

Ofcom Strategic Review of Telecoms, Phase 2: the CBI response

Main points:

- Debate over contemporary communications markets are often treated as a zero-sum game whereby competitors present the issues as a win/lose situation. The CBI believes that there is massive scope for growth in these markets and that regulation should not be constraining on these. On the contrary, regulation can facilitate innovation and growth. In these circumstances all parties can benefit.
- We believe that the best way for Ofcom to achieve such a regulatory outcome is by developing a market-oriented approach that complements both its traditional company-specific focus on *ex ante* regulation of BT with progressively greater recourse to competition law. In this respect, Ofcom needs to see the three options it outlines in its Phase 2 consultation document as not mutually exclusive, but as having elements that can be combined for different market developments.
- Such an approach may very well involve new forms of working with players in the market and with the Office of Fair Trading, providing combinations of market guidance, benchmarking performance against guidance and qualified deregulation in next generation access markets. This could allow Ofcom to stand back from detailed market intervention, as it is currently perceived as doing.
- The CBI does not support the structural break-up of BT. We believe it would create significant damage to the UK's ability to have a dynamic and innovative communications market for the next few years. We also believe that it would be contrary to emerging best practices in e-business that facilitate value-generation along supply chains. This would help attract investment into the sector from content and computer software companies.
- However, we also believe that by developing more market-oriented sets of incentives and penalties rather than conventional regulation, BT's competitors will be better able to sustain more effective competition to the incumbent operator. This will be particularly the case in relation to geographic development of different markets.
- The CBI also believes that Ofcom should withhold ("forbear") from regulating next generation access networks in order to allow operating margins to be improved across the industry and thus facilitate investment and innovation. Such networks are essential in helping UK businesses develop value-adding capabilities for product and service delivery in the face of intensifying international competition from low cost countries. But we also acknowledge that if there were regulatory forbearance Ofcom would still need to establish some form of guidance as to how such competitive markets need to develop (i.e. the concept of contestability).



Introduction

The CBI welcomes this chance to respond to Ofcom's Strategic Telecommunications Review Phase 2. In this submission, we have tried to build on the points we made in our response to the Phase 1 consultation. We have in the main focused our responses to questions on business communications markets, though the discussion of general principles necessarily has implications for residential markets and we have tried to make these implications explicit where they occur. We have also tried to make the submission complementary to those of other business organisations. There are issues that simply have to be worked out directly between BT, its competitors and Ofcom; we have tried to keep our remarks confined to those issues that are in the interest of UK business in general.

We would like to state at the outset that we appreciate the progress Ofcom has made in coming to grips with the details of contemporary business communications markets in Phase 2 from the general issues raised in Phase 1. However, we believe that the consultation document still focuses too exclusively on BT's existing dominant position in traditional domestic fixed-line telecommunications. The document acknowledges the existence of a range of problems in current market structures, the growth of an extended communications value chain and the growing importance of software and content in this chain. But it generally neglects to comprehensively or positively incorporate analysis of these issues into its discussion of how to apply its regulatory principles and instead reverts to an almost exclusive focus on physical network access and its essentially negative responsibilities for restricting BT's market power. We believe that there are more positive ways it can address the issues.

As we argued in our Phase 1 submission, physical control of access to network infrastructure clearly remains a significant component of competitiveness in communications markets. But a disproportionate focus on this essentially restrictive issue overlooks the increasingly more important question of how and where economic value is actually being **generated** in service provision and competition. In this regard, Ofcom's Phase 2 document crucially fails to identify how the drivers of such competitive pressures are increasingly being generated at an international level, and as a result misses the point as to how this can impact on competition and policy options at a domestic level.

With these issues in mind, in this submission we focus on how Ofcom should more decisively establish a regulatory framework that positively helps BT and its UK-based competitors innovate in new and internationally leading-edge convergent services. To do this, it must continue to prevent abuse of market power in PSTN markets where there exist economic bottlenecks through *ex ante* regulation. But it must also go beyond this essentially static regulation of BT to more dynamic, market-oriented forms of regulation that support the development of networked voice, data and video services through market guidance, forbearance and benchmarking triggers that establish milestones spurring all players to innovate.

1. Do you agree with Ofcom's proposed principles for regulation of telecoms markets?

The CBI generally agrees with the principles that Ofcom enunciates for applying *ex ante* regulation under option 3. But we also believe that the three strategic options it proposes (complete lifting of *ex ante* regulation in favour of competition law, referral to the Competition Commission under the Enterprise Act, or establishing real equality of access to BT's network) are not necessarily completely mutually exclusive. We appreciate that Ofcom is primarily concerned with establishing a legal rationale and justification for intervening in the market to deal with significant market power and abuse through *ex ante* regulation. But Ofcom also has a more positive responsibility to support market development in relation to strategically important emerging markets such as those constituted by next generation networks. In fact, that is a fundamental *raison d'être* for its formation out of previously separate regulators. It may be that elements of Ofcom's three options can be applied in some form of combination in relation to different market issues.

In relation to the UK communications market overall, for instance, Ofcom acknowledges that problems arise from a range of factors in addition to BT's market predominance (fragmentation, declining margins, competition based on regulatory arbitrage, sub-scale competitors and the investment community's dim view of the sector). Yet its analysis focuses almost solely on BT (the extended value chain is analysed separately in Annex J and is not incorporated into the main body of argument). The danger with this singular response to what is a broad set of problems is that regulation is likely to be reduced to the lowest common denominator – i.e., sustaining "competition" through constraining BT's capabilities to those of its weakest competitor. In this situation, Ofcom's regulatory

principles are likely to be applied in an unbalanced way that is similar to the current approach that it criticises and that is detrimental to wider market development.

A more rounded and balanced approach involves Ofcom regulating markets as distinct from individual companies. In this approach, *ex ante* regulation can be complemented through the development of forward-looking but broad sets of benchmarks that can trigger its removal and thus create incentives and scope for both BT and its competitors to innovate. This approach might quite possibly involve proactively working **with** the Office of Fair Trading rather than just referring issues to the Competition Commission, as Ofcom's remit gives it the right to do but which the consultation document does not consider.

One advantage of such an approach is that, if the object of the exercise is to develop a competitive and innovative market in emerging-services provision, just placing restrictions on the incumbent operator provides few incentives for either it or its competitors to innovate, either technologically or organisationally. Instead, the incentives often lie in the development of regulatory and legal challenges and manoeuvrings. The CBI believes that Ofcom needs to provide guidance as to the level and nature of competition it believes are needed to sustain emerging markets – and to establish benchmarks that, if achieved, will lead it to either impose, or forbear from imposing, *ex ante* regulation. This would provide greater certainty for investors and provide both BT and its competitors with incentives to innovate in terms of corporate structure, operation, and service delivery.

Such an approach could complement ongoing regulation of BT in traditional PSTN voice markets - but it might also minimise the need for it. Such benchmarks might include criteria such as the number of players and relevant market shares, investment and R&D, and quality of service. Such examples are not inconceivable in emerging communications markets and are taken from mobile markets –though establishing their feasibility in relation to any other particular market would of course require due consultation with suppliers and consumers. By providing market-oriented guidance, however, Ofcom may be able to refrain from more direct intervention and thus avoid the danger of re-creating the detailed but contradictory regulatory mesh that currently exists.

We presume that, to a certain extent, the reason Ofcom has avoided advocating such an approach is because it does not want to be seen to be “picking winners”, determining market shares and micromanaging markets. Yet it will be implicitly determining market structures, investment levels and quality of service in making decisions over questions such as interconnection at MSAN and/or Metronode levels and access to APIs. We would suggest that explicitly providing guidance could help more in avoiding picking specific winners and micro-managing markets than might otherwise be the case (and that has in effect been the case with the existing system).

1 a) What regulatory role should Ofcom play in the wider telecoms value chain?

During Ofcom's Phase 2 discussions, a number of participants have expressed the view that detailed scrutiny of BT will need to be maintained to prevent any backsliding once *ex ante* regulations have been lifted on the basis of, for instance, improved interconnection or unbundling. However, the CBI believes this represents a misunderstanding of the value of emerging markets and that once it has transitioned to new markets BT will not *want* to revert to being a traditional operator. We also believe that it would be hard for it to do so, given the kind of corporate structures it will need to adopt to be successful in the emerging extended value chains that characterise these markets.

As Ofcom has recognised, the current regulatory regime has resulted in an incoherent and sometimes contradictory mesh of detailed regulation of different parts of BT's operations that effectively slows innovation across much of the value chain. But Ofcom's consultation document also argues that competition stimulates innovation; yet this is only true in a system that allows competitive returns, which the current regulatory system does not. The statement only really applies to internally-generated funding of investment. For BT, for instance, the RPI-X formula currently restricts its capacity to generate internal, organic investment funds for innovation. BT's competitors, however, also have their potential returns and room for innovation restricted by the margins that BT's set prices allow and by the fact that many of them are already burdened with debt but are largely reliant upon the availability of external funds for investment and innovation.

The consultation document admits that “BT's competitors lack the scale and profitability to contemplate a major investment in new access infrastructure.... [And that] an appropriate regulatory

regime in current generation broadband could facilitate the emergence of stronger scale players...” Ofcom also states that “technological change offers the prospect of increased competition in voice” and data services. Some circularity thus exists in Ofcom’s view of technological innovation and new investment markets. This circularity raises the question of where the funds for investment in new infrastructure are to come from if BT’s competitors lack sufficient scale and profitability and BT lacks incentives (and a degree of capability) because of regulatory constraints.

Another source of funds is the investment community. Yet since the dotcom crash, institutional investors have favoured companies with strong cash flow and entrenched market power over growth potential. In addition, the investment community clearly values content companies over telecoms companies, and telecoms companies leading the development of broadband (i.e., content-based) services over traditional telecoms. This is because the investment community, and virtually all telecoms companies, are trying to develop services rather than carriage capabilities because they see value as being generated in these services rather than simply carriage and interconnection.

To deal with this dilemma, it is important for Ofcom to grasp how value is generated for businesses within these emerging online supply chains. Though the consultation document discusses the extended communications value chain in some detail in Annex J, it never addresses the question of how and what value is added by the various market players; nor specifically about how vertical integration may or may not add value within the supply chain. The discussion instead focuses on how market power might be reinforced by alliances between individual telecoms, content or software companies, each with market power. It does not consider the possibility that differing vertical alliances of companies with particular market power at differing points along the value chain could actually reinforce **competition** between players in supply chains.

The CBI believes this is an important oversight, as the formation of such supply chain alliances might be able to facilitate a flow of investment funds into the sector from related content and computing software sectors. Our 2002 eBusiness survey, Reality Bites, shows how companies are realising significantly increased value through electronically integrating business operations with their customers and suppliers. Such value-generation is realised through networking content vis-à-vis different sets of customers and the resulting improvements in inventory management, sales planning and information management that this provides. This value-generating nature of online networking means that the valuable data is not so much what content is consumed *per se*, but also how it is consumed, when and by whom. As PWC put it: “changes in technology and the competitive environment are causing an architectural transformation that is breaking down these [vertically integrated] silos. The eventual result will be a ubiquitous Internet Protocol network – sometimes referred to as ‘IP Dial Tone’ – that carries all types of content and runs over various types of network infrastructure.”¹

These benefits apply to the communications value chain where media content markets are fragmenting as much as to manufacturing or other service sectors. Value-generating integration is therefore realised not through ownership of pipes vis-à-vis content *per se* but through networking content vis-à-vis different sets of customers.² Such detailed, specific and targeted customer information is optimised by broadband because the higher the bandwidth the greater the interactivity with (and therefore knowledge of and responsiveness to) a business’ customers. But the value of such information is realised most extensively in IP network architectures that are much flatter than PSTNs and that therefore allow customer access and content management and control mechanisms to be much more pervasive and widely shared.

For regulatory purposes, such decentralisation means that vertical integration between businesses in IP value chains do not necessarily require single legal ownership or separation of all the entities involved; and the entities involved may some times participate in more than one supply chain. What it does involve are critical questions of ownership or contractual rights to use of the data generated and shared

¹ Source: PriceWaterhouseCoopers: Competition in the First Mile: Why Fiber to the Premises is Not the Issue (2004).

² As Deloitte & Touche put it: “in the digital world, the winners will be those who focus on and deliver in a new dimension of competition: personalisation. The consumer relationship will replace content as industry king as companies battle for scale in personalisation – rather than content and distribution – assets.” Source: Deloitte & Touche: The Consumer is King: Thoughts on the 21st Century Content and Media Company (2004).

(or not) within the supply chain and the relative shares of the required investments made by the contracting parties. Some businesses, for instance, have established separate but commonly owned “data rooms” with contractually specified rights of ownership and use of the data generated, others have adopted more traditional and singular forms of ownership. From a regulatory point of view, these are questions that may best be dealt with by competition law as much as sectoral regulation, or some combination of both. But they inevitably rest upon an implicit view of the desirable market structure, levels of composition, investment and quality of service.

The consultation document’s omission of any analysis of the possible positive aspects of vertical integration on value generation and competition within IP supply chains arises from its exclusive focus on company specific and physical access issues rather than on service value-generation at the market level. In our submission to the Phase 1 consultation we argued that Ofcom needed to take a more predictive approach to regulation. The analysis here raises the question as to why companies would want in the medium to long term to organise their operations round what is in effect a relatively depreciating asset – physical access to the network – when value is increasingly being generated elsewhere? The subsequent question is therefore whether Ofcom should really be placing so much emphasis on the enduring *economic* character and regulation of this asset? Encouraging investment into the development of innovative IP value-generating supply chains may best be achieved by standing back from regulation at a company level and thus more easily allowing different competing combinations to be formed between different network, content and software companies along the value chain.

1c) What factors need to be taken into account when considering the scope of demand and supply-side substitution in telecoms markets on a geographical basis?

The more de-centralised architectures of IP supply chains means that geographic and product differentiation of regulatory frameworks is very important for optimising value generation. However, Ofcom will need to make some choices as to the desirable market structure in relation to new and extant levels of infrastructure investment at different geographic levels. This will be necessary in order to prevent cream skimming at the margins by providers who are unable to sustain competition in the medium to long term but undermine the ability of those that can. This should include taking into account mobile and wireless networks, where dynamic innovations can be expected as a result of the liberalisation of spectrum trading and use resulting from Ofcom’s Spectrum Management Review.

2. Where and to what extent should Ofcom rely on *ex post* competition law rather than *ex ante* regulatory conditions?

The de-centralised nature of IP-based networks means that, in effect, there is a growing loss of distinction between network core and periphery networks, and wholesale and retail service provision. As we argued in our submission to the Phase 1 consultation, infrastructure technological and management capabilities increasingly underpin quality of service provision. Competition is increasingly based on the quality and availability of service provision in whatever manner and place the consumer wants (and thus through any delivery medium), not in infrastructure provision per se. In this new environment, Ofcom needs to tackle these infrastructure and quality of service issues together.

For incumbent telecoms operators, this means that the categorical difference between large business consumers and competing telcos is dissolving. For, while the quantity of data transferred is still of importance, it is the prioritisation of different forms of data (whether it be video, voice or text) that is becoming crucial to the retention of final customers. This trend is already clearly apparent in the developing peering arrangements for data transfer on the internet. The implication of this for regulation is that the sharp distinction between *ex ante* and competition/consumer regulation is also dissolving, and the appropriate focus moves from simple physical interconnection to contractual standards and obligations for quality of service provision.

This shift can be seen most clearly internationally where many of the drivers of business markets are now located and from which BT is deriving its greatest relative value and growth. At an international level BT has to both compete against and cooperate with other national incumbents and a range of computer service providers as business customers demand end-to-end quality of service provision

between sites in different countries. It is the pressures of this international competition that is in many respects driving its domestic investment strategy for the provision of IP based networks.

As noted above, managing this process from a regulatory point of view may require new forms of cooperation between Ofcom and the OFT. But, as suggested above, by taking a more market-oriented and less company-specific approach, third party providers of computing services can and do play an increasingly important role in driving competition within this context. Ofcom should consider (perhaps in cooperation with the OFT) more how the competitive contribution of these players could be enhanced.

6. What behavioural changes by BT do you believe would be necessary to achieve real equality of access?

In regard to this issue, the CBI would just raise the question as to whether the practices described as unfair in the consultation document under the section on behavioural change could become more extreme under structural separation. Most of the practices outlined could easily be seen as simply the response of BT Wholesale to the demands of its largest customer. Structural separation could exacerbate this situation by removing the current regulatory requirements for BT Wholesale to treat BT Retail in an equivalent manner to its competitors **in principle**. Under structural separation, BT Wholesale would, presumably, be free to give BT Retail and its competitors differing price discounts, quality of service and product development involvement according to their size.

7. How should Ofcom reflect the competing considerations of efficient investment and consumer protection in determining the regulated returns that BT may earn from its network?

The CBI appreciates that Ofcom recognises the leading role that business plays in determining market development and innovation in the communications value chain. We see the effect here as less “trickle” than “cascade” down, as the results of technological and competitive developments in advanced business applications tend to rapidly spread and accrue to residential ones. While many of the arguments raised here as to how sector regulation and competition law should apply to business markets in driving increased quality of service in ways that are already relevant to consumer markets, however, it will take longer to apply to residential markets. For this transition to occur in a manner that ensures diverse competition in the medium to long term, the CBI believes that in relation to next generation access networks operating margins will need to be raised across the sector.

Given the rapidity with which crossover can and is already occurring through the international drivers of domestic network investment, it is important that Ofcom supports the orderly development of next generation access networks and their sector regulation in relation to residential markets. This is not only applicable to the development of competition in voice telephony but in media sectors such as radio as well, where the public service requirements of commercial radio operators mean that they are unable to make a rapid transition from current distribution media to internet-based ones. In order to maintain diverse competition in the medium to long term, Ofcom will need to ensure that it introduces the commercialisation of spectrum liberalisation in a staged manner.

10. Do you agree with Ofcom’s proposals for deregulation of business voice services?

The CBI believes that the proposals put forward by Ofcom in regard to deregulation of business voice services are generally of a positive nature. Clearly, the business market is an area of more competition than (fixed-line) residential markets and, in accordance with EC directives, there is a very real possibility for specific levels of deregulation within business voice services. We believe that progress has been made towards giving the business voice market a competitive characteristic. This is not to suggest that BT does not possess advantages over its competitors within this market; however there has been a marked improvements since the implementation of LLU, WLR and CPS, with BT’s share of business voice volumes now standing at 40%.³

10 a) Has the voice market for large business become more competitive since Ofcom issued its large business pricing statement, necessitating the conduct of a new market review?

³ Source: Ofcom January Market Update, 2005

The CBI is not sure that the May 2004 business pricing statement has had a major impact on the level of competition within the business voice market in comparison to other procedural changes introduced by Ofcom. Under Oftel, contract negotiations with BT were sometimes difficult due to the need to refer all contract pricing structures back to the regulator; processes such as LLU, WLR and CPS have a marked effect on servicing within this area. That said, the CBI believes that putting price lists into the public arena benefits competition in the business market and promotes transparency of pricing. In terms of conducting a new market review, the CBI believes that the impact of the May 2004 publication has not been great enough to warrant such an expansive task.

10 b) What wholesale inputs should be provided on an equivalent basis before BT should be granted greater freedom in relation to the pricing of voice services to large businesses?

As we move more towards converged NGNs, it will be quality of service that increasingly determines pricing rather than wholesale capacity per se. In the current environment, however, the CBI recognises that providing competitors equality of access to key business voice products would justify BT being granted greater freedom in relation to wholesale pricing structures. But the precise terms of such access need to be decided jointly between BT, its competitors and Ofcom.

13. What should Ofcom's regulatory approach be to next generation access networks?

e-Commerce is growing rapidly in the UK. The key challenge facing British business is increasingly that posed by foreign competitors using cheap labour inputs that are unavailable in the UK. The response of British business must be to raise the value of its products and services through more sophisticated online transactional capabilities with its supply chain partners (particularly SMEs), government and consumers. As the CBI's report on broadband in retail and manufacturing showed, this is where real competitive benefits can be found for business. As a result, the CBI would support Ofcom forbearing from full scale sector regulation in next generation access networks and allowing operating margins to be increased across the industry.

13 a) In what circumstances should Ofcom forbear from regulating next generation access?

In order to further the kind of market scenarios that IP value chains potentially promise, regulation of next generation access should aim to stimulate investment through allowing greater profit margins to be derived on a transitional basis from such networks. The end user should be able to reap the benefits through an environment that is ultimately competitive. An environment that is laden with regulatory burdens would stunt opportunities for innovation, discourage investment and, more generally, have an overall negative effect on ICT usage. The CBI is suggesting that Ofcom establishes a regulatory framework that sets clear *medium-term* goals that can stimulate the development of NGNs.

13 b) How important is it that the investment be made contestable; is this achievable?

Ofcom's January Market Update shows how CPS and WLR uptake has exponentially increased since their introduction. The Office of the Telecommunications Adjudicator has helped to ensure that LLU has proceeded to plan and Ofcom's goal of 1 million local loops unbundled by 2005 looks set to be achieved. What this entails then is a vision of a commercial environment that is set to become more competitive.

BT is one of the first incumbent operators globally to implement such full-scale deployment of a fibre based communications network and the overall organisational complexities and risks that come with such a task. It should rightly receive some reward for this. However, BT is by no means the only operator rolling out an IP-based network, and many operators of critical mass are being driven by opportunity and competition to implement such networks, though we believe that these will be of a more geographically localised than BT's investment.

In order to facilitate competition and investment, the CBI believes that provision of next generation access networks should be made contestable, though we also believe that the notion is not a clear-cut one. Clearly, if BT's ducts remain firmly closed to competitors, many face something of a bottleneck in their own deployment of NGNs. Conversely, enforcing free-for-all contestability will clearly place an enormous burden on BT. But contestability could also arise from the development of next generation mobile networks, fixed wireless and the opening up of alternative utility duct systems – as

well as through municipal development of civil infrastructure. The CBI therefore believes that Ofcom needs to investigate this issue further.

13 d) How might structural options help to eliminate the problems of monopoly access assets being owned by vertically integrated operators?

The idea of a vertically integrated operator, whilst pertinent for the current telecommunications market, will not hold true for a market based around NGNs. An IP-based network infrastructure allows for far greater flexibility in terms of both services offered by operators and greater possibilities of choice by the end-user.

15. What can be done to facilitate the migration of complex corporate services (e.g. VPNs) between suppliers?

Looking forwards, the migration of complex corporate services like VPNs will become far simpler when operating over an IP-based network, with switching suppliers being a matter of DNS servers than physically placing circuitry in local loops. In the current context, however, Ofcom needs to work with BT and the rest of the industry to establish clear guideline for a fit-for-purpose and economically efficient process for migrating customers from BT to competitive suppliers, particularly where this involves moving BT legacy VPN customers to competitors' IP-VPN product offerings.

16. Are any alternative structures for call termination appropriate? Could evolution to IP interconnection introduce market mechanisms that make intrusive regulation unnecessary?

One of the most pressing issues for business mobile users is roaming charges, a subject that Ofcom neglects in the SRT. In regard to moving towards alternative structures for call termination, any move towards a Receiving Party Pays should be resisted (or at the least fully controlled). At least at this time, the phone user has a choice of whether to make a pay call or not – bill receiver could result in massive problems if it is not fully regulated and is therefore of questionable value.