

# Consultation Response to the Ofcom Strategic Review of Telecommunications Phase 2 Consultation Document.

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## Scope of this response

*The main focus of this response is the issue of access. We are concerned that the current regulatory review may be heading in a wrong direction. We highlight economic realities, propose a fourth 'Option' – which differs from the three suggested by Ofcom in its Phase 2 Consultation Document – and review certain competition and regulatory concerns.*

## Defining 'Access'

In this response (and in practice) 'access' may mean, depending on the context:

- The 'customer's rights' to have access to communications services via communications networks; or
- Certain physical infrastructure owned by a network operator whether cable, metallic paths or fibre – in the case of BT it typically still refers to legacy copper wire pairs – often referred to as 'the last mile'<sup>1</sup>.

## Our response is in three parts:

- Economic realities;
- First Mile Thinking and the Fourth Option;
- Competition and Regulatory matters.

## Economic Realities

*Ofcom's Phase 2 Consultation Document (the "Consultation document") contains virtually no financial data (past, current or future estimates of costs and benefits) to help inform the economic and regulatory policy assessments of the major questions which it raises.*

### Profitability, Costs and Cash Flow

The consultation does not present a financial analysis of the UK telecommunications sector whether from a high level or a detailed perspective. It is not possible to establish the financial health of the sector - but we do know that most entrants are losing money. In our opinion Ofcom or the DTI should make an assessment of the cash generation and profitability of firms in the UK telecommunications sector. Establishing current assessments for the costs of BT and other operators, across the sector, would help in understanding the fundamentals of cost structures, margins and unit and indicative future costs trends and related efficiency.

### Investment

Although we recognise that investment in new access infrastructure is unlikely to be on any great scale in the U.K. today, no empirical information is presented in the Consultation document. As regards BT, we do know, from the regulatory accounts, that the BT capital employed for business, residential and other access is about £9 billion, (i.e. some 56% of the BT network total) but few details are available of the asset base, the asset condition or access capital expenditure over the recent past. BT may spend significant sums on access – but we do not know the facts. Considerable access investment has been made by the cable companies and certain other network operators - but does that mean there is no current need for further investment? We do not know the answers to these questions.

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<sup>1</sup> For example, a description of BT's local access network is provided at Section 4, pp15- 17, of Ofcom's 9 December, 2004, consultation on 'Valuing copper access'.

The Consultation document states: “Many believe that we are also reaching the point at which higher bandwidth next generation *access networks* (the edge of the network, closest to the customer’s premises) will be required.”<sup>2</sup> Whilst supporting this view we consider that it is fundamental to establish some ranges or options with regard to how much investment is needed and for what specific purposes. Equally alternative access technologies such as mobile or radio may be a key investment driver, but no financial information has been presented. The Next Generation Networks consultation<sup>3</sup> should provide a better picture, or at least some scenarios, but whether it will contain any financial perspectives on access is unclear. Of course accurate forecasts are difficult to make, but we urge Ofcom to provide their views on the possible future capital requirements to meet differing access investment profiles for both new and traditional services markets in the U.K.

## Pricing

Prices (both retail and wholesale) are a major concern to customers, operators and service providers. As regards fixed network access, one key legacy issue concerns tariff rebalancing. There is scant mention of the legacy of cross-subsidy of access charges. Ten years of huge losses (e.g. £401m in 2004) have been reported by BT on their residential access business. This has been cross-subsidised by telephone calls and other services and, more recently, seemingly by “retained” BT customers (where, for example, call services, or even broadband, are offered by a competing operator and the sole revenue to BT is from the ‘unprofitable’ exchange line rental). Tariff innovation with regard to access and rebalancing has not been tackled; although BT has been permitted to offer a blend of access and call charges in its new BT Together ‘Option’ plans.

The impact of retail tariffs on customers is a key competitive issue. Presumably a proportion of retail customers will accept lower call charges in return for higher line rentals<sup>4</sup>. Perhaps more importantly when the customer is considering whether to take currently available unbundled services from a BT competitor, the (uneconomic) price of the line rental, coupled with the tie-in to BT, enables BT to retain market share which it may then be able to leverage into the developing broadband sector.

## First Mile Thinking – start with the customer

*Customers have a right to access and in our view access should be thought of as **the first mile**.*

Every individual and business wants access (both to and for services and not merely as ‘access’ in itself) – whether for traditional basic services or for exciting new services. **First Mile Thinking** is what the UK industry and its regulatory environment should reflect. We consider that means more than simply ‘putting the customer first’. It means starting with demand, market perspectives, service needs, with innovation and customer service which in turn drive costs and investment needs and take account of risk. Whilst recognising that major access networks incur significant costs and represent (or have historically required) a major investment; we consider that First Mile Thinking would make efficient customer access a more highly regarded and valuable asset. (In the end the customers are the most valuable asset: witness the mobile industries early scramble to acquire subscribers. BSkyB’s latest results show an average subscriber acquisition cost of £230).

## Ofcom Options

**Option 1: Deregulation** is a long term goal which we very much support. **Option 2: Reference under the Enterprise Act** is a solution of last resort. (Our comments are set out below under competition and legal aspects). **Option 3: Real equality of access (equivalence)**: Ofcom states: “Central to the application of our proposed principles is the need to tackle the problem of inequality of access head-on.”<sup>5</sup> We remain sceptical as to whether the proposed components of equivalence at the product level and clear behavioural changes by BT can be made to work in practice,

<sup>2</sup> Ofcom Strategic Review, Phase 2 Consultation document, at page 8, paragraph 1.4, (emphasis in original).

<sup>3</sup> Consultation: Next Generation Networks - Future arrangements for access and interconnection published 24|11|04 Responses by 13|01|05.

<sup>4</sup> Naturally equitable arrangements should be made for those customers, including pensioners and those that need and deserve support or protection, including those with special needs, and these should be part of any new USO framework and funding. Something which is currently the subject of a separate consultation.

<sup>5</sup> Ofcom Strategic Review, Phase 2 Consultation document, p.14, para. 1.35 and p.64, para. 5.28.

particularly given the complications of implementation. The experience of the last twenty years indicates that it is difficult to introduce significant competition in access through detailed regulation of particular products. Moreover, the industry appears to have differing interpretations of what 'equivalence' means<sup>6</sup>.

#### **Option 4**

*The structural separation of BT, **implemented by BT itself**, with its shareholders in agreement and with the commitment of its management and employees.*

Structural separation has occurred in other sectors both in the UK and overseas, for example in gas. In our opinion this is the only satisfactory way to break the economic bottleneck. For the purpose of this response we suggest the BT retail and core business is called "**BT Global**". The access business, which we define below, we refer to as "**AccessTwo**".

#### **AccessTwo**

AccessTwo would essentially be a wholesale operation. As a separate commercial company it would have its own cost base and have to charge economic prices and not discriminate between wholesale customers. This would also remove some of the complex regulatory accounting issues. Very careful network definition would be essential but we suggest that up to the Main Distribution Frame, but including all local exchange buildings, would be placed in the access business together with all field operations and support. The issue of whether Access Two includes ADSL and DSLAM equipment is a key consideration. There would also be significant employment issues and these would need to be given careful consideration and management. Great care will be needed in this work and it must be properly managed. It would probably take one to two years.

As one part of BT Global, BT retail would have to buy all its local lines and would for the first time face the same position that its competitors have faced for some years. It may be that some regulatory price control would be needed at first but prices should quickly reflect real costs - of the new company. As a separate business the real investment needs would also be identified and tackled more speedily by a focussed and properly incentivised management. (N.B. Our proposal is not the same as the current BT retail and wholesale organisational structure).

#### **Competition law**

##### Option 2

Ofcom's Option 2 powers derive from Communications Act 2003 Section 370 which gives it concurrent jurisdiction with the OFT to apply and enforce the provisions for market investigation references under Part 4 of the Enterprise Act 2002 in relation to commercial activities connected with communications matters. There is a strong possibility that any market investigation reference to the Competition Commission ("**CC**") would involve a lengthy procedure then be subject to appeal. Any reference by Ofcom would almost certainly take the permitted two years maximum to complete. Parties to an inquiry who are aggrieved by any decision of the Commission in relation to market investigation reference may apply to the Competition Appeal Tribunal for a judicial review of that decision. This looks like an option of last resort if the costs, not least in management time, are taken into account.

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<sup>6</sup> As regards behaviour see also : Pontarollo, Structural barriers and strategic behaviour in fixed line communications, a paper given at the recent ECTA Brussels conference on 7 December 2004 for an analysis of an incumbents likely strategic anti-competitive behaviours.

## The role of competition law scrutiny

UK competition law has been modernised by the 1998 Competition Act and the 2002 Enterprise Act. In a recent speech<sup>7</sup> the Chairman of the Office of Fair Trading has pointed out that there is much more to good competition policy than good competition law, well applied. (That is in addition to remedies applied ex-post for competition law infringements). In particular, by reference to the *Frammiferi Case*,<sup>8</sup> he pointed out that although it has not traditionally been a role of competition authorities to carry out competition scrutiny of regulation, this is changing. We briefly consider below the role that such scrutiny could play in regard to Ofcom Strategic Review.

Both Articles 81 and 82 EC Treaty apply to operators of fixed telecommunications networks and telecommunications services are subject to Articles 81 and 82 of the EC Treaty, because by providing access to fixed networks and services over such networks on a commercial basis they are carrying out an economic activity and are therefore ‘undertakings’ within the meaning of Articles 81 and 82 of the EC Treaty. (See Case 41/83, *Italy v Commission* [1985] ECR 873, paragraphs 17 to 20). Articles 81 and 82 are mirrored in national law by Chapter 1 and Chapter 2, respectively, of the UK Competition Act 1998.

Whether an NRA is also to be treated as an undertaking for competition law purposes is not clear – but cannot be ruled out. The EC Treaty does not define “undertaking” for the purposes of the competition rules. The concept of an undertaking is much wider than that of a natural or legal person. An undertaking can be either a public body or statutory entity provided it carries on economic or commercial activities – an example is the BBC<sup>9</sup>. The absence of a profit motive or the absence of profits is not determinant provided that the objectives are economic or commercial<sup>10</sup>. The term is also broadly interpreted by the OFT and now by the Competition Appeals Tribunal.<sup>11</sup>

Having regard to the breadth of the activities specified in Part 1 of the Communications Act 2003 it appears at least strongly arguable that Ofcom could be said to be an ‘undertaking’ for the purposes of competition law in certain circumstances. This question may not be academic if, in the course of the Strategic Review, Ofcom were to take initiatives, having an economic or commercial objective, which, when properly analysed, restrict rather than promote competition.

## Re-valuing the copper loop – sequencing of the consultations

In parallel with the Phase II consultation, Ofcom has issued a detailed consultation on valuation of the BT copper loop<sup>12</sup> together with a cost of capital consultation<sup>13</sup>. Replies to the Phase II consultation are due on 3 February, 2005. Replies regarding copper valuation are due on 11 February, 2005. If the copper valuation paper will have a determinant effect on the pricing of certain proposed wholesale products - it would seem preferable that the copper valuation paper and the cost of capital paper should both have preceded the Phase II consultation.

Ofcom has stated that in its view the likely outcome of ‘re-valuation’ will be to see the value of the asset decrease. That will have an effect on retail prices – for which it wants to introduce a ‘glide-path’ - but it will also directly affect the value of the underlying asset in a counter-intuitive way. Investors who previously thought of buying the local loop business clearly thought it was **under-valued** not over-valued. It appears that there may be some confusion, whether of thinking or terminology, between costing, prices and valuation.

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<sup>7</sup> [Good government for free markets](#), Remarks to the Competition Policy conference of the Regulatory Policy Institute, Oxford by John Vickers Chairman, Office of Fair Trading, 15 September 2004.

<sup>8</sup> Case C-198/01, *Consorzio Industrie Fiammiferi (CIF) v. Autorita Garante della Concuuerenza e del Mercato*, Judgment of 9 September 2003.

<sup>9</sup> See EC Commission Statement [1976] 1 CMLR 89 *Re: British Broadcasting Corporation*.

<sup>10</sup> See Joined Cases 209-215, 218/78 *Heintz van Landewyck Sdrl v EC Commission* [1980] ECR 3125, ECJ. See also EC Commission Decision 81/1030 [1982] 1 CMLR 221 (*Re GVL*), and Case 7/82 *GVL v EC Commission* [1983] ECR 483, ECJ; see also e.g. EC Commission Decision 83/546 [1984] 1 CMLR 694 (*Re Cast Iron and Steel Rolls*).

<sup>11</sup> *BetterCare Group v Director General of Fair Trading*, Case N° 1006/2/1/01 [2002] CAT 7.

<sup>12</sup> Consultation: [Valuing BT's copper access network \(part1\)](#) published 09|12|04 response date 11|02|05.

<sup>13</sup> Consultation: [Ofcom's approach to risk in the assessment of the cost of capital](#), published 26|01|2005.

## Conclusions

*Some twenty years ago the industry and regulator were already speaking about sector regulation with a 'light rein'. We believe that structural separation of BT's existing access business is precisely the way to achieve that light rein and re-build confidence in the sector – and that it is also in the long term interest of the United Kingdom.*

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These comments are submitted by and as independent professionals with many years experience in the UK and international telecommunications industry. Bob Franklin is an accountant, FCCA with 26 years experience in telecommunications and finance. He has an independent consulting practice working in the UK and some 20 overseas countries. Including for UNDP, the European Commission and the Commonwealth Telecoms Organisation. He is an Honorary Senior Lecturer at University College London. Len Hawkes is a solicitor and has an independent competition and regulatory law practice, based in Brussels, focusing on Technology, Media, Telecommunications and Brands; including EU and UK Competition law and Regulatory aspects of legal compliance.