WHOLESALE MOBILE VOICE CALL TERMINATION – PRELIMINARY CONSULTATION ON FUTURE REGULATIONS

Cable&Wireless

July 2009

SUMMARY

Cable&Wireless believe that there is a continued need for the regulation of mobile termination rates (MTRs).

We have consistently argued for the reduction of mobile termination rates and welcome Ofcom's current review of the regulatory options for the future.

We believe that the approach taken by Ofcom to evaluating a number of different methods is the right way forward, however this evaluation should be carried out across the broader communications market to ensure that whichever method is selected does not have a distorting effect on competition between different network providers.

C&W favours an approach to future regulation that would allow communication providers (CPs) time to adapt to the changes that lower mobile termination rates will have on the market. Accordingly we favour a gradual reduction in termination rates rather than the radical reduction that would result from the adoption of some of the proposed methodologies such as Bill and Keep.

Our preferred option is Long Run Marginal Cost (LRMC) as we believe this provides both the most economically efficient way of setting MTRs while also producing a gradual reduction in rates - this we believe will result in the best outcome for the market as a whole.

INTRODUCTION

Cable&Wireless is one of the world's leading international communications companies. It operates through two standalone business units – Worldwide and CWI.

The Worldwide business unit provides enterprise and carrier solutions to the largest users of telecom services across the UK and the globe. In October 2008 Cable&Wireless strengthened its position when it acquired UK business communication provider THUS. With experience of delivering connectivity to 153 countries – and an intention to be the first customer-defined communications service business – the focus is on delivering customers a service experience that is second to none. More information on Cable&Wireless can be found at: http://www.cw.com/

Today Cable&Wireless has the necessary scale to meet the needs of UK enterprise customers and we are a strategic provider of voice services to both the UK public and private sectors, offering a range of innovative and market leading voice products. Our customers include most of the UK's top companies and public sector organisations, each of whom has placed its trust in Cable&Wireless to deliver an array of business critical services.

In September 2008 C&W added to its portfolio of voice services by the launch of its new and innovative FMC service. This is a telephony service that combines the benefits of fixed and mobile telephony. The customer can use a single mobile handset that will operate over the fixed network whilst in their office location, but then seamlessly switches to a mobile network when the customer is away from their office location. In the office the service works using pico cells, operating over C&W's GSM Guardband spectrum, and connected back into the customers' fixed line network. Away from the office the connectivity is provided over one of the existing mobile networks under a roaming agreement established between C&W and its partner operator.

This market review is of fundamental importance to our business. In addition to being a new entrant to the mobile market, C&W has direct interconnect agreements with each of the 5 MNOs and each year spends a significant amount of money on mobile termination rates. In addition to providing retail fixed line voice services to the business market, C&W also provides a range of wholesale voice services including end to end fixed line voice to resellers operating in the residential and small business markets. We also supply voice transit to fixed and mobile destinations, international incoming and outgoing voice services of which a large proportion of incoming international voice terminates on mobile. We also sell various services, both voice and data to the mobile network operators (MNOs) directly. The range of services which we provide means that C&W is well placed to comment on the proposals contained in Ofcom's review of mobile termination rates.

CONTINUED NEED TO REGULATE MTRS

C&W is of the view that continued regulation of MTRs is essential to safeguard competition in the market. In the absence of regulation we believe that it is unlikely that termination rates would reduce, rather there is a high probability that they could actually increase given the importance of this revenue stream for the MNOs. Indeed , there is ample evidence that prior to the regulation of MTRs, when left to their own devices with no regulation, the MNOs will over recover their costs for call termination (an essentially non-competitive market) in order to subsidise outbound calls (a competitive market). In our view the only way to achieve lower MTRs going forward is by continued regulation past 2011.

We support Ofcom's approach to evaluating a number of different approaches to how regulation should be applied in the future, rather than an automatic acceptance of the approach put forward by the Commission or a mere retention of the status quo. This will allow a proper assessment to take place of the likely impact that different levels of price reduction in MTRs will have on the market depending on which method is adopted.

However we believe that it is essential that any evaluation of the impact of lower MTRs is done in the round. Ofcom's focus is on assessing the impact on consumers, however it is essential that this evaluation fully takes into account the broader impact that lower termination rates will have on the different aspects of the communications market and how this will affect competition between different network operators. This evaluation is much broader than assessing how MNOs will respond to the changes and needs to take into account both the impact between different fixed network operators and the implications for new entrants to the mobile market.

A MEASURED RATHER THAN A RADICAL CHANGE TO REGULATION

Overall, C&W welcomes a proposed reduction in wholesale MTRs and has consistently argued that they should be lower. However we believe that the reduction should be brought about gradually to allow the market time to adjust to the changes that lower termination rates will bring. Some methods of regulation are likely to have a more radical result for both consumers and CPs than others depending on how quickly and how low the rates are ultimately brought down. In our view too radical a change could actually be damaging to competition which would ultimately be harmful for consumers. Accordingly we support the use of a methodology that achieves a more measured reduction in MTRs such as the introduction of LRMC.

When C&W evaluates the effect of lower termination rates on our business it is clear that the implications are much wider than merely changing the level of our outpayments to the MNOs. The bigger issue for us is how price reductions in MTRs will impact margins and traffic volumes and how we go about ensuring that other areas of the business are not negatively impacted by these changes. For example a move to a termination rate set at zero will have implications on the transit market which could change significantly from what it is today. Similarly the impact on new and innovate services such as FMC would need to be evaluated to ensue its continued commercial viability. Any removal or erosion of such significant revenue streams would be serious and could impact our position vis a vis our competitors more broadly.

There is also the implication that if a consistent approach is taken by Ofcom to the regulation of termination rates, whatever is adopted in the mobile market could also be adopted to regulate rates in the fixed environment. Accordingly it is essential that the correct method is adopted by Ofcom with this broader possibility in mind and the implications that this will have for the market.

In addition Ofcom needs to take into account the likelihood that if MTRs are set very low or at zero, this may result in significantly higher subscription charges at the retail level as MNOs attempt to recover lost revenue. Higher subscription charges could result in some consumers and business users, who currently take both fixed and mobile services, deciding to take just one service to save money. Large numbers of end users opting for mobile only services will cause significant damage to the fixed line operators which in turn will impact investment decisions in networks and services. Ofcom therefore needs to ensure that the regulatory measures it puts in place are consistent with encouraging investment and innovation in a variety of different network technologies, and are in line with other policies such as those set out in Digital Britain. Failure to take account of these wider issues will result in a distortion of competition within the communications market as a whole.

Accordingly we believe that Ofcom needs to ensure that different aspects of the communications market have time to adapt properly to price reductions and how this will feed into retail pricing packages and to ensure that the balance of impact between fixed and mobile operators is not distorting to competition. To avoid CPs receiving “bill shock” by a sudden and dramatic change to MTRs we think a measured rather than radical approach should be taken to the setting of MTRs.

Termination rates are a key revenue source for the MNOs and it is clear that any reduction in revenue from one area of the MNO’s business will result in the need to reallocate that revenue stream to other areas of the business. Ofcom state that lower MTRs will result in greater pricing flexibility at the retail level, however there is a risk that pricing packages could become even less transparent than they are today and consumers could end up paying for bundled services that they may not necessarily want. The implication of this could be that there is a significant shift in regulatory priority away from wholesale pricing to retail pricing to ensure that consumers do not face charges which are too high. Ofcom will need to ensure that the correct measures are in place to deal with these changes.

As part of the assessment of which model is most appropriate for future regulation Ofcom should also consider how compliance with any regulation will be measured. Under the current LRIC model MNOs appear to have significant flexibility in their ability to change their rates according to different time of day weighting. Some operators change their prices on a very frequent basis. These price changes are obviously motivated by a cost benefit to the MNOs or else there would be little point in them doing it. However frequent price changes make it difficult for CPs to assess whether the MNO is complying with the charge control and there is potential for the price changes to result in a detriment of some operators over others depending on the particular operator’s traffic profile. In addition frequent price changes place CPs under an administrative burden as these are reflected in charges to customers. This inevitably ripples through to retail pricing and the customer can have no hope of keeping up with the applicable charge for their calls. There are two issues for consideration:

1. Ofcom should ensure that this undesirable behaviour can no longer continue under the next charge control in a manner where it can have such a impact on other operators. At the very least the incentives for such regular changes should be removed;

2. An effective programme for monitoring compliance with charge control obligations should be put in place.

MARKET DEFINITION

C&W agree the market is developing but do not believe there is sufficient evidence to show that different data services, SMS and VoIP services are sufficiently interchangeable with traditional voice calls to justify widening the definition from call termination to include all services. Consumers tend to use voice and text differently and there are many circumstances in both the business and consumer environments where there is no substitute for a voice call. As such the two markets remain distinct.

There is a need for Ofcom to keep the market under review to ensure that changes in consumer usage are taken into account going forward but this should not result in a change in market definition for the setting of termination rates in 2011.

Should Ofcom consider that there are signs of market failure with regards to the provision of other services then Ofcom may need to put in place specific regulation to cover those services. We believe this approach would be preferable to extending the current market definition of mobile call termination to cover a range of other services at this time.

In carrying out the review of MTRs Ofcom should consider whether it may be appropriate to allow a limited period of asymmetry in the rates between the MNOs and new market entrants. Ofcom has recently determined a number of disputes over the mobile termination rates set by new market entrants and has set those rates against a benchmark of the regulated MTRs. This has effectively created an expectation that new market entrants will set their rates no higher than the MNOs regulated rates as this is likely to be the rate that Ofcom would set if those rates become the subject of a dispute. However continued benchmarking against much lower rates could result in new market entrants failing to recover their costs because they are likely to be higher than those of established MNOs due to slower take up of services and uncertainty over traffic volumes. The EU Commission recognises in its Recommendation that a period of up to 4 years may be appropriate for asymmetry in rates to ensure that innovation and investment in new services is not discouraged. Ofcom should consider whether taking a similar approach within the UK may be appropriate and if so for how long a period asymmetry may be necessary.

LRIC + RETAINING THE STATUS QUO

There have been considerable problems with the applications of LRIC + to the setting of MTRs and the last few years have seen increasing litigation resulting from application of this cost model. This has been time consuming and expensive for the communications industry as a whole and retaining LRIC is likely to result in further litigation going forward. However it is also likely that adopting an alternative model which relies on cost allocation methodology will also result in litigation and thus no greater regulatory certainty than LRIC+. The likelihood or not of litigation should not therefore be a determining factor in selecting a method of regulation, rather the criteria should be to secure the best competitive conditions for the market as a whole.

Continued application of LRIC+ to set MTRs will result in a slower decline in the level of MTRs than will be achieved if other models are used. This is likely to be inconsistent with the Commission's Recommendations. In addition LRIC+ leads to MTRs which are above the marginal cost of provision.

This means that originators pay terminators more than marginal cost, meaning the originator subsidises the terminating MNO. Where the call is mobile to mobile this cancelled out to a large degree, but we agree with the EU analysis that concludes that for fixed to mobile calls this represents a substantive transfer from fixed line customers to mobile customers. Arguably most end-users now have both fixed and mobile subscriptions, but it cannot be economically efficient for the cost of one to be met by the other.

However, despite the problems with use of LRIC it is essential that a move away from this model is only done because the other models are more appropriate and produce the best results for the communications market not just because of pressure from the EU or a desire to avoid litigation.

Although moving away from this cost methodology will have implications for the continued application of LRIC to other charge controls, Ofcom should not be deterred from adopting an alternative methodology on this basis. Ofcom's regulatory duties should ensure the continued use of LRIC where this is the best approach for different products in different markets, and similarly where the use of LRIC no longer produces the right result for the market it is appropriate that an alternative methodology is adopted.

LRMC

The adoption of Long Run Marginal Cost (LRMC) is C&W's preferred option. It provides the best proxy to the costs incurred by an efficient operator in terminating a call and is hence the most economically efficient model proposed by Ofcom.

The adoption of LRMC would result in a reduction of MTRs but not as low as maybe the case under some of the alternative models e.g. mandated bill and keep but lower than may be achieved using LRIC +. A more gradual reduction in MTRs would allow CPs to adjust to changes that to date have not been factored into longer term business plans.

While LRMC requires greater regulatory effort to set the rate than required under B&K and mandated reciprocity Ofcom should not be deterred by this fact as clearly economic efficiency and not regulatory convenience should be the guiding principles to selecting the appropriate method.

However, there are implications for this methodology and the recovery of costs for new entrants to the mobile market. LRMC only allows for the recovery of the marginal costs of providing third party termination. New services may have genuinely higher marginal costs than the established MNOs while they establish themselves and under this approach there is even less opportunity to make up for that by being more efficient in other aspects of their common cost.

Given the considerable cost of building a network it is likely that in the future there will be an increase in the reliance of roaming agreements to provide national connectivity by new entrants to the mobile market. These costs should be recoverable as part of the MTRs as they are incremental to the cost of providing third party termination. However, Ofcom will need to consider how it will allow for the recovery of these costs as they will not form part of the cost stack for the MNOs that have nationwide radio spectrum allocations. Ofcom will need to consider whether it may be appropriate to allow a period of asymmetry in the rates of new market entrants against those of the MNOs albeit that any such period of asymmetry would need to be time bound. If Ofcom does not strike the correct balance on cost recovery this could deter new entry to the mobile market and innovation in services.

CAPACITY BASED CHARGING

C&W recognises that there may be some merits with this approach in that it is still based on cost allocation and can be used in combination with other methodologies. However we do not believe that it would be an appropriate methodology for use in setting MTRs at this time and if implemented could have a distorting affect on competition between fixed and mobile services. In addition the adoption of such a radical change to the methodology of setting MTRs would require strong economic justification and clearly identified advantages over other methods – neither of which have been established at this time.

Charges based on capacity use would require careful monitoring of capacity requirements to ensure that the correct amount of capacity is purchased. This may be particularly problematic where there are large fluctuations in capacity requirement and could result in large over or under purchasing of capacity. It is possible that a sub-market in capacity trading could develop where CPs purchase too much capacity and wish to sell it onto to others. It is unclear at this time how the mechanics of such a market may operate and consideration of this issue will be required by Ofcom.

In addition all interoperator accounting systems are set up to bill on a ppm (or per call) basis and a move to CBC requiring a substantive rip and replace of these systems would run to many £millions. It is also unclear how calls inbound from overseas would be handled.

In the existing usage based approach to charging for termination it is the terminating operator that sets time of day prices to optimise the use of its network. Under the CBC approach it falls to each individual purchaser of termination to set prices that it believes will optimise its own use of the termination network but this process is largely independent of all other purchasers. Therefore we believe CBC could result in a less efficient use of network rather than more efficient, the terminating operator itself is best placed to optimise the use of its network through its own price signals.

MANDATED RECIPROCITY

This model would involve mobile termination rates being set against fixed termination rates i.e. those of BT. C&W does not support this approach.

This approach is more suited to an environment where there is greater convergence between fixed and mobile services and may therefore be better suited to consideration in the future if and when markets have developed more fully in this direction. Current market conditions are not yet sufficiently developed in this respect and applying this regulatory model prematurely could actually have a detrimental impact on their development. For example one of the drivers behind the development of a converged service such as C&W's FMC service is to provide a benefit to customers over and above what is provided by a mobile only service. It is likely that investment in such services would become less attractive if operators were unable to recover their marginal costs through the termination rates they charge.

Ofcom state that the application of this regulatory model does not take into account the different costs associated with the mobile and fixed networks and could result in termination charges which are below cost for mobile. In the same way that LRIC+ leads to the recovery of above marginal cost, and is therefore economically inefficient so too is mandated reciprocity but in the reverse direction. MTRs set below the marginal cost of provision would result in the MNOs, and hence their customers, subsidising fixed operators, and hence their customers.

MANDATED "BILL AND KEEP" (B&K)

C&W does not support the application of B&K to the regulation of MTRs. Under this model all flexibility over wholesale charges is removed by forcing all operators to charge zero irrespective of factors such as traffic balance. This removes the ability of CPs to incentivise usage during periods when the network is least busy. This can make traffic management difficult and can result in inefficient use of network capacity with too much traffic being concentrated during the same period while capacity is under utilised at other times of the day.

In C&W's view the adoption of B&K would be seriously inefficient for UK networks as a whole, because call flow patterns would be quite different from today. It would mean that some CPs would be left with redundant capacity while others would have shortages, requiring the purchase of new equipment. Consequently a regulatory change to the introduction of B&K would result in some equipment being permanently scrapped with associated environmental impact, and extra equipment being required by other CPs, the cost of which would ultimately be borne by the consumer. While a market in second hand equipment could overcome some of these inefficiencies however in reality such a development is unrealistic given the diverse nature of different CP's networks.

There is concern that if this approach is adopted for MTRs and later applied to the setting of fixed termination rates there could be serious implications for transit operators. It is thought that B&K would result in "hot potato routing" whereby the originating operator hands over the call at the nearest possible point on the network as this is the most cost beneficial point for the originator. This would lead to a serious erosion of the transit market and a significant reduction in revenue for fixed operators like C&W. This will impact investment and innovation in networks and services in the long run to the detriment of consumers.

C&W notes that Ofcom welcomes the fact that this approach could result in a reduction in regulatory burdens and the removal of the need for Ofcom to calculate costs to set wholesale charges and thus the associated errors that this entails. However, it is likely that Ofcom would instead need to increase its scrutiny of retail prices to ensure that there is transparency in pricing and that consumers are not being over charged. This could also be burdensome for Ofcom from a regulatory perspective. In addition Ofcom may need to intervene to ensure that traffic flow generating no incremental revenue (call termination) are afforded the same quality of service as those which do generate revenue (call origination).

CONCLUSION

C&W supports continued regulation of MTRs beyond 2011. We welcome proposals for a reduction in MTRs but believe that the reduction should be gradual to allow all communication providers to adapt to the changes that will be required to retail pricing structures and other business plans.

Our preferred option for future regulation would be for the adoption of LRMC in line with the Commission's Recommendation. However, Ofcom will need to ensure that new market entrants are able to recover costs such as national roaming costs which are not incurred by the MNOs but which are nevertheless incremental to providing the service. This could necessitate asymmetry in rates between the MNOs and new market entrants or alternatively a recognition that in calculating the LRMC of an efficient operator there is a need to be open minded as to what constitutes the most efficient network implementation.

In particular Ofcom needs to ensure that it does not seek to regulate MTRs in a way that will damage competition between different network providers. It is clear that the adoption of some regulatory models would seriously impact fixed line operators and it is submitted that these approaches should be rejected at this time due to the longer term implications for the market and their inconsistency with other policies such as Digital Britain.

In carrying out the evaluation of the different methods to apply to the setting of MTRs, Ofcom should give due consideration to how compliance with those rates will be measured. In particular Ofcom should not allow the frequent rate changes that MNOs have been permitted to date and should ensure that any rate changes that are allowed are done so with adequate notice to CPs.

In C&W's view Ofcom needs to be particularly alert to the fact that significant reductions in MCTs will result in MNOs seeking to recover their lost revenue elsewhere from retail charges. This will require careful monitoring by Ofcom to ensure consumer welfare is not damaged and to ensure that such charging mechanisms do not result in a distorting affect on competition