duration in the face of markets which demonstrate volatile characteristics are borne out by the situation that has arisen in the current charge control. In the current control period Ofcom has significantly underestimated the rate of volume reduction in fixed termination and origination. As a result BT's return on fixed call termination (ROCE of 2.2%), and origination (ROCE of 4.2%), are significantly below the allowable WACC of 11%. This highlights the significant risk inherent in setting an inappropriate charge control level due to significant uncertainty in demand. Towards the end of the current charge control period, the demand for fixed services has been overestimated by over 25% (see figure 4.1, page 17). While we accept that projecting future call volumes necessarily involves an element of estimation and thus is by its very nature imprecise, it is a statement of fact that had traffic levels that more accurately reflected reality been applied when establishing the current control they would have lead to a significantly higher charge control cap.
5) We believe that Ofcom's consideration of future volume forecasts is too narrow in its scope (see figure 4.2, page 18) when compared with past forecasting approaches. As a consequence, Ofcom significantly underestimates the large range of outcomes that are possible when assessing the most appropriate level of charges in the next charge control period. This, we believe, results in a significant danger that lower than expected volumes will lead to a charge control cap being set too low. A shorter control period would reduce this risk considerably.
6) We note that Ofcom believes that it has taken the 'utmost account' of the Commission's Recommendation on call termination, and has concluded that current circumstances of UK fixed termination markets require that a different approach to cost modelling than that contained in the Recommendation should be adopted for the period of the next NCC. While we agree that this is probably the case at the present time, we do not believe that such divergence will necessarily continue to be appropriate for the next four years, particularly given that Ofcom's approach to modelling neither accords with the Commission's recommended use of a bottom-up LRIC model, nor does it assume that the core network is NGN based. As Ofcom itself notes, the end date of a four year control period would be later than the ending of the Commission's transitional period for the application of its Recommendation in Member States. We believe that a shorter control period would afford Ofcom the opportunity to reassess the situation at an earlier point and to establish whether UK circumstances did at that time align more closely with the market characteristics envisaged by the Recommendation. We believe that such an

approach would be particularly prudent in the face of the increasing uncertainty around BT's 21CN deployment plans.

Question 4.2: Do you agree with Ofcom's proposal to use a hypothetical ongoing network model to establish the technology neutral cost base for the next NCCs?

Virgin Media believes that in the short term at least, while BT's 21CN rollout plans and hence the rate of migration of traffic and introduction of new services remains nebulous, it is appropriate to use a hypothetical ongoing network model to establish the technology neutral cost base for the next charge controls. However, we do not believe that the proposed approach will necessarily continue to be appropriate for the entirety of the forthcoming four year period. Accordingly we believe that Ofcom should set a control that is shorter in duration such that its approach is necessarily revisited at an earlier point in time.

Should a four year control prevail, we believe it is imperative that Ofcom does not hesitate to reassess the situation at some interim point and potentially adopt an alternative approach, should such action become necessary. In any event, we believe that the current absence of information on 21CN costs and services should not preclude Ofcom from developing and potentially using a hypothetical fixed NGN costing tool (that follows, for example a Bottom-Up approach), or from re-assessing the proposed model, well before the end of the proceeding four year period.

Question 4.3: Do you agree with Ofcom's proposed methodology for the hypothetical ongoing model, including the use of adjusted base year costs from the previous NCC model to create a stable network from which to model costs?

Notwithstanding our belief that a need to establish a model that is more representative of a next generation network may well materialise during the life of the next control period, Virgin Media believes that while perhaps not an optimal solution, Ofcom's proposed methodology for the hypothetical ongoing model represents a suitable approach given the circumstances. If the model is to use base year costs from the previous NCC model we are of the view that it is essential to adjust those base year costs to allow for capital and operating costs that are representative of an ongoing operating environment where the network is being maintained and replaced on a Modern Equivalent basis (consistent with the CCA approach). Failure to make these important adjustments would very likely lead to under recovery of the costs of network provision.

Question 4.4: Do you agree with Ofcom's proposed approach to efficiency as regards BT's 21CN in proposing these charge controls?

Notwithstanding our preferences relating to the duration of the control, Virgin Media agrees with Ofcom's proposed approach to efficiency as regards BT's 21CN in proposing these charge controls. However, we would encourage Ofcom to develop and populate a hypothetical NGN fixed cost model to confirm that its approach will not lead to charges that are materially different to those that an efficient operator might be able to offer by operating a fixed NGN network.

Question 4.5: Do you agree with Ofcom's proposal to use a FAC CCA methodology to establish the cost base for the next NCC?

Virgin Media believes that a principal objective of Ofcom should be to ensure that BT's cost base is transparent and auditable and that it does not, for example, allow BT to exploit the system by unfairly allocating costs to monopoly products and/or to products that it does not use itself. It is our view that LRIC + Equi-Proportional Mark-Up (EPMU) better meets this objective than CCA FAC as LRIC + EPMU effectively removes the ability for BT to allocate common costs in its own interests. The use of such methodology would also be more consistent with the approach to cost modelling as set out in the European Commission's Recommendation on termination rates.

We encourage Ofcom therefore to set controls based on LRIC + EPMU and to require BT to produce its RFS on the same basis. Setting controls on this basis would, we believe, deliver tangible benefits in transparency and monitorability and would, for example, allow Ofcom and others to more easily ascertain whether accounting treatment accords with cost orientation obligations.

Regardless of which methodology is ultimately chosen, it is a fundamental requirement that the relevant figures are audited. We urge Ofcom to ensure that such activity is undertaken on a regular basis.

As we set out above we believe, in addition, that in its reporting of costs relating to 21CN, it is of paramount importance for BT to provide information at a significantly granular level of detail. The forthcoming review of BT's regulatory financial reporting obligations may well be an appropriate vehicle via which to achieve this outcome, but in any event, we encourage Ofcom to ensure that BT is ultimately subject to such a requirement.

Question 4.6: Do you agree that product management, policy and planning and interconnection circuits should be subject to separate controls?

Virgin Media agrees that product management, policy and planning and interconnection circuits should be subject to separate controls. Competitive conditions for each of these services is, and will arguably continue to be, materially different. It would therefore be inappropriate and potentially damaging to competition to combine these services into a single charge control basket.

Question 4.7: Do you agree that there is no need to introduce sub-caps on rental charges in the ISB basket?

Virgin Media agrees that based on the evidence available at the present time, there is no need to introduce sub-caps on rental charges in the ISB basket. However, given that it is possible that CPs might re-arrange their interconnect estates as a result of BT's 21CN deployment and/or the proposed de-regulation of certain wholesale narrowband markets, we would urge Ofcom to monitor developments closely.

Regardless of the approach that Ofcom ultimately adopts, we believe that it is critical that BT reports costs for each and every charge in order that its compliance with cost orientation obligations can be assessed.

Question 4.8: Do you agree that Ofcom is not in the position to regulate BT's 21CN wholesale voice services at this point?

Virgin Media agrees that Ofcom is not in the position to impose charge controls on BT's 21CN wholesale voice services at this point. However, as outlined elsewhere within our response we do not believe that this situation will necessarily be the case for the extent of the forthcoming four year period, nor will the continued absence of 21CN services from the charge control necessarily continue to be appropriate. We therefore urge Ofcom to honour its commitment as set out at paragraph 4.113 to consider the regulatory treatment of these services when the details of such services become clearer.

Further, we believe that as 21CN deployment becomes more prevalent, there is a material risk of BT exploiting the inconsistency in application of charge control as between TDM and 21CN services. In particular, we believe that there is a tangible risk that a situation similar to that which arose in respect of 2G/3G mobile call termination charging will materialise. As Ofcom will be aware, these circumstances afforded MNOs significant flexibility in their 'blended' charging levels as a result of the 3G element not being subject to any charge control. We believe therefore, that while 21CN services are absent from the control, the principle of congruent pricing or 'commercial neutrality' should be applied, such that the charges for 21CN services are equivalent to those of the comparable TDM services.[1]

Question 4.9: Do you agree with our proposed efficiency adjustment range of 1 – 3% Annually?

While we acknowledge the difficulties associated with establishing an appropriate efficiency adjustment, and indeed recognise that Ofcom's proposed approach is consistent with that proposed for the Leased Lines Charge Control, we believe that Ofcom may have overestimated BT's ability to make efficiency gains in this instance. We note, for example, that both NERA and Deloitte have concluded in their efficiency studies that BT is on or above the upper decile of international comparator benchmarks. Further, while we note that Ofcom has attempted to factor in a level of volume decline, we believe that it may be difficult for BT to achieve efficiency gains in a market where volumes continue to reduce. We therefore urge Ofcom to revisit its efficiency adjustment range.

Question 4.10: Do you agree with Ofcom's proposal that BT be required to provide all data necessary to monitor compliance with the NCC within three months of the end of each NCC year?

Virgin Media agrees that BT should be required to provide all data necessary to monitor compliance with the NCC within three months of the end of each NCC year. Compliance with, and strict adherence to, reporting obligations is critical to the efficient working of a regulated charging environment. It is therefore imperative that accurate and transparent information is provided on a timely basis by BT such that compliance with controls can be monitored and assessed. We believe that this requirement regarding the provision of information within three months of the end of each NCC year should be rigorously enforced.

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[1] *Virgin Media acknowledges that 3G termination rates were not subject to a cost orientation obligation (whereas 21CN charges would be), however we believe that this example demonstrates the consequences that can materialise as a result of an inconsistency in the application of charge controls.*

Question 4.11: Do you agree with Ofcom that NCC charges should be set using RPI as the measure of inflation for indexation, prior year revenue weights to calculate charge changes, and with provision for carry over?

While perhaps not a theoretically optimal solution, Virgin Media believes that RPI is a suitable measure of inflation for indexation to set the NCC charges in this instance.

Virgin Media agrees with Ofcom's proposal to continue to use prior year weights to calculate charge changes in the NCC compliance model. Such an approach would, we believe, provide greater transparency and would result in more certainty around the price cap levels.

Virgin Media favours an absence of provision for carry over. We believe that in the interests of providing certainty and predictability for other CPs, carry over of credit from charge changes into subsequent NCC years should not be permitted. However, notwithstanding this view, in the event that Ofcom decides to allow carry over, we would urge Ofcom to limit its application to a low percentage of the absolute charge.

Question 4.12: Do you agree with Ofcom that NCC charges should be aligned with modelled FAC at the end of the NCC period using a RPI+X glide path?

Virgin Media agrees that NCC charges should be aligned with modelled FAC at the end of the NCC period using an RPI+X glide path. However, as set out in our response to question 4.1 in order, amongst other factors, to reduce the period during which BT's charges are below costs, we believe that the control duration should be set at 24 months as opposed to 4 years.
In addition, as a result of the ongoing volatility in the financial markets and challenges in obtaining funding/credit, we believe that the proposed value of WACC used in the model may well be too low and thus requires reconsideration. In particular, we note that recent calculations of BT's equity beta result in a figure higher than that referenced in the consultation document.

Question 4.13: Do you agree with Ofcom that, in the event that starting charges for the next NCC are below DLRIC floors, the NCC should allow increases in the first year of the NCC to align charges to DLRIC floors?

Virgin Media agrees that in the event that starting charges for the next NCC are below DLRIC floors, the NCC should allow increases in its first year to align charges with those floors. As a minimum requirement, we believe that charges should be above the DLRIC floor not just in the first year of the charge control, but in each subsequent year. Such an approach would ensure consistency with the cost orientation obligation.

Failure to allow BT to recover a sufficient return will in time result in a general disincentive to invest, as BT and other CPs will fail to recover reasonably incurred costs. The price signals CPs receive from a distortion in the charges for BT's wholesale narrowband services are likely to be reflected in their own network charges, which will potentially lead to those CPs undertaking inefficient investments. A good example of where such a scenario might manifest itself would be the upgrade to NGN networks.

We do not accept Ofcom's argument that the fact that BT has previously been allowed to keep the benefits from other charge controls is a valid reason for BT not to be allowed a reasonable return on its ongoing investments in narrowband services. We believe that each market should be considered on its own merits. In this instance, the under-recovery on BT's fixed termination and fixed origination is due to lower volumes than anticipated when setting the current charge control. There is little evidence to suggest that BT's under-recovery has arisen as a result of inefficient investments being undertaken by BT (a point confirmed by the fact that 21CN direct costs have been excluded from the make up of the charges). As such, we are of the view that BT should be allowed to fully recover the legitimately incurred costs of providing its narrowband services.

In addition, we would urge Ofcom not to be detracted from allowing BT to make a sufficient return purely because of unsubstantiated objection to such an approach by other CPs.

Virgin Media welcomes the opportunity to respond to this consultation, and we would of course be happy to discuss the matter further or expand on any of the points that we have made. Please do not hesitate to contact me should you wish to do so.

Yours sincerely,

Andrew Wileman.

For and on behalf of Virgin Media