4 June 2009

Fixed Narrowband Market Review: T-Mobile's response

T-Mobile welcomes the opportunity to respond to Ofcom's three consultations that relate to the fixed line telephone market:

- Fixed narrowband retail services markets;
- Review of the fixed narrowband services wholesale markets; and
- Review of BT network charge controls

Given the extent of the cross-over issues between these separate consultations, we have only prepared one response to cover T-Mobile's response to all three consultations. We have not answered the specific questions from the consultations, but have instead focussed on the areas in which T-Mobile is able to provide real input towards.

Executive Summary

With the proposals set out in these consultations, Ofcom appears to have taken seriously its real responsibility to act with a bias against intervention. T-Mobile welcomes the principles of deregulation in these mature markets, where competition can be allowed to work of its own accord. We think that Ofcom should apply the principle of deregulation where possible, as long as this will not lead to a negative impact on consumers. To some extent it appears strange that it is doing so in the fixed market and not to mobile market, where there is markedly more competition and no dominant player, such as BT. In some areas however, it is not clear whether regulation is still appropriate or whether, whilst not being essential now, it may soon become appropriate again in the future. In these areas Ofcom should adopt a cautionary approach, without regulating fully or closing off all regulatory options.

There are a number of areas in this narrowband market where we agree with Ofcom that it is not appropriate to regulate BT in the same way as has been done historically. However complete deregulation is not the only other option in these areas. Ofcom could instead ensure that it still has the option to step back in quickly to regulate the market again if necessary. There may also be other areas which historically have never been ex-ante regulated, but may now need some new intervention.

In the retail market, T-Mobile believes that the price of calls to mobiles is one of increasing concern and could warrant regulatory intervention in the future. The price of calls to mobiles increased after 2007 when the new mobile call termination price control came into place. This is counter-intuitive and implies that the reductions in mobile termination rates have only lead to an increase in BT's margins on these calls, as opposed to any direct consumer benefit. Ofcom should investigate this area and ensure that the price of calls from fixed to mobiles is linked directly to the regulated mobile termination rate. Otherwise Ofcom needs to revise any future mobile termination regulation to take into account the lack of pass-through to consumers.

In the wholesale market, T-Mobile understands why Ofcom is reviewing the regulations on BT in the transit markets. Indeed the current market structure may make it appropriate to step back from price controls. However this market structure could very easily change, especially considering BT's delayering of its network as part of its 21CN network. This may remove the business case for other transit operators to interconnect at the DLE, and therefore compete strongly with BT. The existence of long-term wholesale contracts could exacerbate the impact of any short-term advantage that BT may get. Therefore we believe that there is a big risk in removing all SMP designations on BT. Instead Ofcom should maintain BT's SMP status to allow it to quickly bring back price controls if and when appropriate.

In their review of BT's network charge controls, Ofcom have applied a number of detailed progressive ideas. Whilst we have not been able to consider a number of these issues in depth, we feel that it is important that, when Ofcom begin to review the mobile call termination price controls, they apply these same principles to the mobile operators. This would ensure a consistent approach that does not favour a particular technology. Any other approach would be creating distortions to the telecommunications market.

<u>Fixed narrowband retail services markets;</u>

Fixed-Mobile Substitution

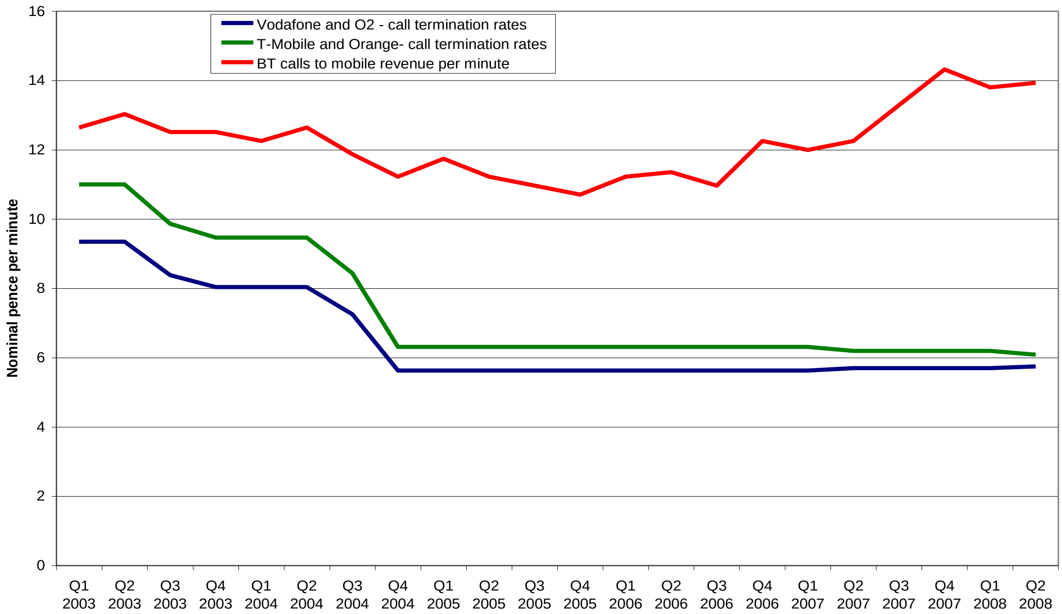
T-Mobile agrees with Ofcom's conclusions with regards to the substitutability between fixed and mobile access as well as the substitutability between fixed and mobile calls. It is correct that they should fall into separate markets. Whilst consumers are able to use either device to make voice calls, there are other different aspects of both services which make them very different. In our experience, consumers consider their mobile phone to fulfil different needs to their fixed phone, and vice versa. This is confirmed by the fact that the majority of people purchase both fixed and mobile access as opposed to instead swapping one for another. We do not think that the extent of fixed-mobile substitution is enough to consider them in the same economic market.

The price of fixed calls to mobiles

One interesting thing to come out from this consultation is details concerning the price of fixed calls to mobiles. From information given in this consultation, it is clear that the price of calls to mobiles has not fallen to the same extent as the price of other calls. When discussing the appropriate price for mobile call termination, BT have argued strongly for a reduction in the price control, on the basis that it would lead to a reduction in the price of calls to mobile and subsequent consumer benefits. However given this information, it appears that any consumer benefit from a reduction in the price of fixed calls to mobiles would be negligible.

Indeed if we compare the time series of the revenue per minute for BT calls to mobiles from figure 4.9 in the consultation with the regulated rates for mobile call termination, we can see that the wholesale price reductions have not been passed on to consumers. Figure 1 shows this comparison and we can see that the margin between wholesale MTR costs and the BT retail revenues has grown over time. This shows that savings in the wholesale rate have not been passed on to consumers.

Figure 1: Comparison of mobile termination rates with BT's revenue per minute[1]



Ofcom have noted that "the price of a fixed call to mobile increased significantly relative to a fixed geographic call between 2007 and 2008."[2] This period coincided with the start of the new mobile call termination price control, where aside from the new glide paths in place for the four 2G operators, H3G began to be regulated for the first time and had a steep reduction in their termination rate. It seems inconsistent that BT reduced the price of their calls to mobiles slightly during the last mobile call termination market review, but then increased their prices significantly once the mobile regulation was finalised.

In BT's response to Ofcom's March 2006 consultation, following their reasoning for a reduction in call termination rates, the issue of call termination pass-through was dealt with:

> *"Finally, BT has offered to extend the commitment we have made in the past to pass on any further reductions in mobile call termination rates to our customers. Competition in the provision of fixed-line services should, in any case, mean that lower call termination charges will continue to be of direct benefit to fixed users. "*[3]

This follows similar informal commitments given by BT in June 2004, after Ofcom had previously regulated the termination rates. BT then promised to "pass on these reductions penny for penny to consumers".[4] Given the evidence that we have seen presented in this consultation of actual revenue per minute for calls to mobiles, we have seen that BT has not followed up on this commitment. Instead once the glide path was finalised for the 2007 – 2011 period, BT actually increased the revenue per minute for calls to mobiles.

Ofcom have also noted that since 2007, BT's gross margins for calls to mobiles has increased. Furthermore as their wholesale costs fell, following the latest call termination price controls, their revenues actually rose.[5] The increasing of margins is definitely contrary to the wishes of consumers. It shows that in fact it is BT, and not their fixed line consumers, who have benefited from a reduction in call termination rates.

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[1] BT's revenue per minute was read from Ofcom, Fixed Narrowband Retail Services Markets, 19 March 2009, Figure 4.9
[2] ibid 4.76
[3] BT's response to Ofcom, Mobile Call Termination Market Review, March 2006 , paragraph 29 found at http://www.ofcom.org.uk/consult/condocs/mct/responses/bt.pdf
[4] see http://www.computerweekly.com/Articles/2004/06/02/202842/bt-promises-mobile-price-cuts.htm
[5] Ofcom, Fixed Narrowband Retail Services Markets, 19 March 2009, A5.11 and Figure A5.7

It has been acknowledged by regulators that as MNOs receive less revenue from termination, they will attempt to recover this reduction from retail services. This is known as the "waterbed effect". The Competition Commission concluded that lower termination rates would therefore lead to higher retail prices:

> *"In our view, there will be a waterbed effect, i.e. most of the reductions in revenue from termination charges being capped will be recovered from the retail market."*[6]

As Ofcom have explained in this consultation, the vast majority of adults have access to both fixed and mobile lines, and only 8% of adults have access to only a fixed line.[7] Therefore for the vast majority of adults, the reduction in mobile call termination rates would have lead to a corresponding increase in their retail mobile prices. Given that there has not been the equivalent pass through of reductions in call termination rates to fixed prices to mobiles, these consumers who use both fixed and mobile are in fact worse off as a result of reductions in termination rates.

It is clear that there is no competitive pressure on BT or other fixed operators to bring down the price of fixed to mobile calls. Even as BT's price of calls to mobiles has risen over recent years, they still price such calls cheaper than other fixed operators who have also increased their prices of calls to mobiles.[8] Indeed fixed operators like BT hide behind what they perceive as "extortionate" mobile call termination rates as the reason why prices of calls to mobiles is high. This is despite the fact that even as mobile call termination rates have halved in nominal terms between 2003 and 2008, the price of fixed calls to mobiles rose over the same period.

Given the lack of competitive pressure on BT to pass-through any wholesale reductions, together with their refusal to continue with their "commitment" to reduce prices of calls to mobile "penny for penny" with reductions in the mobile call termination rate[9], it appears that more proscriptive regulation on BT is now necessary. In 2003, during the previous narrowband market review, Oftel noted that they would be prepared to deal with a lack of pass-through by BT:

> *"If BT were to fail to pass on the great majority of termination charge reductions, the Director would be prepared to investigate and take appropriate regulatory action, to ensure that the benefits of lower termination charges were indeed passed through."*[10]

In the subsequent mobile call termination market review, Ofcom repeated their position that they will monitor the issue of pass-through closely and will regulate through ex-ante regulation as necessary.[11] Despite this implicit regulatory pressure, BT has still been able to increase its margins on calls to mobiles in recent years and not passed on savings to consumers. T-Mobile believes that there is a need for specific regulation to be put into place now to ensure that BT and other fixed operators pass through any subsequent reductions in wholesale termination rates onto the price of calls to mobiles. If this regulation is not in place, then any evidence suggesting consumer benefit from reducing termination rates should be tempered with the knowledge of the low levels of pass-through.

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[6] UK Competition Commission, "Calls to mobiles report", 2003, paragraph 2.290 found at http://www.competition-commission.org.uk/rep_pub/reports/2003/fulltext/475c2.pdf

[7] Ofcom, Fixed Narrowband Retail Services Markets, 19 March 2009, Table 4.2

[8] Ofcom, Fixed Narrowband Retail Services Markets, 19 March 2009, A5.12 and Figure A5.8

[9] see http://www.thisismoney.co.uk/bbphone/article.html?in_article_id=422007&in_page_id=182 where "A BT spokesman said: 'We are committed to passing on savings from mobile termination price cuts to our customers across a range of products and services, rather than just fixed to mobile prices"

[10] Oftel, Fixed Narrowband Retail Services Market, 26 August 2003, G8 found at http://www.ofcom.org.uk/static/archive/oftel/publications/eu_directives/2003/fix_narrow_retail0803.pdf

[11] Ofcom, Wholesale mobile voice call termination, 1 June 2004 , 5.18 found at http://www.ofcom.org.uk/consult/condocs/mobile_call_termination/wmvct/wmvct.pdf

Review of the fixed narrowband services wholesale markets; and

Market for geographic termination

T-Mobile agrees with Ofcom's conclusion concerning fixed/mobile substitution and not including mobile termination in the market for geographic termination on a given network. The market definition is therefore fixed geographic call termination on each network. We agree with Ofcom that mobile operators do not possess countervailing buyer power to prevent BT from setting high call termination rates.

Local-tandem conveyance, local-tandem transit and wholesale transit services

Ofcom have noted that since the last review, several Communication Providers have deployed their own networks to interconnect to BT at the local level in the BT network. This means they are less reliant on BT to provide services that carry traffic from its local exchanges to their own networks. Ofcom have provided data to show that the amount of Local Tandem Conveyance (LTC) has declined over the last 5 years. The main reason given by Ofcom for this reduction in volumes is the option of DLE interconnection which has allowed other communications providers to bypass BT's single and double tandem products. This has ensured that a price increase by BT would not be profitable. In addition, mobile operators are able to interconnect directly with each other and avoid any transit element for mobile to mobile calls

We have seen in recent years that as double tandem products have been deregulated, the price charged by BT has reduced significantly. This is due to the flexibility they now had to offer better prices. However a by-product of the deregulation is that now only BT bids for providing this service as others cannot afford to match the lower prices. There is a risk that further deregulation and allowing BT to take a larger share of the market could lead to other transit operators from ceasing to provide the service. BT would then end up in a position with SMP and could increase their prices above the efficient level.

Another risk to today's competitive environment is the development of BT's 21CN network. This is likely to involve delayering of their network with fewer points of interconnect. In practice this will mean that the DLE layer of the network will be removed. This will mean that the advantage that other communications providers have through the option of DLE interconnection will no longer exist. This may mean that they are unable to competitively price their transit services any more. There is therefore a significant medium term risk that BT will have a fundamentally cheaper service and can undercut its competitors so that they stop providing interconnection. At that point BT could potentially increase their prices above the efficient level. However BT would also want to fill up their new 21CN network with traffic and will therefore want to transit as much traffic as possible, especially mobile-mobile transit traffic. This may act as a short term detriment to stop them raising prices significantly.

T-Mobile believes that a more proportionate response from Ofcom would be to maintain the SMP status that BT currently has, to take into account the fact that any greater levels of competition currently experienced in these markets may only be temporary. Price controls and associated remedies could be set aside in the short term, if Ofcom believed that the competitive environment allowed for this. However the maintaining of the SMP status would allow Ofcom to act fast if the situation changes and DLE interconnection does not continue to act as a constraint on BT's pricing in future. Complete deregulation for this market, as Ofcom currently proposes, could lead to significant problems in the future for the reasons described above.

Transit to non-geographic numbers

Transit to non-geographic number is an important issue that has not been dealt with specifically by Ofcom. There are 140 operators who BT has a single transit rate for. For the majority of these, BT offers the only point of interconnection. No other operator provides the breadth of connections and all other operators therefore rely on BT to transit these calls. Ofcom needs to amend the figure it has for BT single transit traffic[12] to incorporate a new category for calls to non-geographic numbers. The risk for T-Mobile and other operators is that following any move away from BT for transiting mobile-to-mobile calls or mobile-to-geographic calls, BT will put the price up for transiting calls to non-geographic numbers, which they have a monopoly on.

Given the lack of competition in the market for transiting calls to non-geographic numbers, Ofcom need to consider this market separately and continue to impose regulation and price controls as necessary to prevent BT abusing their dominant position.

[12] Ofcom, Review of the fixed narrowband services wholesale markets, table 9.4, p124

Review of BT network charge controls

T-Mobile has not carried out the detailed analysis that would be required to produce a robust assessment of Ofcom's proposed charge controls in the wholesale narrowband market. Given that we have no fixed line services, it would be difficult for us to assess many of the actual cost elements from Ofcom's modelling. Therefore we have used this response to highlight any perceived inconsistencies between this charge control and the mobile call termination charge control. We have also noted parts of Ofcom's methodology in setting this charge control that we feel would be as relevant for setting the mobile call termination charge control.

Synchronising fixed and mobile charge control periods

One area of Ofcom's reasoning T-Mobile agrees with is their assessment of the option of setting an 18-month control to synchronise with the timing of the mobile termination charge control. Fixed termination and mobile termination are very different regulatory issues and any attempt to deal with them in one consultation would probably lead to Ofcom not dealing with either with the necessary level of detail that would be required. The sheer size of any combined consultation documents would probably mean that no stakeholder would be able to prepare a robust response to the consultation as a whole and fixed operators would end up only responding to the fixed section and mobile operators only to the mobile section. The cost structures of the different technologies are very different and therefore any attempt to build one model to determine both fixed and mobile termination rates would be fraught with many difficulties and caveats. A single termination rate for both fixed and mobile would not fulfil the obligations incumbent on Ofcom to set a cost-orientated price control for either market.

Efficient size of BT's network given the reduction in traffic

T-Mobile accepts that the evidence presented in Figure 4.1 and Figure 4.2 shows that the volume of calls for network charge control (NCC) services has fallen faster then previously forecast by Ofcom and is forecast to fall over the length of the charge control. However what we do not accept is that this necessarily implies that the charge control should be increasing in real terms to the extent proposed by Ofcom. It seems counter intuitive that in a period when Ofcom is reducing Mobile Termination Rates dramatically, the rates for fixed operators will rise in real terms. Appropriate questions need to be asked about the size of BT's network, and the appropriate investment over the period of the charge control, given the fall in traffic volumes. A charge control that is set to increase by up to 10.5% above inflation each year would imply that the cost base is not efficient given the expected volumes.

In the same way that the mobile termination rate is set only using efficient costs that are necessary for the provision for that service, we would expect the cost base for the NCC services to only include the costs that are strictly necessary to incur for that level of traffic. We would expect that Ofcom would look into this issue in more detail and determine the cost of a hypothetical efficient network dealing with the volume of NCC traffic that is expected on BT's network.

Efficiency Factor

Ofcom have calculated that BT's unit costs for a given volume will decline over the 2009-2013 period by between 1-3 % annually. They have used a number of sources to assess the efficiency of BT's network and the appropriate target for cost reduction. This level of reduction, and the analysis used to determine it, appears sound and robust when considered by itself. However when compared to the reductions forecast in Ofcom's Mobile Call Termination LRIC cost model, these seem modest. In particular, in Ofcom's March 2007 model, reductions of between 3 – 5% annually are considered the norm for most aspects of the mobile operator's network during the 2007 - 2011 charge control period.[13] This discrepancy implies that mobile operators are expected to achieve a higher level of efficiency than BT, which is unjust and must surely be rectified so that the same level of efficiency is assumed to exist for both of the mature technologies.

T-Mobile would expect that any new LRIC cost model that is developed for the next mobile call termination charge control would also have an "efficiency factor" or expected cost reductions for the hypothetical efficient operator to be more in line with what is determined for BT in this latest NCC model.

Ofcom's consideration of the European Commission Regulation on call termination

Ofcom have noted in this consultation that "the current circumstances of UK fixed termination markets requires a different approach to cost modelling than that contained in the draft Recommendation."[14] It is correct that Ofcom's position as a national regulator enables it to both fully consider the EU draft recommendation whilst proposing a different approach for fixed operators in its country. However it is crucial that the consideration given for fixed regulation is the same as the consideration given for mobile regulation. The EU recommendation covers both mobile and fixed termination and if Ofcom believe that a different approach can be adopted for fixed termination then a different approach is also suitable for mobile termination. Conversely if Ofcom believe that they need to follow the EU Recommendation with regards to cost modelling for mobile termination, then it also needs to be applied for fixed termination.

Provision for Carry-Over

Ofcom have noted that a feature of the existing NCC has been the ability of BT to use the *'credit'* created by setting charges below NCC requirements within a given year towards NCC compliance in the following year. They note that this approach avoids any perverse incentive to manipulate the timing of charge changes just to make NCC compliance easier in subsequent years. For this reason, for the new NCC Ofcom intends to retain the ability for BT to carry-over the credit from charge changes into subsequent NCC years.

With the mobile call termination charge controls, there is no similar system for taking account of *'credit'* created by the average termination rate ending up below the TAC for that year. Indeed in recent years there have been a number of uncertainties with regards compliance with the charge controls as a result of the Termination Rate Disputes from September 2006 – April 2007 and discrepancies between the operators with regards to the inclusion and exclusion of volumes of minutes to determine the weighted average termination rate. In all these cases, T-Mobile has been advised by Ofcom that the appropriate way to deal with these uncertainties is to set rates to ensure that compliance will be met even in the 'worst case scenario'. In recent guidance concerning future compliance with the charge controls, Ofcom have advised T-Mobile that if the methodology for including volumes of minutes is not

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[13] See the **Unit expenses** and **Unit investment** tabs of the **3 - Cost** sheet from Ofcom's March 2007 Mobile Call Termination LRIC cost model
[14] Ofcom, Review of BT network charge controls, 19 March, p45

consistent with Ofcom's guidance then the prices charged will need to be reduced to take account of this.[15]

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It seems perverse and anti-competitive that for the NCC, BT has a system in place to ensure that it will on average hit the charge control requirements precisely whilst the mobile operators will in reality have to recovery less than the level of their equivalent price control. It is surely incumbent on Ofcom to set the same compliance rules and regulations for all types of charge control.

Negative Inflation

In Annex 6, Ofcom explain that whilst they are still using RPI as the inflation index in its NCC formulae, given that we are now experiencing a period of deflation this may not still be appropriate to use in future. Ofcom have noted that they will keep this under review. This issue is as relevant to the mobile call termination charge control and will be of increasing importance between 2009 and 2010, during the existing charge control period. Indeed if present forecasts are correct, the RPI figure will be positive in time for the new mobile termination charge control in 2011. Therefore if Ofcom determines that RPI is not appropriate to use for the NCC going forward, it needs to make an equivalent statement with regards to the remainder of the mobile charge control.

In T-Mobile's view a cap needs to be put in place which has regard to the suitability of using RPI in periods of low or negative inflation. The exact level of the cap will need to be determined but should be consistent across all RPI based charge controls.

Another area that has taken on increasing importance in today's economic environment is the exchange rate. Given that all the mobile operators are multi-national organisations, we are all impacted by fluctuations in the exchange rate. Indeed the current low price of the Pound in relation to the Euro means that anything priced in Euros is now more expensive than last year, even if the actual underlying price remains the same, or has fallen. It would be correct for Ofcom to take account of these exchange rate fluctuations when determining the efficient costs for both mobile and fixed operators.

[15] Letter from Joanna Gough to Daniel Jacobson of 29 April 2009