



Online Infringement of Copyright

Implementation of the Online Infringement of Copyright (Initial Obligations) (Sharing of Costs) Order 2012

TalkTalk Group submission

Non-confidential version

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1 Introduction

- 1.1 This is TalkTalk Group's ('TalkTalk') response to Ofcom's consultation on the Implementation of the Online Infringement of Copyright (Initial Obligations) (Sharing of Costs) Order dated 26 June 2012 (we refer to this as the Consultation) which is focussed on the setting of the fees paid by Copyright Owners.
- 1.2 Though TalkTalk fundamentally disagree with key aspects of the Digital Economy Act ("DEA"), Ofcom's proposals to set the fees appear broadly sound though there are a few important areas where we consider that the proposals are lacking.
- 1.3 We explain our views below. We would be very happy to provide Ofcom additional information to help in its consideration of these issues.

2 Overall design / mechanics of the scheme

- 2.1 In this section we comment on a number of aspects of the overall mechanics / approach that Ofcom has proposed.

2.1 Threshold

- 2.2 As we have articulated in TalkTalk's response to Ofcom's consultation on the initial obligation code, we consider that the threshold used to decide which ISPs are initially required to comply with the obligations of the DEA is set inappropriately low (and captures only 6 ISPs as qualifying ISPs). Ofcom has manifestly failed to demonstrate in any meaningful or sound way that the threshold it proposed (of 400,000 subscribers) is proportionate in the sense that the net benefits will be less if the threshold is set lower (or indeed higher).

- 2.3 TalkTalk have provided Ofcom evidence and analysis that indicates that if the costs of churn and distortion are included then the appropriate threshold would be set so that around 20 ISPs would be included. We consider that churn and competitive distortion are both costs that should properly be reflected in Ofcom's analysis of the proportionality of the threshold:

- 2.3.1 Churn is a genuine cost incurred by ISPs. That Ofcom consider that churn is not an Relevant Cost (in terms of cost recovery – see §7.15) does not mean that this cost should be excluded from a consideration of the proportionality of the threshold

- 2.3.2 Ofcom's obligation to set fees under the costs order is subject to its duty to promote competition (Communications Act s4(3)) – see §3.5. Therefore, Ofcom is required to consider the impact of its proposal on competition including competitive distortion. Further, it is clear from the reasoning underlying the proposal to set a higher fee per CIR for 'smaller' ISPs, that competitive distortion and how that might be considered discriminatory is a key consideration in Ofcom's analysis of setting fees. There is no good

reason as to why Ofcom should consider competitive distortion in its analysis of assessing fees but not for assessing the threshold

2.4 The mechanics of forecasting and committing to CIRs appears to mean that even fewer than 6 ISPs could receive CIRs. Copyright Owners may forecast zero CIRs for certain ISPs – for instance, the smaller ISPs, EE and O2 – in order to avoid the higher CIR fee (see §8.7). Such behaviour would result in (a) increased churn (since there would be more options for customers to churn away to ISPs who do not send letters) and (b) increased competitive distortion since the cost burden would be more uneven creating distortions. We think it is inappropriate to allow Copyright Owners to effectively choose to exclude certain qualifying ISPs from the obligation to send letters. Once Ofcom has set a threshold Copyright Owners should not be allowed to undermine that decision (even if that decision is flawed).

2.2 Timing of cost recovery

2.5 We agree with the approach of recovering ISP's capex in fees in the first period (see §6.31 and Question 6.3). Prompt recovery has two benefits: first, it reduces the risk that ISPs do not recover (75% of) their capex; second, in subsequent periods the fee is set closer to marginal cost thereby increasing allocative efficiency. Prompt recovery does not mean that Copyright Owners pay any more than they would if the recovery was spread over multiple periods.

2.6 Regarding the recovery of Ofcom costs that have already been incurred (the 'Initial' costs) Ofcom has proposed that these costs should be recovered over the first two periods. We consider that, in line with the recovery profile for ISP capex costs and for the same reasons, Ofcom's initial costs should be recovered in the first period. This will reduce the risk of non-recovery and also improve allocative efficiency

2.7 In fact, the most efficient recovery approach would be to in effect recover ISP capex (and possibly annual fixed costs) on day one and then for the fee per CIR in the first (and subsequent periods) to only reflect the marginal costs. The same approach for Ofcom costs would also be efficient.

2.3 Other aspects of the design / mechanics

2.8 The way the scheme is designed means that all qualifying ISPs (within the large ISP category) receive the same payment per CIR (based on the costs of a notional 'efficient' ISP) even though they will have different actual costs per CIR (due to differing actual volumes). This creates a situation where an ISP who receives a low forecast of the number of CIRs (i.e. lower than 25% of the total forecast CIRs of the large ISP group) will not recover (75% of) their efficient costs. This could create a perverse incentive whereby an ISP will be more 'profitable' if it has higher levels of infringement occurring over its network.

2.9 We agree that ISPs should not be required to make any material investment of capital or resource until there is a binding commitment on Copyright Owners to pay (which requires a binding forecast) – see §4.24

2.10 It appears that Ofcom's intent is that ISPs are paid in full at the start of each period on the basis of each ISP's forecast number of CIRs and the CIR fee and that if the actual number of CIRs is less than forecast that the ISP receives the same amount. We agree with this outcome. It would be useful if such an approach was made more explicit.

2.11 Regarding productive efficiency (§3.9) we consider that the current scheme promotes productive efficiency (i.e. cost minimisation) since ISPs have a strong incentive to minimise costs since, because the fee is fixed, any reduction in costs fully (or partially) results in increased profit.

3 Assumptions

3.1 In this section we comment on the assumptions used to calculate the fees.

3.1 Churn costs

3.2 TalkTalk have provided evidence that indicates that churn cost (as a result of sending letters) could be very material.

3.3 Ofcom considers (§7.15) that since churn cost is "a cost of economic opportunities lost" then it is not a Relevant Cost. We consider that Ofcom is wrong to exclude churn costs. There are several reasons for this:

3.3.1 Churn costs are not "costs of economic opportunities lost" and so are not explicitly excluded by §1(5)

3.3.2 Churn costs are Relevant Costs within the meaning of Relevant Costs as outlined in Article 2 since they are reasonably and efficiently incurred

3.3.3 Excluding churn costs would reduce efficiency which is contrary to Ofcom's duty to promote efficiency

3.3.4 Excluding churn costs would create competitive distortions which is contrary to Ofcom's duty to promote competition

3.4 The Schedule to the Costs Order states (Schedule §1(5)):

Relevant costs must exclude ... costs of economic opportunities lost as a result of compliance with obligations under the relevant copyright infringement provisions.

3.5 Ofcom says that churn costs "fall squarely within this exclusion" (§7.15).

3.6 We do not consider that churn is a lost economic opportunity. The straightforward meaning of an 'opportunity' (in the context of an economic opportunity lost or opportunity cost) relates to a new and different activity that can no longer be

pursued as a consequence of fulfilling the DEA obligations. For instance, a lost economic opportunity would arise if as a consequence of complying with the DEA an ISP was no longer able to develop its system in other ways that would reduce costs or increase revenues (for example, the slippage referred to in §6.37). The definition of opportunity cost is relevant – it refers to alternatives:

Opportunity cost: The loss of potential gain from other alternatives when one alternative is chosen¹

3.7 We do not consider that the churn cost is a lost opportunity or alternative – rather it relates to an existing activity. Therefore churn cost is not necessarily excluded as a Relevant Cost by §1(5) of the Order.

3.8 We also consider that churn costs are within the meaning of Relevant Costs defined in the Order (Schedule §1(5)) since churn costs are reasonably and efficiently incurred:

“relevant costs” means costs which would be reasonably and efficiently incurred by a notional qualifying internet service provider in carrying out its obligations under the relevant copyright infringement provisions;

3.9 Churn costs are plainly reasonably and efficiently incurred since they are an unavoidable consequence of fulfilling the obligations (they are certainly not discretionary).

3.10 In setting a notification fee (and by implication deciding whether churn costs should be included or not) Ofcom must have regard to promoting efficiency (§1(6)(a)):

In setting a notification fee OFCOM shall have regard to the desirability of ... promoting efficiency in the exercise of rights and the performance of obligations under the relevant copyright infringement provisions

3.11 Excluding churn costs will reduce allocative efficiency since Copyright Owners will not incur the full marginal costs of their decisions resulting in them demanding an inefficiently high number of CIRs. It is only by including the cost of churn will Copyright Owners internalise the full marginal cost of their decisions and therefore make efficient choices. In our view §1(6)(a) clearly points to the need to include churn costs.

3.12 Ofcom’s obligation to set fees under the costs order is subject to its duty to promote competition (Communications Act s4(3)) – see §3.5. Therefore, Ofcom is required to consider the impact of its proposal on competition including competitive distortion. Excluding the churn cost is likely to result in more CIRs and so a higher level of churn and this increase the level of competitive distortion.

3.13 Our view regarding the need to include churn cost is reinforced by Ofcom’s treatment of complaint handling costs which it does consider a Relevant Cost even though it could be argued that such activity does not facilitate the fulfilment of the Initial Obligations.

¹ From Google dictionary

3.2 Save costs

3.14 We consider that save costs should be included in Relevant Costs for the same reasons that churn costs should be included.

3.15 In particular, we note that Ofcom explains that it does not consider ‘save’ costs as Relevant Costs since “it is not an activity which facilitates the fulfilment of the Initial Obligations. Instead, it is at the discretion of each ISP as to whether to carry this out” (§7.13). We consider this reasoning as unsound. It is unclear how Ofcom concludes that Relevant Costs should be restricted to only those activities / costs which facilitate the fulfilment of the Initial Obligations – no such wording is contained in the Schedule to the Costs Order. Similarly, there is no wording in the Order regarding the inclusion / exclusion on the grounds of a costs being of a discretionary nature. Rather the Order itself says that Relevant Costs are those costs reasonably and efficiently incurred. We consider that save costs are reasonably and efficiently incurred – indeed Ofcom says that “such activity is understandable and makes good commercial sense” (§7.13).

3.3 Capex / first year cost estimates

3.16 Ofcom has based its estimate of ‘efficient’ ISP capex and first year fixed costs on the basis of the lowest complete cost estimate (£1.32m) provided by an ISP (see §6.44).

3.17 We concur with the intent of using efficient costs to set costs. However, we do not agree that in this case that the lowest cost is the efficient cost – the other estimates may also be efficient. For example, ISP5 has a higher estimated cost of £2.02m. This higher cost may not be due to inefficiency but rather be a consequence of the ISP’s existing design of systems and processes that means that it is inherently more expensive for it to comply with the DEA obligations. If this is the case, then the £2.02m is the efficient cost for ISP5² and by only allowing ISPs to recover £1.32m ISP5 would effectively be penalised for prior decisions that it made about its systems and processes that were efficient based on what it knew at the time (when it did not know about the DEA obligations). Therefore, we consider that a better efficient cost estimate would be the average of the four complete cost estimates i.e. £1.68m³.

3.18 We note that Ofcom does not provide its estimate of the fixed annual operating costs. These costs are included in the table below §6.43 (which shows capex plus fixed annual opex) and given the table below §6.35 shows only capex it is possible to estimate the fixed annual opex – which appears to be about £300k per year. However, it would be useful if Ofcom can provide its estimate of fixed annual costs in

² A similar issue arises in the case of costing of BT SMP wholesale products when the MEA (modern efficient asset) is considered. Ofcom in its recent Leased Line Charge Control has set BT’s efficient costs on the basis of the MEA technology but has also allowed BT to recover the cost of migrating from its legacy technology to the MEA technology. In other words they have not considered efficient costs in the abstract but rather with specific reference to the position of the operator in question.

³ In an idealised situation it might be appropriate to set an efficient cost that differed between ISPs but this is probably impractical

order that stakeholders can estimate costs in period 2 (when capex will not be recovered).

3.4 Letters per CIR

3.19 Ofcom is assuming that 45% of CIRs will result in a letter. One of the key reasons for assuming less than 100% is that multiple CIRs may relate to the same subscriber (and so multiple CIRs may result in a single letter). This reflects that Copyright Owners “propose to submit all the CIRs they generate” (§7.57) even though different CIRs may be for the same IP addresses. We do not consider that Ofcom can rely on this ‘proposal’ of the Copyright Owners. It is clearly in Copyright Owners interests to not send CIRs that duplicate IP addresses since by doing so more letters will be sent (but at no extra cost to the Copyright Owners⁴).

3.20 Therefore, we consider that Ofcom should set its assumption on the basis that Copyright Owners do not send CIRs which duplicate IP addresses. Alternatively, if Ofcom do assume that Copyright Owners send duplicates, then Ofcom must ensure that such an approach (sending duplicates) becomes part of Copyright Owners obligations.

3.21 We consider that the experience from the MOU in 2008⁵ may act as a good benchmark. In the case of Tiscali the data is as follows (the data is attached):

- 3.21.1 13,711 CIRs were received (CIRs were referred to as IPs)
- 3.21.2 11,481 CIRs related to valid IP addresses (i.e. that were allocated to customers)
- 3.21.3 2,075 CIRs were duplicates⁶ with other valid CIRs within the week
- 3.21.4 9,406 (= 11,481 – 2,075) were valid IP addresses that were not duplicates
- 3.21.5 245 of these related to invalid accounts (either B2B or customer had left)
- 3.21.6 9,161 (= 9,406 – 245) letters were sent
- 3.21.7 of these letters 2,606 were 2nd (or more) notifications over a period of 12 weeks. Under the DEA regime not all these letters would be sent since there is a one month ‘grace’ period (rather than a one week grace period that was implicit in the MOU scheme – this account for the 2,075 duplicates)
- 3.21.8 assuming that ½ of these 2,075 would not be sent as a result of the grace period then 8,123 letters (= 9,161 – 1,038) would be sent
- 3.21.9 thus the letters per CIR is 59% (= 8,123 / 13,711)

⁴ Ofcom bases its estimate to a large degree on the HADOPI scheme. We are unclear as to how the HADOPI scheme works but it may be that in that case there is an incentive to send duplicates – for instance, since the cost to the ISP is not on a per CIR basis

⁵ This was a so-called voluntary letter sending scheme over a period of 12 weeks in late 2008

⁶ some of these duplicates (within a week) will be the same IP address (and same customer) and some different IP addresses (and same customer)

3.22 For the reason given above, Copyright Owners are not incentivised to send duplicate IP addresses under the DEA scheme. Therefore, it is likely that the letters per CIR would be higher than 59%. For example, if it were assumed that all of the 2,075 duplicates within the week had the same IP address (and so they would not be sent as CIRs) then the percentage would be 70% (= 8,123 / (13,711 – 2,075)). Some of the 1,038 CIRs might also not be sent.

3.23 An alternative approach that would overcome the difficulty in predicting the number of letters per CIR would be as follows:

3.23.1 Copyright Owners forecast the number of letters

3.23.2 the fee is set on the basis of a fee per letter

3.23.3 Copyright Owners allowed to send up to (say) two CIRs per forecast letter

3.23.4 require ISPs to only send letters up to the forecast. Additional CIRs that take the number of letters above this level are effectively rejected

3.24 This is, in our view, a superior approach since most of the costs depend on the number of letters rather than the number of CIRs.

3.5 Complaint handling costs

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3.6 Other

3.28 Ofcom’s costs must include not just directly involved staff but also the cost of other staff involved such as the Board, senior management, public affairs. Further, the costs of all staff must include not just direct remuneration costs but also associated costs such as accommodation, IT, training etc.

3.29 We note that Ofcom have not included the cost of ISPs assessing whether customer who claim they are not a Subscriber but rather an Internet Service Provider or Communications Provider (in which case they need to be treated differently).

3.30 Where there is a difference in timing between a cost being incurred and recovered then interest (at the weighted average cost of capital, WACC) should be included.

4 Other issues

4.1 Ofcom explains its logic behind a grace period:

individuals have a grace period during which they are expected to change their behaviour

- 4.2 This is nonsense. In many (if not most) cases the individuals sent letters are subscribers who have not committed any illegal filesharing themselves. Therefore, there is no negative behaviour that needs to change. It is important that Ofcom corrects this 'untruth'.