

## Ofcom Strategic Review of Telecommunications

### Response to Phase 2 Consultation

Osney Consulting welcomes the opportunity to respond to the Phase 2 Consultation of Ofcom's Strategic Review of Telecommunications. We are a specialist management consultancy which advises public sector clients on the procurement of telecommunication networks.

Our responses to Ofcom's questions are based primarily on our observations with respect to two main subject areas:

#### 1. Pricing

One of the functions of an industry regulator is to prevent cartels from forming and raising prices above competitive levels. In our view, Ofcom should also address the opposite problem, of prices being set too low for competitive markets to develop. There is rather more evidence at present of this situation existing than of price-fixing through cartels.

##### 1.1 Profitability of telecommunications industry

In figure 13, on page 55 of its consultation document, Ofcom shows the market capitalisations of seven leading public telcos. It is instructive also to study the "bottom lines" of these companies:

BT	Earnings £1.4bn on	turnover of £18.5bn
Cable & Wireless	Losses of £212m,	turnover £3.7bn
Colt	Losses of £125m,	turnover £1.2bn
Kingston	Losses of £118m,	turnover £324m
Thuis	Losses of £25.2m,	turnover £332m
Easynet	Losses of £19.8m,	turnover £116m
Fibernet	Losses of £5.1m,	turnover £42m

Notwithstanding Ofcom's observation that earnings from voice services far exceed earnings from data services (consultation document, paragraph 4.8) and the implication that data services are subsidised by voice services, any allegations that the

industry is currently over-charging are not logically consistent with the fact that so many suppliers are losing money.

## 1.2 Affordability of telecommunications services

Ofcom has noted that the real price of voice services has fallen dramatically since deregulation. We would contend that the price of neither voice nor broadband service today represents a major proportion of the typical household or corporate budget. Residential broadband services are now available at a price equivalent to six pints of beer per month, or four tanks of petrol *per year*. Whilst we do not question the need to provide low-priced telecommunications services to families on low incomes, we would suggest that current market rates are seldom beyond the means of anybody in employment, and that broadband services in particular offer excellent value for money in relation to their increasingly widely accepted benefits.

We believe that one effect of continuing downward price pressure has been to make it economically unviable for many companies to enter the market for residential broadband, and that this represents an “own goal” for consumer pressure. Neither the alternative telcos nor any but a very few of the community broadband initiatives that emerged in 2002 and 2003 were able to build sustainable business cases for providing broadband in rural areas at the market rates then prevailing (around £25-30 per month). Very few operators seem to have considered the possibility of charging more for broadband in rural areas than in cities, even though this would have made it very much easier to balance the books and still would not have taken a major slice of a typical customer’s household budget. This is in contrast to community initiatives set up to provide telephone and electricity services in rural areas in the early 20<sup>th</sup> century, where higher charges were accepted as part of the cost of living in the countryside<sup>1</sup>.

Although we note that “almost all of the Phase 1 consultation responses mentioned low prices as a critical feature of a well-functioning market” (paragraph 4.63), we believe that the following paragraph – “prices need to be sustainable” – is also of prime importance. Unsustainably low prices can be construed as predatory pricing by the incumbent operator.

## 2. The Universal Service Obligation

We welcome Ofcom’s recently announced Review of the Universal Service Obligation, and we shall respond to this consultation in due course. Ofcom notes that the USO has barely changed since privatisation (10.2), and we believe that the time is right to review its scope to ensure that it meets present and future requirements. It is possible that one of the factors that inhibited telcos and community groups from offering rural broadband services earlier but at higher, sustainable prices, was a perception, derived from the USO, that telecommunications services should be charged on the same tariffs nationwide.

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<sup>1</sup> For example, see Fischer, C.S. (1992), *America Calling: a Social History of the Telephone to 1940.*, and Brown, C.D. (1980), *Electricity for Rural America: the Fight for the REA.*

Furthermore, we believe that any revision to the USO should include a requirement for a *functional broadband service* rather than merely a *functional Internet service*. In view of the present low cost of DSLAM and equivalent equipment, we do not see that this would represent an unacceptable additional burden on the USO supplier.

### Responses to Ofcom's Questions

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

Yes, we are in broad agreement with Ofcom's seven proposed principles. However, we would urge a degree of caution with regard to the third principle: "as soon as competitive conditions allow, withdraw from regulation..." Although we agree that Ofcom should withdraw from active *regulation* at the earliest opportunity, we do not believe that the industry watchdog should ever withdraw from *watching*. It is Ofcom's responsibility to ensure that it has sufficient resources for continuing vigilance.

*1 b) How should Ofcom reflect differences in competitive characteristics in different geographical areas?*

We agree that Ofcom should recognise the widely different market environments in different geographical areas. However, to the greatest extent possible, a single set of regulatory principles should be devised which will cover all circumstances.

*1 e) Would you support a requirement to provide Ofcom with data on particular products on a geographic basis as part of the regular reporting requirements? What is the correct level of disaggregation?*

Yes, this would be an appropriate requirement for Ofcom to make. We would suggest a small number of categories based on population density.

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

Whilst we support the principle of applying the minimum amount of regulation consistent with the promotion of a competitive market, we would not agree with applying so little regulation that frequent use of competition law is required to remedy violations that have already taken place. Although "regulation is not a cost-free or risk-free activity" (5.16), we believe that such costs will prove to be modest compared to the costs of pursuing extended legal actions. We also observe that the majority of complaints tend to be made by smaller operators who are financially less able to withstand mounting legal costs, even if the courts ultimately find in their favour. We believe that if the *ex ante* regulatory conditions are working well, a minimum number of cases will need to be referred to *ex post* competition law.

*Question 3. In what circumstances would it be appropriate for Ofcom to make a reference under Section 131 of the Enterprise Act?*

We note firstly that making a referral under Section 131 of the Enterprise Act would not necessarily lead to structural separation of BT, but rather would initiate an investigation to determine whether or not a structural separation was appropriate. Our main argument against the structural separation of BT concerns the practical difficulty of doing so effectively. Despite Ofcom's assertion that "legally separated wholesale and retail entities would have no common interest beyond those of a purchaser and supplier" (5.23), we note that this particular purchaser and supplier would continue to enjoy an unusually close working relationship, the inevitable result of years spent together in the same offices. It would not be difficult to find cases where the relationship between wholesale and retail BT staff extended beyond business.

We are less convinced by the argument that BT's vertically integrated structure helps to justify investments in innovation. Throughout the history of the electronics industry, innovation has tended to be driven by networks of small businesses rather than by conglomerates. Ofcom notes that similar patterns have been observed in the aviation industry (5.24).

Despite our reservation mentioned above, reference under Section 131 of the Enterprise Act is an option that deserves serious consideration. We urge Ofcom to investigate this possibility further, beginning by clarifying what knowledge would be produced by a Competition Commission investigation, additional to the information already available to Ofcom.

*Question 4. Should Ofcom adopt a broad approach of focusing regulation on enduring economic bottlenecks while tackling the problem of inequality head-on?*

Yes. The practical difficulty of ensuring equality of access should not be underestimated (question 3, above). This provides all the more reason for vigilant regulation at this level.

*Question 5. How can real equality of access be achieved at the product level?*

We believe that this is close to impossible in the current environment. For the reasons cited in our response to question 3, even the structural separation of BT would be unlikely to achieve equality of access with current products. Ofcom suggests (6.5) that, with BT's 21<sup>st</sup> Century Network, "there is ... a one-off opportunity to build the principles of equality of access into the network". It is self-evident that BT has a strong incentive not to do so.

In our view, true equivalence of access will be more easily applied to forthcoming telecommunications infrastructures – Next Generation Networks – than current ones. We are particularly encouraged by recent work on duct-sharing in several municipalities worldwide. It would be a bitter disappointment, and an indictment of

Ofcom, if any company were eventually to hold a near-monopoly over fibre to the home in the UK.

5 a) *Do you agree with Ofcom's definitions of the various forms of equivalence?*

Yes, we agree with Ofcom's definitions of product, process and price equivalence, and its appreciation of the importance of all three.

5 b) *Do you agree that equivalence of inputs can deliver more effective equality than application of equivalence of outcomes?*

Yes. Despite Ofcom's comment that "it may be costly to introduce for some products" (6.13), we have failed to identify circumstances where equivalence of outcome would be preferable.

*Question 6. What behavioural changes by BT do you believe would be necessary for real equality of access?*

As stated previously, we believe that real equality of access is almost impossible to achieve while customers are reliant on a local loop which is owned by BT. The real solution is a last mile connection which is not owned by BT, such as mobile telephony or fibre to the home.

Allegations of ungentlemanly conduct by BT are rife; Ofcom mentions only a few (6.18). We suggest that most corporations, answerable to their shareholders, would behave similarly in similar circumstances. The solution is to remove, as far as is possible, BT's options for taking actions which place its competitors at a disadvantage, i.e. monitoring and enforcement as suggested in 6.21.

We do not consider it sufficient to ask BT to produce proposals for the means by which it should be regulated (6.20). It is inconceivable that such an arrangement would not ultimately favour BT. Instead, Ofcom should review the extent to which inequality of access is a consequence of BT's internal structure, and thus the extent to which this structure needs to be changed. Ofcom should conduct this review in association with a committee of senior industry and government figures, selected on the basis of experience and integrity. Such a committee would be able to provide an accurate and useful analysis of the problem within a short time. Its findings could also inform Ofcom's decision on whether or not to proceed with a reference under Section 131 of the Enterprise Act.

In our view, Ofcom's statement that "we do not believe that BT's different divisions should be prevented from collaborating to the benefit of citizens and consumers" (6.22) is inconsistent with the principle of equality of access. We consider it important that BT's different divisions *should* be prevented from collaborating to any extent greater than is possible between supplier and client.

*Question 8. Do you agree with Ofcom's proposed approach to current generation broadband?*

We are in broad agreement with Ofcom's proposed approach. In particular, we endorse Ofcom's observation that current generation broadband is only a bridge to future fibre-based solutions. We also believe that LLU provides the best prospect of real mass-market competition in current generation broadband and agree that equality of access to LLU should be a major focus of regulation for Ofcom.

*8 a) What should Ofcom's approach be to naked DSL?*

We believe that there will be a requirement for a regulated naked DSL product sooner rather than later. The use of voice over broadband products, such as Skype, is increasing exponentially. Furthermore, a small but significant proportion of consumers are cancelling their PSTN services and relying on mobile phones for all their voice calls. As a general principle, regulated products should support "unbundling" to the greatest possible extent and aim to minimise the incumbent's opportunity to cross-subsidise one product with the profits from another.

*8 b) Should there be different regulated wholesale products for current generation broadband in different locations?*

No. As mentioned elsewhere in this document, we believe that a regulated current generation broadband product should be part of the Universal Service Obligation. The price of this product should be sufficiently high for it to be self-supporting; as discussed previously, we consider that the price of consumer broadband products has now fallen to such a level that they do not represent a large proportion of the typical customer's disposable income. The outcome that we would expect is that customers in rural areas would then have the regulated product available to them, at a price that almost all can afford, but customers in built-up areas would be able to choose from a variety of products, which would compete on various parameters, including but not restricted to price. Furthermore, we would favour making such a broadband product available at a lower regulated price to customers on the lowest incomes.

*8 c) How should the potential lack of equivalence faced by LLU operators in a 21<sup>st</sup> Century network environment be addressed?*

The only robust solution is to ensure equivalence of inputs, as defined in paragraph 6.8 of the consultation document.

*Question 11. How should the regulation of narrowband internet evolve as networks migrate to NGNs, and how will functional, low bandwidth internet access be provided in future?*

As stated above, we believe that a revised Universal Service Obligation should include a regulated current generation broadband product. This would remove the requirement for a regulated narrowband product. We would add that ADSL modems

are now extremely inexpensive, so customers would not be excluded on the basis of equipment costs.

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

Ofcom has noted that, 20 years after privatisation, the UK telecommunications industry is still dominated by one supplier. In our view, this is directly attributable to BT's ownership of key assets, and specifically of the local loop. None of the various initiatives undertaken by Oftel, Ofcom nor BT's competitors has fully compensated for this ace up BT's sleeve.

The move to Next Generation Networks provides a unique opportunity to stimulate a truly competitive telecommunications market in which no single supplier need dominate. We believe that Fibre to the Home (FTTH) will be widely deployed earlier than many commentators predict; indeed, it is already being installed in several cities worldwide. Once FTTH is available, BT's copper last mile will have minimal commercial value. At this point, telecommunications providers will be able to compete on equal terms. Ofcom has a responsibility to ensure that this opportunity to nurture such a competitive market is not wasted.

Ofcom's regulatory approach should continue to be based on a principle of equality of access, as for current generation networks.

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

Ofcom should not forbear from regulating next generation access under any circumstances. Forbearance would result in a "land grab", with the inevitable result that the company with the greatest capital resources – BT – would grab the majority of the land. It does not surprise us to learn that "BT has in fact urged [Ofcom] to adopt such a policy." (8.64)

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

We do not support a policy of forbearance, either with or without contestability.

*13 c) How should Ofcom regulate next generation access if market power were to emerge in this market?*

All steps should be taken to prevent such a situation from arising – see 13 a).

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

As a general principle, we believe that “natural monopoly” assets should be owned by public bodies or non-profit organisations rather than commercial enterprises. There are now several successful open access duct schemes based on these principles. Further to Ofcom’s observation that “these countries all have different demographic, competitive or political environments to the UK” (8.56), we would note that political environments are subject to change, and that successful precedents abroad can allow decision-makers a glimpse of what might be possible here.

Regarding the list of structural options presented in paragraph 8.67, we would tend to favour one or more of non-telco or public-sector ventures, use of alternate civil infrastructures, and different structures for new-build housing. We believe that industry joint ventures and divestment of dark fibre and duct assets by BT would both be fraught with practical difficulties.

*Question 18. What should be the arrangements for funding the USO in future?*

We believe that the status quo, whereby the USO is funded by BT and Kingston, should continue. Reference to the table of telco earnings at the beginning of this document suggests that BT is by far the best equipped to afford it.

*Question 19. How could competition for delivery of the USO be organised in future?*

We cannot foresee a situation whereby suppliers would compete vigorously for an opportunity to fulfil the USO, and consequently we do not consider it a suitable candidate for a tender process. It is by definition an obligation and is necessarily a low-margin service. For as long as there is a single dominant supplier in the market, the USO should an obligation on that supplier.

*Question 20. Should mobile technologies be used to help address the existing USO?*

Now that the reliability of mobile technologies has been proven, they can be considered a viable means of meeting USO requirements. If the USO were amended to include a requirement for broadband access, as we suggest, radio-based technologies may well be the most economical way to meet this requirement in remote districts.



We welcome any questions or comments relating to this document. They should be addressed to Kevin Jones at:

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