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Dear Dougal,

Telecommunications Strategic Review – Phase 2

Kingston Communications (Hull) Plc (Kingston) welcomes the opportunity to respond to the second stage of the consultation surrounding Ofcom's Telecommunications Strategic Review.

Kingston supports the submission made by UKCTA overall, but there are a number of areas where the "view from Hull" diverges from that expressed in the UKCTA response. Some of these are relatively fundamental, at least in terms of emphasis. However, it is important to note that Kingston does broadly endorse UKCTA's support of the general thesis behind Ofcom's "Option 2" and is happy to commit its support to the extensive programme of work that will be needed to turn the proposal into reality.

Overview

Ofcom's review is the most fundamental reassessment of the regulatory framework for telecoms since the "Duopoly Review" of the early 90s. Since then, as a result of both UK and EU initiated policy development, we have a body of regulatory precedents and *ex ante* rules that have shaped and partly determined the level and types of competition evident in the UK telecoms market. Ofcom has, quite rightly, identified that this rather unstructured regulatory framework lacks coherence and fails to provide the real forward-looking certainty that market participants and capital markets require. This alone would more than justify the resource intensive process of the TSR. Coupled with the fundamental changes that implementation of Next Generation Network technology will bring, however, it is no exaggeration to state that the industry is facing a major discontinuity. The combination of fundamental regulatory **and** technology change will challenge the resilience of market participants, and the underlying viability of their varying business models.

Some of them will not survive. This is a healthy outcome of a competitive market. We would share Ofcom's implicit suggestion that the current instability of the market is, in part, due to excess capacity, and that it would be rational for this to change as a result of market exit and/or consolidation. In addition, competitive models that are purely based on regulated service arbitrage can be expected to suffer more than those based on real

product or service innovation. Again, this is healthy, and Ofcom's proposed emphasis on encouraging competitive investment in the lowest possible point in the value chain should send clear and unmistakable signals to market participants that this will be the case. In our response to the last phase of consultation on the review, we noted:

"Recently, at the launch of the consultation on the wholesale local access market, and the conclusion of the Broadband Market Review, Stephen Carter made the following comments:

"We have made clear our desire to see sustainable long-term competition. Service-based and infrastructure - or facilities-based - competition are interdependent. We will exercise our regulatory discretion towards creating a framework which provides proper incentives and reward for investment for scale and reach. This is particularly relevant in broadband datacarriage networks and services, which can provide, at residential level, always-on, high-speed internet access to content rich material, Video on Demand, and voice calls by VOIP. For small and medium sized businesses, access to extensive and cost-effective broader-band networks, services and VOIP will be a vital tool in Britain's international competitiveness in the coming years.

BT's strategic commitment to broadband and its recently-announced nationwide DSL roll out programme have been welcome. With the right competitive framework, cable and alternative carriers and service providers can complement and drive this, to make Britain a leading economy in the G7 in terms of broadband access and take-up."

If this statement provides an accurate foretaste of the conclusions of the Strategic Review, we can only applaud Ofcom's vision. However, this vision must be complemented by a steadfast unwillingness to tinker with the regulatory regime as the market develops and/or policy perspectives alter. Regulatory certainty **over time** is as important in incentivising investment as the creation of competitive opportunity. The prospect that such opportunity can be "legislated away" or devalued by subsequent regulatory decisions is, in itself, the most effective investment disincentive there can be. Ofcom also needs to be mindful of the potential effects of other Government policies on the investment climate and ensure that all public sector bodies recognize the economic impact of their decisions. "Joined up" Government must be assessed on a whole economy basis."

Our views are unchanged but our concerns have been accentuated by a number of recent policy initiatives by Ofcom themselves that appear aimed at significantly reducing the input costs of "bottleneck services", and/or extending the scope of what this category covers. Whilst this may appear to be an attractive outcome, since it may lead to lower consumer pricing in the short term, it may not be in the interests of longer term sustainable competition. Cheaper and cheaper regulated access service prices will make Ofcom's tentative conclusions about economic bottlenecks in this area a self fulfilling prophecy, and could jeopardise the commercial prospect not only of those with access assets that compete with the incumbent, but those reliant on regulated service inputs, because of the impact on market confidence of the consequent revenue decline.

We would contend that patterns of consumer behaviour (as evidenced by switching inertia, use of mobile instead of fixed etc) suggest the cost of fixed telecoms has fallen to a point where consumers attach more value to innovation than further price erosion. Consequently we believe that all telecoms companies should be allowed to make a

reasonable return on investment so that they can invest that return in innovation, to the long term benefit of consumers. BT in particular should be allowed to earn a reasonable rate of return on its copper infrastructure and next generation network investments, reflecting the relevant degree of risk involved.

We would agree that it is appropriate for Ofcom to review the cost of copper, but it is vital that Ofcom take a rigorously objective approach to this and not be unduly influenced by a potentially ill thought through¹ policy desire to reduce the cost of wholesale line rental or LLU, to match those in other peer group economies, notwithstanding their vastly differing economic and competitive ecologies. Regulating the cost of copper too harshly will unfairly undermine investment in alternative cable infrastructures, both current and next generation.

The most important stimulus that can be provided to altnet competition is equality of access, as discussed in Ofcom's consultation document and articulated over the last few weeks in industry-Ofcom discussions. Provided that BT commits to delivering equality of access (both product and behavioural), and subject to adequate margin squeeze safeguards, we would be happy to see a regulatory settlement that rewarded BT with a decent return on copper and capital.

There are six subsequent issues where Kingston would wish to make specific comments:

1. Dark Fibre – Kingston is concerned that Ofcom's approach of investigating services rather than the underlying infrastructure has led to a skewed perspective of the degree of infrastructure competition.
2. Constraints on LLU – Kingston believes that the UKCTA proposal of creating equivalence by forcing BT retail to use the same upstream inputs as LLU operators is fundamentally flawed. Kingston believes that the correct approach is to allow LLUOs the same opportunities as BT retail.
3. BT's activities regarding their Consult 21 project. Kingston is concerned that BT's lack of engagement with industry so far will allow BT to leverage their current advantages into the new environment.
4. The prospects for Next Generation Access Network investment
5. NGN economic issues – Kingston is concerned that the economic debate surrounding moving to an interconnect world using new technology is not yet taking place and that this has the potential to hinder plans for NGN roll out.
6. BT behaviour in corporate markets

We have taken each of these issues in turn and explored each concern in some detail below.

¹ In practice, savings in WLR resulting from the review are likely to be competed away, leaving BT's WLR/CPS competitors in little better position than before

“Dark Fibre”

In assessing the extent of current and future competition in markets served by fibre based connectivity, Kingston has a real concern that Ofcom has underestimated the amount of competitive infrastructure that already exists in the middle and last mile access markets.

Ofcom has previously attempted to analyse the competitive state of the services and connections to customer sites, particularly in the context of the leased lines market review. However Kingston believes that this has not been entirely effective, as it is possible that Ofcom has undertaken the analysis from the wrong perspective. In practice, what Ofcom have sought to capture is the raw market shares of market players in conventional point to point service markets. This may badly misrepresent the underlying infrastructure position, for two reasons. Firstly, many alt-nets may predominantly such connectivity as part of a broader managed service, such as an IP-VPN, and would not be able to report the relevant data for point to point links requested by Ofcom. Secondly, a large number of such links are provided to national scale customers who are only prepared to deal with a single provider, traditionally BT because of their ubiquitous national coverage. Consequently, regionally base operators may have great difficulty in securing what would appear to be the proportionate share of such business and their infrastructure may appear underused or, indeed, non-existent

What is needed is an understanding of the extent of competitiveness within this access infrastructure market itself, rather than on specific derived service markets. Kingston suggests that Ofcom undertakes a study whereby all relevant ECNPs with significant infrastructure (such as Kingston, NTL, Telewest, Thus, Colt, C&W, YourComms etc) are asked to provide access network data from their GIS systems covering their middle and last mile infrastructure deployment. This data should then be compared to that of BT to ascertain geographically speaking, if and where there are enduring economic infrastructure bottlenecks.

Once this has been established Ofcom would be able withdraw regulation from where there is demonstrable access competition, proven by the existence of significant competitive infrastructure, and focus on the areas where competition has yet to be established.

Constraints on LLU

For historic reasons, LLU Co-location facilities have been contractually restricted to the function of direct access to the copper access network served by the MDF located within the same building, supported by a specific range of back-haul services.

This effectively constrains the ability of ECNPs to achieve economies of scale and scope through aggregation of services on combined platforms that could be situated in the co-location and hence removes the opportunity for efficient service management that BT itself has. Kingston urges Ofcom to consider how to enable the management of co-location space effectively, in a way that would open its use for different services (both regulated and unregulated). This has been a particular problem for Kingston and we attach correspondence with BT on this matter, as a confidential annex.

BT's activities regarding their 21CN project

BT, like most incumbents is in the process of implementing NGNs to carry their future converged services. Some of the design decisions they are now making will affect future competition by restricting or enabling particular modes of interconnection. Initially, BT was proposing to limit "interconnection" to around 100 main network nodes (roughly comparable to the number of "DMSU/tandems" within the current "POTS/ISDN" network). They did not see interconnection as being available at the ~5500 Multi Service Access Nodes (MSANs) that will replace the POTS DLE/RCU and Broadband DSLAM layers. In many of these locations, competitors have already invested in building facilities to collect traffic at points that may be 'stranded'.

Whilst BT are now addressing this issue through the "21Consult" process, this approach immediately raises a number of fundamental concerns:

- Devaluing or stranding of investment by alternative network operators in local network assets in the "middle mile" risks undermining the ability of the market to sustain competing networks, and undervaluing the contribution that competitors make by carrying traffic on their own networks.
- Removal of the option of "bitstream" type service provision: while LLU access is an important enabler of longer-term competition, we still see a major role for "bitstream" access on at least a transitional basis until LLU enabled or other forms of competitive access are close to ubiquity.

Clearly, incumbents now have sufficient confidence in the economic and business advantages of NGN to make the massive corporate capital and resource commitment needed for the transition. Whilst some aspects of how they will interconnect their NGN and the services they support with those of other operators remain unknown, it is hard to see how this confidence can be shared across the industry. This may have a chilling effect on altnet NGN investment plans that are already susceptible to the general lack of confidence in the sector still evident in capital markets.

Kingston is also concerned with BT's continuing lack of effective engagement with industry with its plans for the deployment of its NGN. Kingston has made every effort to get actively involved in the "Consult21" project, with Huw Saunders co-chairing the main steering group, and Nancy Saunders co-chairing the OSS working group. However it appears to us to date that these positions of co-chairs are only there to give the impression of an industry partnership working group, as at this time there is no evidence that BT intend to take any real heed of suggestions from the co-chairs or other industry participants.

Left to itself, the process of developing the "Next Generation Interconnection Framework" could lead to years of disputes over standards, protocols and commercial

principles. Based on past experience, BT is unlikely to accept or be receptive to bilaterally generated requirements and it seems certain that it will take time to get fit for purpose access arrangements in place.

Without clear and continuing signals that Ofcom intends to act as steward of the competitive process, BT will face strong incentives to seek to establish a first mover advantage in downstream markets for the services enabled by all-IP networks. It would be unfortunate if this was the case and Ofcom consequently had to spend years trying to untangle the mess. Inaction now would not bode well for the medium term prospects for competition and the long-term interests of the citizen-consumer.

Next Generation Access Networks

What do we actually mean by next generation access networks? What are they likely to be used for? When if ever is the market likely to start deploying such solutions? Is there a need for regulatory intervention of any form, or more radically, any fundamental policy reason for government or public sector intervention?

It is noteworthy that, in events associated with the TSR2 document, senior Ofcom representatives have mentioned that this was one area of the review that, to date, has generated little, if any, coverage. Perhaps that is an indication of stakeholder priorities, perhaps it is because there is genuinely little interest at this stage. Ofcom have polarised the comments received to date as falling into broadly two camps, firstly a number of mainly public sector respondents encouraging early intervention, citing Japan and South Asia as role models; secondly a number of network operators stating that there was, as yet, no identifiable economic demand for the services NGN access can deliver and, hence, there was little enthusiasm for any investment.

This polarisation is in danger of distorting the fundamental position – it suggests that there will not be any investment in “broader-band” services delivery without early intervention and this “market failure” needs to be addressed because of the potential economic and social consequences.

This analysis is both inaccurate and unsubstantiated for a number of reasons. Firstly, Ofcom’s conclusions about technology and topology choices are rather pessimistic. Whilst the FTTK or FTTH models offer the most well understood “next generation access network” it is by no means the only one viable even in the short term. Ofcom have noted the potential promise of “wireless” access, particularly in the context of the Spectrum Review. We would concur – UWB, Wi-Max and other “4G” technologies offer a very promising route to broadband service delivery within a matter of months rather than years and at an economically attractive price. Wi-Max is already being rolled out in North America and provided Ofcom follow through with their proposals on spectrum use restriction relaxation, there is no reason why it should not start to roll out in the UK during 2005.

In addition, the review does not recognise the potential for newer variants of DSL technology deployed at the MDF site to deliver higher bit rate services. In particular, ADSL 2+ can deliver 10 to 15 Mbps to a significant proportion of the population for little incremental investment. 3rd generation DSL line cards such as those to be deployed by BT in 21CN and by a number of LLU operators, will offer this flavour of DSL as a purely

software selectable option and is already being deployed in a number of markets such as France. It will require modification to the ANFP rules on DSL deployment and these will need careful consideration to ensure there are no long-term consequences for other technologies particularly VDSL and FTTK. This process is already underway, with the NICC DSL Task Group agreeing during January to undertake this modification. This opens up the prospect for higher bit rate service deployment at little or no incremental cost in the access network.

Given these relatively low cost options, it seems likely that competitive pressure will provide sufficient incentive to drive investment, in order to provide product differentiation, and/or to match other providers. This suggests that investment will occur in the UK sooner rather than later leading, perhaps, to the same conclusions that the FCC reached in the USA with respect to forbearance. Clearly, regulatory signals need to be carefully selected, but it is important that incumbent or new entrant investment is not deterred by premature imposition of “cost oriented” wholesale service obligations, where “cost” does not include a suitably attractive profit margin.

In the light of that, there is no convincing argument for a fundamental or radical change of policy, or public sector intervention at this stage, for both practical and policy reasons. “Broader band” services will be delivered – let us see how consumers react before we conclude that something “needs to be done”.

Whilst the enthusiasm for many stakeholders in this area is understandable, radical intervention based purely on “policy considerations” unsupported by any rigorous or robust economic analysis risks introducing fundamental distortions in the market. Given that Ofcom elsewhere in the document has concluded that extension of the USO to current broadband is wrong, this seems dangerous in the extreme.

That does not mean that there is no need for a debate – what it does need is a proper and measured consideration of the issues rather than unsubstantiated rhetoric. We would encourage Ofcom to engage in this debate soon; a number of initiatives involving public sector subsidy for next generation access networks have already been proposed by RDAs and local authorities which seek to address a perceived ‘market failure’ by investing in subsidised ‘civil infrastructure’ (or in some cases service provision). These have the potential to undermine existing private sector investment, inhibit future investment and displace private sector activity with less efficient publicly subsidised (and often publicly managed) activity. Although some of the wider policy issues fall outside Ofcom’s remit, Ofcom has a clear remit to promote efficient operation of the market. We believe Ofcom should:

- provide a more rigorous analytical framework for assessing the extent of market failure and the degree of unsatisfied demand;
- provide clarity on what ex-ante regulation would apply to such public sector entities (assuming that there is indeed market failure);
- contribute to the development of government policy on the application of state aid rules to such interventions.

There is also a related issue of whether or not broadband should be viewed as a candidate service for an enhanced or extended USO. Ofcom is currently addressing the USO in a separate consultation. Interestingly this does not address the overall scope of the USO, but rather its delivery and funding. This seems to be for two reasons, firstly the scope of the USO is not within its remit or gift as it is defined in the EU Universal Services Directive and secondly, because the Telecoms Strategic Review is addressing this specific issue.

The conclusion of the TSR Phase 2 document on this is that there is no sustainable case to be made at this stage for a broadband USO. This is because there is no evidence that there are serious network externalities or inefficiencies in the roll out of broadband, or that there are any significant problems of social inclusion caused by a lack of broadband take-up or availability. With broadband availability likely to approach 99.4% of the population in the very near future, but penetration running at around 20% this is surely the right position to take.

We would, however, concur with the general sentiment of Ofcom's statement at paragraph 64 of Annex K. Ofcom has however noted at paragraph 66 that there is a broader range of arguments put forward by some proponents of the broadband USO. These arguments are particularly focussed on the issue of so called "broader band". There seems to be an assumption that without some form of regulatory obligation or public sector intervention, investment in next generation access networks will not take place, and the subsequent market failure will have severe economic consequences for the UK. This is both unduly pessimistic, as indicated above and not sustained by anything other than rhetoric.

NGN economic issues

The next wave of network technology will change some of the fundamental truths about how operators deliver services and interconnect their networks. Regulators, policy makers and stakeholders need to be thinking about these issues since some of the implications of 'next generation networks' could drastically undermine the interests of citizen-consumers in effective competition between telecoms networks.

Some of these issues are driven by the introduction of "Voice over IP" solutions, replacing conventional PSTN networks. Many of the current assumptions for both PSTN and broadband pricing at both the retail and interconnect level may have to be amended to accommodate this move.

The majority of the current debate has up until now, quite rightly been focussed on the technology of NGN. However Kingston is concerned that the economics of using this new technology is in danger of being overlooked. As was mentioned at the very start of this submission, Kingston's own plans for NGN deployment are quite well advanced. However, before final decisions can be taken, it is essential that information regarding the costs associated with different interconnect scenarios are known.

There is a danger that commercial practices that are current in today's networks are replicated in tomorrows without clear analysis and understanding of whether or not they

are appropriate. One possible scenario is a move away from the “pay as you go” or “ppm” model that dominates current POTS interconnect for some or all of the services that converged NGNs will support, in favour of capacity-based charging. In part this reflects the differing cost drivers and fundamentally divergent service economics that such networks display compared with legacy systems. It could also reflect that NGNs are IP based and the dominant model for “interconnection” in the Internet is rather different, based on “peering” that has some similarities with the old telco model of “bill and keep”. It may be necessary to develop differing models for different services, reflecting differing quality of service needs for instance by a “pay-for-packet” or other such bandwidth usage tariff system. This does, however, increase complexity and costs for all concerned and careful consideration needs to be given to such trade-offs.

There are also issues arising from the potentially very different service creation architectures that all-IP NGNs will enable. There may be multiple levels of “operator” ranging from very large (the former carriers) to the smallest service provider. Since regulators are likely to need to set rules (or at least principles) governing interconnection, those rules may need to recognise that traditional distinctions between “network operators”, “service providers” and “customers” should be thought of in new ways (if they exist at all). NGNs will have vastly increased intelligence at the edge of the network, with flexible, multi-service core networks providing an open platform for service delivery. The result could be a greater variety in the type and number of services that can be offered over a converged access services. This may require new approaches to interconnection, particularly if incentives for investment in access and core networks are to be maintained.

BT competitive behaviour in the corporate sector

Like all of the competitive telecoms operators in the UK, a major goal is to win market share from the incumbent, BT. Latterly, with the introduction of more regulated access services such as CPS, WLR etc, and a more effective approach to enabling competition evident from Ofcom, the intensity of competitive activity has heightened. For the first time, BT has been losing ground in its core markets that generate a disproportionate share of its revenues and profits. This includes the larger businesses and some public sector organisations that are generally referred to as the “corporate sector”.

This increasing intensity of competitive activity is to be expected as the market matures, and may, in some instances, lead to irrational or unsustainable commercial propositions being made, some of which appear to be below the relevant costs. Ofcom will be aware that a number of our competitors have accused various other market participants of instigating or leading such behaviour. Whilst we may not welcome this type of action, as it may undermine the overall viability of the sector in the medium term, we would not seek regulatory intervention unless any prohibited anti-competitive behaviour could be demonstrated, such as the leveraging of dominance in other markets by using monopoly profits to sustain such predatory pricing. However, if the incumbent seeks to match such activity in order to maintain its market share, a greater degree of regulatory oversight and intervention is clearly called for.

It is no surprise that BT's recently evident greater commercial focus and more aggressive management style should result in what we would consider to be problematic behaviour. It could be argued that incumbents have a responsibility to their shareholders to "push the regulatory envelope" so as to maximise business performance. In such circumstances, the regulator has a responsibility to provide clear indications of where the boundaries of acceptable behaviour are to be drawn and to provide effective incentives to remain within them. We are concerned that in this vital part of the overall market, this has not happened and that BT are exploiting Ofcom's commitment to "light touch" regulation, and the arguably greater freedom granted to them under the Communications Act regime, to compete unfairly for business to the detriment of sustainable competition, and the longer term interests of customers.

We understand that BT have been maintaining for some time that some elements of this sector are already effectively competitive, and that their traditional market power is no longer evident. Ofcom investigated some aspects of this during 2004 in its consultation that was initially launched by Oftel into "BT's pricing of services for business customers". Rightly, this concluded that the time was not yet right to allow BT more freedom, particularly in bundling "SMP" and "non-SMP" services and that prohibitions on non discriminatory pricing should continue. Unfortunately, we suspect that BT is willing and able to evade such constraints as and when it suits them.

Some of this behaviour is well established; anecdotal evidence suggests that BT have been willing to price "off list" in order to retain its top 20 or 100 accounts for many years. Recently, however, it appears that this behaviour has become more systematic and widespread, using service pricing that does not appear to be related to its established pricing and discount structures. Whilst interpretation of the BT Pricing Manual is sometimes difficult, we are convinced that many of these instances can only be explained by "off list" pricing, or the allegedly "coincidental" launch of a new discount variant that enables BT to match or better our offer. In either event, we would maintain that breaches of obligations not to unduly discriminate have been committed.

This type of aggressive and non-compliant pricing behaviour is also complemented by other apparently anti-competitive acts. These fall broadly into four categories:

- a) Bundling of non-SMP and SMP services, where non-SMP prices are well below cost and obviously subsidised by profits from SMP services.
- b) Apparent misuse of information gained from retail contract novation requests from Kingston.
- c) Various instances of denigration by BT of Kingston as a competitor.
- d) BT claiming, improperly, that it has exclusive rights to provide services to public sector customers under umbrella contracts.

In many cases, the customers involved are unwilling to get embroiled in a regulatory dispute, and we have consequent difficulties in providing concrete supporting evidence. Unfortunately, this appears to prevent us from lodging any type of formal complaint with Ofcom, in the light of your policy with respect to the evidence base necessary before a complaint or dispute can be considered. Whilst we fully understand the underlying rationale behind this position, in that it discourages "vexatious" complainants, reduces the dangers inherent in excessive regulatory intervention in markets, and encourages



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negotiation and other means of dispute resolution, we do have real concerns that, in this instance, this could lead to irreparable damage to the development of an effective and sustainable competitive market. It seems that we have a variant of the classic “Catch 22” - there is insufficient evidence from which Ofcom could conclude there is a case to be answered, but only the formal evidence gathering powers available to Ofcom in such an investigation are likely to produce such evidence. In our view, this problem can only be properly addressed by Ofcom contemplating an “own initiative” investigation or market review.

This particular problem is of such significance that, if it were left unresolved, it could prejudice the medium term prospects for effective competition. In the light of the commitment to consider the prospects for further relaxation of regulation in this area in the Telecommunications Strategic Review Phase 2 document, we believe that it is vital that Ofcom consider what the effects of what seems to be a newly established pattern of behaviour for BT might have before contemplating this course of action.

Should you have any questions relating to this submission, please do not hesitate to contact me.

Huw Saunders
Group Regulatory Affairs and Technology Development Director