

TELEWEST RESPONSE TO THE STRATEGIC REVIEW OF TELECOMMUNICATIONS PHASE 2 CONSULTATION DOCUMENT

3 February 2005

Executive Summary

Telewest continues to support the Ofcom Strategic Review of Telecommunications (SRT), particularly its timing and market relevance. Our response to Ofcom's Phase I stage focused on the need to avoid intervention in new markets unless structural problems dictate the need and, if intervention is necessary, then be mindful of achieving the right economic balance (the level of profits in new markets will dictate investment in the same). We continue to believe that the quest for commercial solutions to market demand should take priority over any regulatory intrusion, specifically where fair competition exists. Our response here focuses on the Phase II consultation but also takes combined account of the same with the related consultations. The reason why we have adopted a "combined" approach is due to the linkages in the Phase II consultation that cross between Ofcom's apparent positions in the SRT and the other consultations. Ofcom has chosen to deal separately with the SRT, 21CN and next generation networks, the valuation of BT's copper loop and BT's cost of capital. We suggest that this is a potential weakness and that Ofcom should adopt an integrated approach that will lead to the consistent application of strategic principles.

Ofcom and the future of access network

At one level, the SRT is a broadly positive narrative of the state of UK markets. However, where the SRT does venture further, in terms of policy objectives, there is, we believe, an unclear approach in the areas of access network and investment incentive. While there are some positive looking statements, on deeper analysis it appears as though Ofcom is actually less inclined to believe in the role of contestability in access networks and the necessity for sound economics to underpin the same. It appears that Ofcom believes that access networks can never be contestable, and so the BT access network should be regulated to a far greater degree than previously, particularly in terms of economic return, without any acknowledgement that such a policy could chill investment in the same area of the market. Furthermore, Ofcom appears to regard Local Loop Unbundling (LLU) as the panacea for the perceived structural failures in the UK access market, even though LLU will not lead to access investment. As we stated in our Phase I response, we believe that such a view is short sighted. We feel the UK market is more progressive and dynamic than Ofcom acknowledges. Specifically, looking at the SRT Phase II we observe the following:

- **A need for clear differentiation in the treatment of core and access Next Generation Networks (NGNs)**

A differentiated policy is needed for core NGNs from access NGNs. It is clear that there is a delicate balance for Ofcom to strike between promoting adequate returns on both access and core NGNs, while encouraging resellers (on BT) in both areas.

- **The economics of access**

On a similar theme, we believe that Ofcom's approach to the economics of access infrastructure should be cautious and balanced. In particular, Ofcom's policy being centred on LLU, but without any consideration of LLU's potential to jeopardise long term investment in access, is a potential danger point. Telewest recognises the innovative role that LLU-based services will play in the UK broadband market but believes Ofcom may create a false economy via unduly heavy intrusive intervention in the same. The long-term impact of this will, potentially, be less bandwidth in the UK access infrastructure.

- **De-regulation may turn into a spread of regulation amongst more players**

There is a welcome belief by Ofcom that certain geographic areas of the UK are competitive to the point where regulation can be withdrawn. This is tempered though by the apparent contradictory policy that more competition may mean a spreading of regulation across the industry at the same time as dilution of regulation on BT. We see this as regressive step by Ofcom and seek clarification in this area.

- **Equivalence works at the simple interconnect level, but not at the retail innovation level**

We support Ofcom's decision to not currently pursue the structural separation of BT. We continue to believe the costs to the industry and delays from such a process would outweigh the benefits.

We have reservations about the definition of equivalence, given that the section of the industry that may have the most demand for the same is, itself, unclear what business strategies and products of the future may drive equivalence. Indeed, the entire concept of equivalence as proposed by Ofcom appears to assume symmetry in the ability of BT and third party companies to innovate, invest in future products and implement the same. The reality of markets is that there will always be asymmetry in these areas and Ofcom's proposed narrow approach to equivalence could lead to a collective sterilisation of innovation across the industry. In essence, if Ofcom demands equivalence for a high proportion of the input components to retail services, then the market will have little room left to innovate, and those whose market success is based on innovation or service differentiation will be disadvantaged.

That said, at a pure operational level in the area of interconnect, we can see how equivalence could be potentially workable. It is anticipated, however, that there will be genuine and unavoidable major technical issues impacting on both BT and competitors that will require significant investment on all sides, in terms of systems and resources to implement. A key issue is whether these costs are justified in the context of what they will ultimately deliver, particularly in the context of equivalence.

- **Self - regulation and consumer information**

Ofcom appear to be following a steadily increasing policy of replacing formal regulatory obligations with a requirement for the industry to provide consumer information, to enable consumers to make informed purchase decisions. While we would support such a general relaxation of formal

regulation and move towards a more self-regulatory approach, Ofcom needs to ensure that this philosophy is applied only where appropriate, and where the market and suppliers are sufficiently mature to take this responsibility sufficiently seriously.

Conclusion

We recognise that Ofcom is now accelerating forward based on its Phase II consultation and using the same as the basis for several initiatives, including the copper loop re-valuation. However, we believe that the nature of our response and what we believe other companies will say, dictates that Ofcom need to adopt a balanced approach to their dialogue with the industry and pause to contemplate whether their proposed policy will promote a healthy market in core and access NGNs.

1.0 Introduction

1.1 Access and core NGNs: A need for a differentiation in policy from Ofcom

Both the SRT and the consultation on next generation network (NGN) access should aim to differentiate Ofcom's approach to core and access NGNs. The reality is that the form and incentives for investment in core NGNs will be very different from access NGNs. Contrary to Ofcom's assumptions underpinning its copper loop valuation exercise, we believe access NGNs may carry a higher level of financial risk. Core NGNs may carry less. Given this we believe that the next stage of the SRT must be a clearer and structured approach to the treatment of both types of NGN. This change in approach should permeate across to the copper loop re-valuation where artificially tight financial regulation could deter investment in upgrades to access NGNs.

1.2 Forbearance in the regulation of NGNs. The LLU by-pass mechanism

We believe that Ofcom should follow the principle of forbearance, for the following reasons:

- With a focus on intervention in the next generation network market there is an inevitable structural danger being introduced to the market by Ofcom. Therefore, the regulator must be cautious in its policy formulation, including economic regulation underneath the same.
- That an undue regulatory push of LLU by Ofcom may become the centre of gravity of access and there may be no incentive for new or widened market entry.

1.3 The concept of equivalence - The conundrum of new products and the innovation process

We believe that at the standard interconnect level, the concept of equivalence is applicable. However, we do not feel the application of equivalence to BT at the entire retail to wholesale level is a workable concept. Indeed, we believe that unless Ofcom veers away from a broad application of equivalence (as it defines it), the UK market could rapidly deteriorate into a sterilisation of the product innovation process. Specifically we believe that the fact the different parties in the UK communications market will have different levels of competence in innovation plus differing capabilities to invest in risky innovation, means that the wide concept of equivalence will flatten such variances. The net result will be a significant detrimental impact on consumer welfare, via fewer new products and, potentially, less price competition.

A variety of inputs is required by downstream telecommunications activities, many of which, as in BT's case, may be provided from within the same firm. In the case of BT, with a wide range of retail products directed at many sectors of the market, these inter-relationships are likely to be complex. If full equality of inputs were to be imposed, then this would necessitate bringing under regulation a variety of products that might not hitherto have been regulated (such as Operational Support Systems), or which might have been deemed to be effectively competitive. One result of this might be that downstream competitors all come to rely on a standard set of inputs at regulated prices and on the same terms – thus creating the very scenario that Ofcom is anxious to avoid, through its policy of seeking competition at the deepest level. The likely consequence would be

that innovation would be discouraged and price competition limited to squeezing the downstream margins. Instead innovative competitors should be encouraged to provide solutions over a wider range of the value chain.

A further consequence would be that the economic welfare benefits that can flow from vertical integration – provided that this integration is not used to project upstream market power into downstream markets (and Ofcom has a range of instruments at its disposal to counteract this) – are denied to consumers. These benefits normally derive from such factors as reduced transaction costs, which would tend to be removed by the mechanisms put in place to ensure equality of access.

Annex B

List of questions and Telewest responses

1. Do you agree with Ofcom proposed principles for regulation of telecom markets?

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

On the basis that Ofcom has little, if any, ability to identify and segment commercial value, given its regulatory context, Ofcom's role in the value chain should be to support and ensure fair competition and no undue exploitation of dominance. This implies that Ofcom should veer away from intervention that occurs outside such a competition remit and that it should reject an approach based on a market priming objective which enhances market value for specific segments of the industry, but which unduly reduces value elsewhere within the supply chain.

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

Very simply, the Ofcom remit in geographic areas where there is competition should be limited to that of a competition regulator, while in those areas where there is no geographic competition (nor likely to be), Ofcom should focus its policy on securing the provision of universal services..

1 c) 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?

Telewest believes that a key factor that must be taken into account is that the retail product development for new communications markets is, and will be, in very short cycles. This implies quick innovation followed by short timelines to market. Hence, Ofcom could find itself in the position where it delivers what it believes to be an appropriate "regulatory" solution to an access issue, only to find that the retail cycle for which it was intended has passed. This means that any regulatory intervention on the supply side must be at a high enough macro level e.g. so high that it is immune from the variances of retail product cycles.

1 d) 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?

Market share variances between and within geographic areas (that are contested and contestable) are not inconsistent with a normal national market at work. It is also important not to confuse installed base, unfulfilled market demand, and product

availability, the latter based on the changing cost of delivery/implementation, as is the case with DSL roll-out. Ofcom should therefore follow a cautious and conservative approach to identifying any specific geographical areas as separate and incontestable markets, particularly within the framework for identifying markets that has been set out by the EU.

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

We are not clear what Ofcom mean by "geographic basis", nor what the Ofcom objective behind the question is. However, if it means by post code (for example), we do not believe that such data collection will be either immediately feasible but we are willing to discuss this further with Ofcom.

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

We do believe that if there is a well-founded belief within Ofcom that any company has acted in contravention of the Competition Act, then it should not shirk its responsibilities to act under the same.

If Ofcom follows the logic of regulatory retreat then it should resort to the use of competition law for resolution of specific access issues. It is at this level that we believe *ex post* competition law can best be deployed.

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

We cannot currently foresee any circumstances under which Ofcom's use of the Enterprise Act (Section 131) would be appropriate.

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

Yes, although we are not entirely convinced that enduring economic bottlenecks pose the same challenge as inequality of access. We believe that the latter is far less defined and ambiguous than the former.

5. **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?**

We believe that they are a reasonable position to elicit discussions on the area.

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

In principle "yes", although we believe that they may be as much a reflection of what some parts of the industry want to hear/see as a practical reality. Also full and genuine equivalence of input may mean excessive costs for some players in terms of the scale of practical systems implications and may actually stifle their innovative capability making them totally dependent upon BT in terms of basic underlying product capability but also system surround. Different players will require equivalence at different levels. It is not clear that a comprehensive approach is feasible without the deadening effect on innovation identified earlier.

5 c) Do you agree with the principles proposed on where equivalence should be applied and the specific suggestions for individual products?

This is likely to vary by both competitor and geography, dependent upon individual requirements. Ofcom should look at equivalence at a high level and keep away from getting involved in too detailed an approach.

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)?

Is equivalence really required in these situations? By definition, "equality" cannot be achieved in these cases, unless BT's downstream activities are obliged to consume inputs that they do not require. A more sensible approach would be to apply the standard SMP framework to these products and to apply any remedies that this process suggests are necessary.

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

BT needs to properly understand at all levels involved in delivery of wholesale products, that reseller competition will be an integral part of the UK market. Within such a market undue preference to its own in-house retail arm (BT Retail) will continue to be counter productive. This may require a widespread re-education of all relevant BT staff, a full review of all in-house processes and reward systems, and clear and unambiguous leadership from its senior management. This programme needs to be made public to engender belief in competitors. But the emphasis must be on the financial incentives that BT is responding to, as once these are changed, behavioural change will follow. We also suggest that Ofcom review how the current "Chinese" walls regime works within BT and whether any tightening of the regime is needed in this area.

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?

We fail to understand that while on the one hand Ofcom recognise the scale and scope of competition in the UK communications market, it can on the other believe that

there is still scope for excessive pricing. Moreover, there is a lack of explanation as to what excessive pricing is. To Telewest the flow of objectives is clear. If there is efficient and deep investment by BT and its competitors then there won't be excessive pricing (as defined in its narrowest sense) because there will be healthy competition. On the contrary, if there is no investment (e.g. in access) because of Ofcom's policies, then there will be a lack of new products and associated rigidity in pricing. We believe that Ofcom's approach to the re-valuation of the BT copper loop could lead to this latter scenario. It is vital that considerations of consumer protection do not lead to artificially low returns in the industry through price levels that would stifle investment.

8. Do you agree with Ofcom proposed approach to current generation broadband?

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

"Naked" DSL should be offered by BT but only on the basis that the cost recovery of the PSTN element of the copper line (via PSTN revenues) be transferred to the LLU/DSL price e.g. in moving to naked DSL, the wholesale cost of the copper line should move upwards proportionally.

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

Yes. We believe that in those geographic areas where there is competition and contestability, then BT should not be obliged to offer the form of regulated wholesale access that it offers/provides in non-competitive areas. However, BT should still be obliged to offer wholesale products on an averaged price basis e.g non-discriminatory pricing.

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

Not applicable to Telewest.

9. Do you agree with Ofcom's proposed approach to deregulation of voice services?

9 a) Do you agree that Ofcom should review regulations of retail voice markets in 2005?

Yes.

9 b) Do you agree with Ofcom's proposals for deregulating call conveyance markets and wholesale IDD?

Yes.

9 c) When would it be appropriate to remove the requirement on BT to provide indirect access?

At the point where the indirect access market is no longer economically viable, due to rebalancing.

- 9 d) How should PSTN-specific regulation evolve under NGNs? What should next generation CPS and WLR products look like?**

We expect the 21CN consultation process to provide clarity on such products within the context of the BT NGN.

- 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 PTSN-specific regulated products?**

We believe the prospects are high e.g. VOIP, but that there may be no requirement to ensure product specific access given that VOIP may be a bundled element (at a network/technology level) to wholesale access.

- 9 f) How should Ofcom ensure competition in areas where alternative platforms were not in place?**

Via a progressive and innovative universal service policy. e.g. potentially "tendering" out universal service provision.

- 9 g) When do you expect fixed-mobile substitution to result in a single economic market for voice call origination?**

We believe that this is already the case.

- 10. 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?**

Yes. We believe that the business services market is now fully competitive.

- 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?**

For the time being; wholesale line rental, local loop unbundling, and carrier pre-selection.

- 11. 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 believe that the provision of highly regulated low bandwidth dial up wholesale services has been at an artificially low level that has distorted the wholesale broadband market. We would support a quick and complete withdrawal of regulation from wholesale dial up internet access.

12. How can the arrangements for access and interconnection to next generation networks best address our proposed regulatory principles?

We firmly believe that there needs to be a new set of economic models to support NGN access and interconnection. We do not believe that the legacy LRAIC methodology used in PSTN interconnect, nor the reliance on pence per minute charging, will be transferable to NGNs. It may well be that new arrangements need to be capacity charge orientated and support incremental and historic capital and opex cost recovery plus a higher rate of return based on high WACC.

13. 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?

We believe that this question is the reverse of what it should be e.g. the key question is under what circumstances should Ofcom intervene in NGN access. The answer, we believe, is that Ofcom should intervene in the areas of NGN access that are enduring bottlenecks. We do not believe that such bottlenecks are readily identifiable nor, ultimately, will they be that numerous.

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

We believe there is some confusion within Ofcom policy as to the investment boundary of NGN. In particular, it may well be that via LLU there will be multiple investments in core NGN network. However, we have seen nothing to suggest that LLU will promote any investment in access network. We believe that there will be investment in competitive access networks, but that Ofcom should carefully consider its focus on LLU economics and fully considers the influence of the same on access network economics. To this end, we believe that Ofcom must concentrate on ensuring both access and core NGN's are fully contestable at the economic and technical levels.

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

Until such market power is identified, we see no structural reason for regulatory intervention.

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

Ofcom's proposed structural options and policies could, in themselves, lead to an embedded copper loop monopoly based on BT ducts. We do not believe that the

access network is a natural monopoly, as witnessed by the level of competition.

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

The current provision of WLR, CPS and PPCs should continue.

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

The portability of VPNs appears to be problematic to the extent that VPNs have evolved on the basis of bespoke design solutions. Ofcom should explain why it believes VPNs are homogeneous to the extent that seamless portability is an option.

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

Yes.

- 17. What approaches should Ofcom adopt to reducing search and switching costs in telecoms?**

We believe that consumers have sufficient information with relation to services and products, solely because the market ensures the same. Ofcom provide no substantive evidence that the opposite is the case. Unnecessary intervention by Ofcom in this area could result in a stifling of marketing innovation.

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

We believe that USO funding should, in the future, be contestable e.g. USO service provision should be put out to tender

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

Responses to this should be part of the USO consultation.

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

The USO should not include a requirement to deliver mobile services at the current time. There is no restriction currently on mobile technology being used to deliver the fixed USO should the operator choose to do so.

