

## Ofcom review of BT's network charge controls, March 2009

Vodafone welcomes the opportunity to respond to this consultation and provides comments on the basis of calculation of X and the proposed levels of X for certain of the traffic elements inside the NCC basket. Vodafone's particular concern is with fixed call termination, since it is a major purchaser of this traffic type, but our comments can be applied to the NCC basket generally.

It is notable that this charge control proposes rather different values from those embedded in the previous two network charge control regimes, as the table below shows, using as the proposed rate the Ofcom base case version as per table 6.12 of Annex 6 of the consultation:

Service	2001-05	2005-09	2009-13	
	Actual	Actual	Proposed	
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Call termination	RPI - 10%	RPI - 5%	RPI + 6.75%	
Call origination	RPI - 10%	RPI - 3.75%	RPI + 5.75%	
Interconnection services	RPI – 8.25%	RPI – 5.25%	RPI + 4.00%	
PPP	RPI + 0%	RPI + 0.75%	RPI + 3.25%	

It can be seen that the previous pattern of cost reductions has morphed into cost increases. Whilst in the 2005 NCC statement Ofcom was able to proclaim *"required cuts in BT wholesale charges on a range of services during the four years to 2009 .... that should save retail customers about £350 to 400 million"*<sup>1</sup>, no such benefit can be claimed in this consultation – rather Ofcom is proposing that regulated rates will be allowed to rise in the case of fixed call termination, by a compounded value of 30% by the last year of the charge control, effectively wiping out all the savings from 2005 and before. Ignoring the impact of inflation, this increase will put the level of fixed call termination in 2012/13 back to a similar level to that of 2003/04 – in effect turning the clock back nine years, to the rate that existed when Ofcom came into being.

There appear to be two principal underlying causes of this directional shift – falling traffic volumes, and failure to implement 21CN. In the 2005 consultation Ofcom stated: "*BT has suggested to Ofcom that it expects that at least 50% of the relevant traffic will be routed through the new network by 2008 (i.e. within the duration of the new NCCs from October 2005 – September 2009).*"<sup>2</sup> However this has not happened. As a consequence Ofcom has felt forced to develop costs for 2009/13 on some form of hybrid technologically neutral model, using not actual costs but an assumed level of extrapolated costs. These costs are not BT's actual costs expended on the old PSTN network, nor are they the lower long run costs that might be expected from the 21CN network, when finally implemented, but are at a level higher than

<sup>&</sup>lt;sup>1</sup> Ofcom, Review of BT's Network Charge controls, statement August 2005, paragraph 1.3

<sup>&</sup>lt;sup>2</sup> Ibid, paragraph 3.11



both. This does not seem to be intuitively an attractive outcome or a sound basis on which to project such a significant price rise.

So, what is the direction of BT's own actual costs? Analysis of the outputs of BT's regulated financial statements show a step change in the cost of fixed call termination between 05/06 and 06/07 that appears to be unrelated to the underlying level of traffic volumes:

Year	Revenue	CCA op costs	Mean capex	Revenue	CC FAC	LRIC floor	LRIC ceiling
	£m	£m	£m	ppm	ppm	ppm	ppm
2003/04	262	153	497	0.201	0.155	0.128	0.289
2004/05	242	153	448	0.187	0.154	0.115	0.276
2005/06	212	143	430	0.172	0.154	0.115	0.275
2006/07	211	198	455	0.171	0.202	0.154	0.384
2007/08	181	171	414	0.169	0.203	0.165	0.347

Between 2005/06 and 2006/07 whilst the revenues (and hence the volumes) are broadly similar year on year, there is a significant change in unit costs, in that the reported CC FAC cost rises by over 30% and the LRIC floor and ceiling by even more. In the following year, although the revenues fall with volume, the FAC cost remains the same. Ofcom suggests in A6.7 that the reason for this increase is because of the inclusion in the calculation of 21CN components as well as PSTN components, and that removal of the 21CN components results in a CC FAC cost for 2007/08 of 0.157p – a result that is consistent with those experienced in 2003/04, 2004/05, and 2005/06, i.e. 0.155p, 0.154p and 0.154p respectively, suggesting that the path of BT's own costs has been flat across the period, rather than rising as volumes fall. This has broadly confirmed the appropriateness of the level of X in the 2005-09 charge control, with X and RPI at least since 2005/06 more or less in balance. In 2007/08 the revenue per minute is recorded as 0.169p, still comfortably above the CC FAC modelled cost of 0.157p.

Ofcom however states that this CC FAC cost result is not acceptable: "due to the depreciated nature of the PSTN, the costs associated with its components are not robust. In particular we would expect the reported NRC to be too low and the operating costs to be higher than would be appropriate for an ongoing network. Although BT's reported costs require adjustments if they are to reflect an ongoing network, the size of these adjustments is by no means clear."<sup>3</sup> But why should the PSTN, rather than 21CN be the basis of the ongoing network, particularly in the face of falling volumes, and why should the falling volumes give rise to such a substantial increase in the cost of fixed termination?

<sup>&</sup>lt;sup>3</sup> March 2009 consultation, paragraph A6.8, Vodafone emphasis.



By adjusting the CC FAC output in 2007/08 from 0.157p to 0.196p Ofcom is effectively saying that BT's actual costs are not representative of the level their costs would have been had BT not been in the process of running down their PSTN assets in order to switch to a lower cost 21CN - so because of BT's failure to switch to the lower cost 21CN as early as previously expected, BT is being rewarded with a rate that is higher than both their actual costs of PSTN operation, and presumably also than the costs of their future 21CN operation. Vodafone struggles to see the merit of this argument. In figure 4.3 of the consultation Ofcom appears to be saying that since the combined total of PSTN and 21CN costs incurred in the first part of the charge control period exceeds by the size of area A the proposed regulated rate there is a justification for allowing BT to over recover its costs by the size of area B in the second part of the period. This is tantamount to saying BT is entitled to recognise and recover its 21CN costs before services on the 21CN commence – this is an unusual principle. Any 21CN costs incurred by BT before the 21CN is launched are merely an initial investment to be recouped over the life of the new network post launch, not from current PSTN operations, and at a level no greater than actual cost recovery from the PSTN.

In any event Ofcom makes clear in A6.8 onwards that there is no robust basis from which to derive the costs of this hypothetical ongoing network. The 0.196p modelled unit cost for 2007/08 is taken not from a recalculation of 2007/08 BT data, since the sizes of any necessary adjustments are unclear to Ofcom, but by reverting back to the previous NCC base data, i.e. to 2003/04, and then adjusting this for volumes, efficiency and asset price changes to bring this forward to 2007/08, and then continuing the adjustments through to 2012/13 to derive an appropriate level of cost recovery in this year. In effect therefore 2012/13 costs are being estimated from a base of 2003/04.

There is no particular objection to the principle of this, although clearly in the calculation as explained in annex 6 Ofcom are compounding assumption on assumption and approximation on approximation, but one must go back to the 2005 charge control and consider the modelling method employed. In the 2005 statement Ofcom records in 6.73 onwards that previously (for 1997 to 2005) LRIC + EPMU had been the basis of setting the NCC, but that as CCA FAC and LRIC + EPMU appeared to produce similar results to each other in the 2001 review and Ofcom was not satisfied with some of BT's adjustments to the LRIC model in 2005 it was decided to proceed with CCA FAC, with a small adjustment, as a proxy for LRIC. In the current consultation, paragraphs 4.75 onwards discuss the merits of the two cost modelling methods, and explain the difficulties of obtaining a reliable LRIC model, and conclude that for this reason, and for consistency with other charge controls, and continuity with the 2005 statement, that CCA FAC should be adopted. What is missing from this analysis is:

- an indication that the justification for switching the method in 2005 was that at the time both methods had historically produced a similar result;
- and any consideration of whether CCA FAC and LRIC are likely on a theoretical basis to produce different results for 2009-13.



In fact there are sound grounds for assuming that the two methods will produce very different results over the new charge control period. Whilst both FAC and LRIC will vary over time with efficiency and asset price changes, the FAC approach by its nature is much more sensitive to volume change than LRIC which is fundamentally designed to be resistant to year on year fluctuations in traffic volumes. It is reasonable therefore to expect that the CCA FAC and the LRIC results would have diverged by 2007/08 and moved even further apart by 2012/13, with the CCA FAC being some distance higher than the LRIC.

There are two components to this. First from the 2003/04 starting point Ofcom have adjusted this in the present consultation, as A6.12 and A6.16 explain, by "the observed decline in volumes (as opposed to the then forecast decline), falling asset prices, and efficiency savings based on the target set in 2005" to a modelled cost in 2007/08. Given that the outcome of the 2005 charge control in 2009 (where the result should have converged on the assumed underlying costs) must be approximately 0.168p<sup>4</sup> i.e. when using the forecast decline in volumes, yet the outcome of Ofcom's adjustments is a modelled cost of 0.196p when using the same assumptions except for the volume change, we must conclude that this difference of 0.028p or some 15% is solely due to the volume change. Second from the 2008/09 charge of 0.168p at the end of the 2005-09 charge control, Ofcom is proposing in its base case to charge an X of + 6.75% - this will, ignoring inflation, give rise to a charge in 2012/13 of approximately 0.218p. This represents an increase of approximately 11% on the 2007/08 cost modelling starting point of 0.196p. We know that from this starting point for cost modelling Ofcom is applying an efficiency reduction of 2% in the base case, and a set of price changes that on average would appear to be negative, so if volumes were unchanged, one would expect that the modelled cost in 2012/13 would be lower than the starting point. It must therefore be that it is solely the volume decreases that are driving the cost increase.

But is this approach reasonable? Ofcom explains in paragraph 1.18 that it is using CC FAC as "the best available proxy for long run incremental costs plus an appropriate contribution to common results", a point that is missing in the discussion in section 4. Vodafone accepts the point that the use of the CC FAC modelling approach as a proxy for LRIC is perfectly acceptable where the two methods will produce broadly similar results. It also recognises the very significant problems for Ofcom in producing a LRIC result from the data that it has. But where the volumes are changing over time, the two methods will produce significantly divergent results – falling traffic will generate a roughly flat or falling profile under LRIC, as was the case for the 2G cap in the mobile termination review process, where despite a forecast traffic decline of 51% between 2006/07 and 2010/11 the LRIC model produced a cost *reduction* of 14% over that period. However a decline in traffic of approximately 25% (from inspection of table A6.3 there is a decline from an index value of 85 in 2008/09 to 65 in 2012/13) is producing a cost *increase* of 11%. It is difficult to reconcile the two outcomes and assert that CC FAC can be seen as a reasonable proxy for LRIC.

 $<sup>^4</sup>$  2007/08 was 0.169p per the table above \* (1 + 4.6% RPI – 5% X)



In Vodafone's view therefore fixed call termination and the other elements of the NCC should not be allowed to rise over the period 2009-13 on two grounds:

- Had Ofcom been able to generate a LRIC model of its hypothetical ongoing network it would, given the fall in asset prices and increase in efficiency, most likely have shown a falling underlying cost from 2005 through to 2013 rather than the step up of costs in 2009 and subsequent rise that the FAC model is showing in response to falling traffic volumes.
- Given that BT is in the process of switching from PSTN to 21CN, the idea that BT should be rewarded for the delay in this switch by receiving a charge control that allows rates higher than both BT's actual costs under FAC of PSTN operation and the lower long run cost expected in the future under 21CN would not appear to be in the best interests of consumers.

There is absolutely no justification for Approach B, the suggestion of a P<sub>0</sub> adjustment made in section 4.

Vodafone suggests therefore that no increase it warranted and that a RPI – 0 or a RPI – RPI charge control be imposed. This will, given the likely trend of unit prices and efficiency, allow BT to recover its actual costs incurred under PSTN and still permit a favourable return on 21CN when implemented.