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Dear Dougal

Strategic Review of Telecoms – consultation response

We welcome the opportunity to provide comments on the above consultation and these are attached. In this cover letter, we explain our interests in the telecoms sector and then summarise the main themes of our response.

Scottish and Southern Energy plc (SSE) is primarily an energy company, with subsidiary companies operating throughout the electricity supply chain in Great Britain from generation to final supply to end-customers. Three companies in the SSE Group have a direct interest in the telecoms market: SSE Telecommunications (SSET) and Neos Networks Ltd (Neos) own and operate communications infrastructure, while SSE Energy Supply Ltd (SSEESL) has recently started to provide a telephony service to energy customers through a Carrier Pre-Selection (CPS) arrangement. SSET and Neos have both invested in innovative types of infrastructure provision in powerline communication and ethernet service provision respectively. SSE also has an interest in the telecoms review as a purchaser of telecoms services to support its electricity networks, which form part of the critical national energy infrastructure.

The major element of our response centres on our view of the required features for the regulation of the telecoms market going forward. We have two additional areas of concern, however: the withdrawal of regulation where appropriate; and the protection of customers where withdrawal of specific services is being contemplated by BT.

<u>Withdrawal of Regulation</u>

We welcome Ofcom's conclusions (in F49) that, apart from the additional regulatory measures that are needed in respect of network bottlenecks, in other areas of the market, regulation should move "towards greater use of competition law and less reliance on continued ex ante sector-specific regulation." In the general area of consumer protection, there is already a large body of legislation. Given this background, we do not see the need for significant further Ofcom activity in consumer protection, particularly given the existence of Otelo and similar dispute resolution bodies. We have become concerned in recent months that Ofcom is moving towards a more intrusive regulatory approach on consumer issues, which will, in our view, increase the regulatory burden on BT's competitors. A specific example of this is the recent proposal to enforce a mandatory sales and marketing code of practice. This appears to be taking regulation in the opposite direction from Ofcom's general intention.

<u>Protection of Customers from Withdrawal of BT Services</u>
In this area, we have a general concern that the availability of existing products are threatened by new products and technologies. In particular, as the owner of electricity transmission and distribution networks, we have a key concern that the deterministic switched services used for network protection, stability monitoring and control systems are likely to be "switched off" by BT in favour of the NGN based non-deterministic services. This matter has already been raised by the electricity industry with both BT and Ofcom and we await further dialogue to resolve these issues. The issue is broader than this, however, and we discuss this in more detail in our response to question 14.

<u>Framework for Regulation of Telecoms</u>
Ofcom puts forward three options for consideration in section 1 of the consultation. We agree that option 1 (deregulation) is not appropriate. Option 2 (reference under the Enterprise Act) has some merit but we agree that a prolonged period of uncertainty is not in the interests of the industry and its customers. We therefore support option 3, which Ofcom characterise as "real equality of access". It has also been described as the "equivalence" option and we recognise that there are degrees of equivalence and some dependency on what BT is willing to support. The key features that are necessary, in our view, include the following.

- A ring-fencing of network where BT has a monopoly or near-monopoly. This would include all the access network as a minimum. For these assets, a high level of network regulation would be required, consistent with allowing regulated access to third party service providers. BT Retail (which would own no network assets) would have to be offered terms and treated on the same basis as any other service provider. For convenience, in the rest of this response, we refer to the part of BT which contains the network assets as "BT Wholesale". We recognise that not all these assets would need to be subject to full monopoly or "SMP" type regulation and that some could be considered "unregulated" if competition in their provision is sufficiently established.

- The features of network regulation relevant for the regulated part of BT Wholesale are:
  - Overall control on allowed revenue, consistent with a regulated cost of capital;
  - Separate price caps for certain key services;

  - An underpinning principle of non-discrimination in prices and any other terms of access between all wholesale and retail customers;
  - Prohibition of cross-subsidy from or to the regulated entity and "financial ring fence" conditions around it;
  - Transparency in regulatory accounting and tariff setting;
  - Provisions for business separation, including protection of sensitive information owned by the regulated business and pertaining to the activities of its customers; and
  - Regulation of quality with both overall target levels of compliance and penalties for failure payable to customers in individual cases.

- The regulatory environment should not preclude competitive offerings being developed, where innovative infrastructure providers can see commercial opportunity against the regulated tariff structure of BT Wholesale. Supplementary regulatory oversight which might be required in this area is that of monitoring any developments in tariff structure which might have an adverse effect on competitors.

- It is also important for independent market processes to be developed e.g. for customer transfers and what is termed in energy as "supply point administration". Rather than BT running these systems on behalf of the market in a non-transparent way leading to the sort of concerns that have been raised about BT's use of "Cancel Other", these functions should be separated out in IT and governance terms. An alternative structure should then be developed such that all market participants are able to have an interest in the operation, statistics and development of the systems, with relevant network/infrastructure businesses such as BT Wholesale having the obligation to ensure that such systems are set up and maintained. In the electricity market, for example, the network monopoly businesses have licence obligations to provide "the master registration agreement" and "the data transfer service" which, in practical terms, they discharge by the establishment of separate operating companies.

- Another relevant area is that of the development, timing and release of wholesale products. As Ofcom notes, this has been far from satisfactory in the current regulatory environment. BT Wholesale product development should take place with requirements for third party access "designed in" to the products at the outset. We agree that such products should not be available in a form that only BT Retail can use.

We believe that much of the above could be achieved within Ofcom's powers to set conditions on BT's operations and behaviour and with the commitment of BT plc's management. Legal separation, unless volunteered by BT, could probably not be enforced within the existing framework. Our view is that this is not necessary, providing that BT is willing to set up robust and transparent arrangements to achieve similar effect. For example, there would need to be quasi-legal arrangements to allow the transactions between BT Wholesale and BT Retail to be, in practical terms, on an identical basis to the contractual arrangements between BT Wholesale and its other customers. Similarly, accounting information for BT Wholesale, while not on the statutory basis required for legally separate entities, could still require directors' statements and audit reports as though it was a separate entity.

We characterise the improvements we would wish to see in the regulatory environment as a commitment by BT, underpinned by new SMP conditions, to adequate separation, transparency and transactional equivalence between BT Retail and its competitors.

In order to determine whether Option 3 is viable, we suggest that Ofcom should set out proposals for the detailed regulatory requrements such as those discussed above. This, together with any statements that BT wishes to make about its intentions could form another consultation from which Ofcom could gauge the views of the industry. Subject to the further comments from the industry, further “SMP” conditions could be applied to BT Wholesale, after which Ofcom would have enforcement powers to require the appropriate behaviour from BT.

I hope these comments are helpful.

Yours sincerely

Rob McDonald
Director of Regulation

Consultation Questions

Q1. Do you agree with Ofcom's proposed principles for regulation of telecoms markets?
1 a) What regulatory role should Ofcom play in the wider telecoms value chain?
1 b) How should Ofcom reflect differences in competitive characteristics in different geographic areas?
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?
1d) To what extent would it be appropriate in the future to take into account differences in competitive conditions in different areas through (i) the aggregation of similar geographic areas or (ii) through different remedies?
1e) 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?

1. We support the broad thrust of the 7 principles set out in the consultation document. These cover promotion of competition, focussing of regulation on access equality and the withdrawal of regulation where possible. Given the significant problems in access arrangements that have been documented, we consider that the emphasis initially should lie in that area. In our view, the removal of the difficulties and uncertainties of the access regime should, in itself, create a more stable and predictable climate for competition in the provision of upstream network infrastructure and therefore also line up with most of Ofcom's other suggested principles.

1 a) We believe that the promotion of standard technical interfaces and open architecture will be an important regulatory activity in the wider telecoms context. Without a regulatory imperative in this area, proprietary standards could become a source of market power with the potential to damage competition from alternative infrastructure providers and technologies. Other than this specific area, we expect that light touch regulation would be appropriate coupled with a vigilance on any evolving market issues which could be addressed using competition law.

1 b) c) d) e) – Geographic considerations. In remote and rural areas, BT dominance of the network will generally extend further towards the core network then in other more densely populated areas. Our response to the Phase 1 consultation suggested a "local franchise" approach to encouraging the development of infrastructure at the extremes of the core economic network.

Q2. Where and to what extent should Ofcom rely on ex post competition law rather than ex ante regulatory conditions?
Other than for cases of significant market power (SMP) in retail activities, where a range of regulatory safeguards such as those in place at present are warranted, we believe that the competitive area of retail offerings to end-users should only be subject to minimal ex ante regulation.

Q3. In what circumstances would it be appropriate for Ofcom to make a reference under Section 131 of the Enterprise Act?

We agree with Ofcom that there is merit in trying to avoid the disruption that such a reference would bring to the telecommunications industry and its customers. Our perception is that the degree to which Ofcom's proposed approach, set out as "option 3", will bring an improvement in the telecoms market depends critically on actions and proposals from BT in the areas of organisational change and approach to equality of access. At some stage in the present review process, Ofcom will have to establish whether the expected proposals from BT will be sufficient to enable an acceptable and enduring level of improvement.

As discussed in our covering letter, we advocate that Ofcom should set out the detailed framework of regulatory obligations that it would expect BT to accept under the current regulatory environment. If, in the opinion of Ofcom and a consensus of industry participants, this framework together with BT's proposals would lead to the acceptable level of improvement, then Option 3 should be pursued. If it does not hold this prospect, then the option of a reference under the Enterprise Act should be considered.

Q4. Should Ofcom adopt a broad approach of focusing regulation on enduring economic bottlenecks while tackling the problem of inequality of access head-on?
We agree that this is the right approach.

Q5. How can real equality of access be achieved at the product level?
5 a) Do you agree with Ofcom's definitions of the various forms of equivalence?
5 b) Do you agree that equivalence of inputs can deliver more effective equality than application of equivalence of outcomes?
5 c) Do you agree with the principles proposed on where equivalence should be applied and the specific suggestions for individual products?
5 d) How do you suggest the principle of equality is achieved for 'associated products' that BT does not depend on (such as migration products)?

As discussed in our covering letter, equality of access requires that a range of regulatory measures be imposed on BT Wholesale, such that all access products are designed with transparent, non-discriminatory access to all wholesale customers. This has to be supplemented, in our view, with independently operated market systems such as customer transfer processes so that all market players have the confidence that they can participate on an equal footing in the relevant retail markets.

5 a) We broadly agree with Ofcom's descriptions of equivalence of input and equivalence of outcome.
5 b) Yes.
5 c) We are strongly in favour of the approach of equivalence of input and are not convinced that continuation of any form of "equivalence of outcome" is in the best interests of the market overall. However, we recognise that it may not be economic to require equivalence of input for products with a limited remaining life.
5 d) For products that BT Retail does not need to use, such as migration or interconnection products, the notion of "equivalence" or "equality" appears to be of little relevance to the issues of quality of service for BT's wholesale customers who require to use these products.

In these circumstances, Ofcom's outlined approaches to setting service standards and price equivalence appear reasonable.

Q6. What behavioural changes by BT do you believe would be necessary to achieve real equality of access?
This is a key area that we discuss in our cover letter. Annex G of the consultation document sets out some examples of the sort of "inequality of treatment" that competitors to BT currently face, together with some measures that have been suggested in the Phase 1 consultation responses. We agree that the key issues are those of non-discrimination and transparency.

In the energy markets, regulation of the monopoly distribution networks includes many requirements to promote non-discrimination along with transparency and verification of accounting information. Such requirements largely existed before the Utilities Act 2001, which required actual legal separation of distribution business activity from the competitive supply business activity, which is analogous to the activity of reselling service providers in telecoms. We have discussed these in our cover letter and see no reason why Ofcom could not propose similar regulatory requirements for BT Wholesale.

In our view, it should be possible for these obligations to work without requiring legal separation, provided that BT is willing to operate on a quasi-legal basis in relationships between its wholesale and retail activities. It would also need to facilitate the preparation of more rigorous regulatory accounting information, which should be subject to the discipline of external audit requirements. We would expect that BT, if willing to proceed along these lines, would make statements about how this "quasi-legal" separation would be carried out and that these would be issued for interested parties to comment upon in a process of dialogue with market participants.

Ultimately, a legal separation would make the relationships between different parts of BT more transparent and put currently "internal" arrangements on a clearer contractual footing, but we agree with Ofcom that this step is not actually necessary, provided that other measures are taken to establish the benefits of such separation. We also agree that the "non-legal" separation route provides more flexibility in the longer term for assets to move between the regulated and competitive parts of BT's operation as initially monopolistic areas are opened up to competition in the future.

Q7. 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?
We have some concerns about Ofcom's theme of protecting BT's incentives to invest. It is certainly reasonable to reward BT Wholesale's investment in regulated network assets at a cost of capital appropriate to a regulated utility business and this is the essence of setting monopoly price controls. However, we do not believe that it is necessary for Ofcom to incentivise BT over and above this figure for investment in new technologies that will lead to a lower cost base. The prospect of lower operating costs that can be retained for a period before being passed on to customers in the form of lower prices following subsequent price control reviews is a powerful incentive for investment in any regulated network business.

We therefore consider that incentives to invest and consumer protection line up in the longer term under the traditional "RPI-X" style of regulation. Once an economic price level has been determined, based on the traditional price control building blocks of cost of capital, asset value and efficient operating cost, then it is reasonable to apply the charge level, irrespective of the technology used to provide the service, as Ofcom suggests for core networks. This should, in itself, be sufficient incentive for BT to invest in new technology where it is economic to do so. It will also provide a stable reference price level for any potential investors in competing technologies and infrastructures.

In considering the matter of potential competitors in relation to price-controlled network services, we consider that there has to be some regulatory oversight of BT's pricing approach. This is largely a Competition Act issue, however.

Q8. Do you agree with Ofcom's proposed approach to current generation broadband?
8 a) What should Ofcom's approach be to naked DSL? Control of wholesale price
*8 b) Should there be different regulated wholesale products for current generation broadband in different locations?*Yes
8 c) How should the potential lack of equivalence faced by LLU operators in a 21st Century network environment be addressed? Allow them to make a return.

The specific example of current generation broadband and its reliance on the DSL technology operated by BT appears to us as a microcosm typifying the regulatory issues throughout the communications market. BT has an effective monopoly over the access network, broadband DSL technology and its interconnection to the lower level transport networks of BT or its competitors. Service level competition is possible through the availability of a BT wholesale access product while local loop unbundling (LLU) allows operators to interconnect further back in the network and provide competing wholesale products with broadband capability. Meanwhile BT is also dominant at the retail service level. As part of the commercial background, the issue of new technology (the potential NGN "broadband dial tone") creates uncertainty over the continuation and success of the LLU initiative.

Against this background, in our view, Ofcom should aim for the following:

- Strict regulatory control on BT Wholesale access and interconnection products – these to be available on a non-discriminatory basis between BT Retail and other service providers;
- Regulatory surveillance of BT Retail's pricing policy for retail broadband products to avoid predatory "margin squeeze" behaviour;
- Promotion of as many competitors as possible at both LLU or retail level;
- That customers continue to have as wide a choice as possible of different technologies;
- Avoidance of "picking winners" in technology terms; and
- Promoting a framework where competitors to BT who have invested in the LLU arrangements are able to make a return on their investment.

In terms of the consultation questions, therefore, our comments are as follows.

8. We agree with Ofcom's proposed approach to current generation broadband, whereby competition should be promoted at the deepest level of infrastructure where it will be effective and sustainable.
8 a) "Naked DSL" should be subject to strong regulation of this effective monopoly – cost allocation is a less important issue than that of ensuring that BT Retail is demonstrably required to "pay its way" for the access product on an identical basis to its competitors.
8 b) We consider that different regulated wholesale products are probably required for different locations to take into account the different features of the network.
8 c) Complex questions are raised by the advent of new technology in an environment where BT product development has proceeded in an integrated manner, with wholesale access products having been designed as an afterthought. In our view, if the appropriate separation and transparency between BT's Wholesale and Retail interests are put in place, the environment should develop where wholesale access is "designed in" from the start of a product lifecycle. Similarly, migration strategies, when required due to new technologies, should then be developed in collaboration with the industry and its customers. We cannot comment on which of the alternatives would best address the potential lack of equivalence in the NGN environment, as this is best addressed by the operators concerned. However, we do consider that their competitive position should be protected, at least for a transitional period.

Q9. Do you agree with Ofcom's proposed approach to deregulation of voice services?
9 a) Do you agree that Ofcom should review regulation of retail voice markets in 2005?
9 b) Do you agree with Ofcom's proposals for deregulating call conveyance markets and wholesale IDD?
9 c) When would it be appropriate to remove the requirement on BT to provide indirect access?
9 d) How should PSTN-specific regulation evolve under NGNs? What should next generation CPS and WLR products look like?
9 e) What are the prospects for increased competition for voice services provided using broadband access products (such as LLU and the evolution of DataStream)? What conditions and transitional arrangements would need to be in place to allow service providers to secure access on the basis of commercial terms rather than PSTN-specific regulated products?
9 f) How should Ofcom ensure competition in areas where alternative platforms were not in place?
9 g) When do you expect fixed-mobile substitution to result in a single economic market for voice call origination? This is likely to happen more quickly.

We have significant misgivings over Ofcom's proposed approach of a "phased withdrawal" from regulation of the voice market. In our view, it is too soon to consider this move. We are not convinced that retail voice regulation needs to be reviewed as soon as 2005, given that significant consultations associated with the strategic reviews are still taking place.

In general terms, we believe that more stringent tests of the competitiveness of a market are needed than a reliance on the availability of "a fit-for-purpose WLR" product. The history of the development of such wholesale access products, in the integrated BT environment, has been one of "delays and inadequacies" as Ofcom acknowledges in paragraph 4.88 of the consultation paper. There are many ways in which the CPS product maintains differences between the treatment of BT Retail and other service providers. We are therefore very wary of accepting that a "fit-for-purpose WLR" product will indeed provide the required equivalence of treatment. The product needs to be tested in operation and be shown to be improving the competitiveness of the market, not just "be available". Up to that time, it will be appropriate to continue with existing forms of regulation of the voice market.

With respect to the theme of the detailed questions above, we do not believe that voice over internet will become established in the near future. In our view, there is likely to be greater substitution of mobile for fixed networks earlier than significant movement towards voice over internet. There will, for decades in our view, be sectors of the community that do not wish to change from traditional fixed line telephony. Their choice should be respected and the regulatory environment should continue to protect their interests.

Q10. Do you agree with Ofcom's proposals for deregulation of business voice services?
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?
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?

We do not believe that the voice market for large business has become more competitive since Ofcom issued its business pricing statement. We have concerns about the prospect of BT being allowed greater freedom to bundle SMP and non-SMP services as set out in our response to Ofcom's consultation on the subject in late 2003. These concerns remain and we do not consider it appropriate for the current level of regulation on BT services to business customers to be relaxed at present.

Q11. How should regulation of narrowband internet evolve as networks migrate to NGNs, and how will functional, low bandwidth internet access be provided in future?
We do not see any reason why narrowband internet access should not continue to be available for a good number of years yet. The prospect of this service being withdrawn seems premature. Customers should have a choice about whether they wish to use this product or migrate to newer technology. The regulatory framework should protect that customer choice and put some constraint on BT Wholesale's ability to withdraw products, as discussed in our cover letter, with particular reference to the electricity industry's concerns over the potential withdrawal of deterministic private circuit technology.

Q12. How can the arrangements for access and interconnection to next generation networks best address our proposed regulatory principles?
As discussed in response to question 8 above, in our view, if the appropriate separation and transparency between BT's Wholesale and Retail interests are put in place, the environment should develop where wholesale access is "designed in" from the start of a product lifecycle. NGN, or BT's "21st Century Network", is little more, at present, than the concept of a new infrastructure product from BT. The development of that product should involve input from other infrastructure providers and customer groups and should certainly involve consideration of wholesale access at the earliest stages, as Ofcom have advocated. As a further general rule, the development of new technology products should not be allowed to undermine

infrastructure competitors. The withdrawal of existing products should be discussed with the market, as discussed in our response to question 14.

Q13. What should Ofcom's regulatory approach be to next generation access networks?
13 a) In what circumstances should Ofcom forbear from regulating next generation access?
13 b) How important is it that the investment be made contestable; is this achievable?
13 c) How should Ofcom regulate next generation access if market power were to emerge in this market?
13 d) How might structural options help to eliminate the problems of monopoly access assets being owned by vertically integrated operators?

We consider that NGN should be considered as a product, not as a technology that requires a fundamental shift in the principles of regulation. If the regulatory framework were to be established as advocated above, then it naturally follows that BT Wholesale would be regulated on the provision of access networks as a near-monopoly supplier. In this framework, it would invest in the new technology if it was economic to do so and wholesale access would be made available to all service providers on a non-discriminatory basis. This framework would not preclude competitive provision of access infrastructure. As noted in the document, independent infrastructure providers have emerged in the electricity and gas network industries against a background of a dominant, but regulated incumbent provider.

13 a) We consider that it would be very damaging for competition for Ofcom to "forbear" from regulation of investment by BT in this area in any circumstances.
13 b) There is no reason why investment should not be made contestable. It is achievable, is compatible with regulation of the dominant infrastructure provider and would be encouraged by the development of a clear regulatory environment. For example, in energy networks, the regulation of independent network operators is developing[1] the concept of "reference price regulation" for such operators. This relatively light touch regulation on independent infrastructure providers would have to be complemented by obligations on BT Wholesale to offer interconnection terms to such providers on reasonable terms, perhaps by means of a lower level regulated access product.
13 c) With the same approach as it has to the regulation of existing market power.
13 d) We have some concerns with the "structural" options put forward in the consultation document. Some of these suggest a degree of industry collaboration that may be inconsistent with the provisions of the Competition Act. More generally, we are concerned that any separate legal structure that involved BT would still be dominated by BT's interests and that the viewpoints of smaller operators would be even more diluted than in the present environment. In our view, the issues in the telecoms market do not stem from vertical integration as such, but the lack of adequate separation, transparency and transactional equivalence as discussed in our cover letter.

Q14. What set of wholesale access services should BT be required to provide in order to promote competition in the business market?

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[1] See, for example, Ofgem's "Regulation of Independent Electricity Distribution Network Operators - Initial Proposals Document - January 2005 (18/05)

We believe that BT Wholesale should publish and maintain a stable set of products and not be able to simply withdraw those products purely at its own discretion. Its current ability to do this undermines competition and can also have a direct adverse effect on end-users. For example, operators using one LAN extension product and building a business based on that will face increased costs if that product is withdrawn and the only alternative is a more expensive, higher bandwidth product. The very fact that this might happen discourages investment by competitors. We have already discussed the adverse effects on the electricity industry of the potential withdrawal of deterministic switched circuits.

With communications infrastructure representing an almost universal service to businesses and residential customers alike, dominant providers of infrastructure should be under an obligation to give customers reasonable notice (over a period of years) of the withdrawal of products that their customers have come to depend upon. There should be active consultation by BT Wholesale on the possibility of withdrawal, the timing and the possible migration paths for affected customers.

Q15. What can be done to facilitate the migration of complex corporate services (e.g. VPNs) between suppliers?
We do not consider that this is an area that needs regulatory intervention. The processes are complex but a number of companies have developed commercial expertise in providing migration services. As a general point, part of our suggested approach to regulation is to introduce independently operated processes for customer transfers and this, in itself, might help reduce complexity.

Q16. Are any alternative structures for call termination appropriate? Could evolution to IP interconnection introduce market mechanisms that make intrusive regulation unnecessary?
No comment.

Q17. What approaches should Ofcom adopt to reducing search and switching costs in telecoms?
We believe it is appropriate for Ofcom to provide general customer-oriented information on the structure of the market and the choices available. It would also be helpful in promoting competition amongst resellers, if retail offerings were obliged to distinguish between access charges, common to all service providers, and other service charges. We believe the emphasis of Ofcom’s efforts should be in ensuring that customer transfer processes are as simple as possible so that it is easy for customers to switch.

Q18. What should be the arrangements for funding the USO in future?
Q19. How could competition for the delivery of the USO be organised in future?
Q20. Should mobile technologies be used to help address the existing USO?

We believe that competition is not yet sufficiently developed for current arrangements on universal service to be changed.