TELEFÓNICA O2 UK LIMITED'S RESPONSE TO OFCOM'S CONSULTATION: WHOLESALE MOBILE VOICE CALL TERMINATION, PRELIMINARY CONSULTATION ON FUTURE REGULATION

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Executive summary

1. Telefónica O2 UK Ltd ("O2") welcomes the opportunity to respond to Ofcom's consultation on mobile voice call termination[1].

2. O2 is deeply concerned at the approach that Ofcom seems to favour in this consultation document. Any proposal to abandon cost based charge controls (including an allowance for fixed and common costs) would represent the rejection of a key, sound regulatory principle, and, if implemented, would be damaging to consumers. The evidence presented does not provide a robust justification for the proposed change of direction; the arguments in favour of it fall far short of the requisite standard, of being able to withstand profound and rigorous scrutiny.

3. Two parties (H3G and BT) have been vocal in their attempts to "terminate the rate". However, it is easy to establish why they make their proposal, driven, as it is, by self interest, rather than an evidence-based case in support of consumers.

No case to change the well established approach

4. It is a well-established regulatory principle that the purpose of charge controls is to do the job of the market, in the absence of effective competition. That is, a regulator's role is to set a charge control at a level that an effectively competitive market would generate; it is a proxy for a competitive price.

5. That is as true for mobile voice call termination now as it has been in the past and as it is for any other electronic communications service; it is a cornerstone of the regulatory regime, reflecting economic theory and enshrined in both European and domestic law.

6. In practice, this has meant imposing charge controls on the basis of long run incremental costs, plus a mark up for fixed and common costs (the so called LRIC+ methodology), in circumstances where competition is not effective. Divergence from cost based pricing has only been considered appropriate, in principle, in order to capture wider, social benefits and costs (ie externalities).

[1] Wholesale mobile voice call termination. Preliminary consultation on future regulation. Ofcom. 28 May 2009

7. In this consultation, Ofcom proposes to replace this fundamental objective with another. According to Ofcom, there is a problem in fixed and mobile retail markets that needs to be addressed. It is that operators have insufficient pricing flexibility, because high mobile termination rates act as a "floor" for the prices of retail calls to mobiles. If termination rates were lower, it is argued, fixed and mobile operators would respond by reducing prices and innovating to create larger and more comprehensive call bundles. Thus, instead of seeking to mimic prices a competitive wholesale termination market would generate, Ofcom proposes to reduce termination rates as far as possible, to allow greater flexibility at the retail level.

8. Although at first sight, this might seem intuitively appealing, O2 believes that there would be serious repercussions, which would act *against* consumers' interests as a whole. Furthermore, BT's regulated products are subject to LRIC+ (or analogous) regimes. It would be inconsistent to adopt one approach for fixed and another for mobile.

Ofcom should not adversely impact low income households

9. H3G, alone of the mobile providers, has been particularly vocal in its support of lower mobile termination rates. However, it seeks to serve predominantly high value, contract customers. As we show in this response, the main detrimental impact of these proposals would be felt, unambiguously, by low income pre-pay customers of the other operators, and, in particular, the MVNOs. It is important that Ofcom is candid as to the reasons for this, rather than glossing over the issue, by referring to "retail pricing flexibility".

10. If operators were not allowed to recover their efficiently incurred costs in providing termination services, they will seek to recover them elsewhere. There would be pressure on subscriptions, handset subsidies and call charges. Prepay customers, who tend to receive more calls than they make, might be particularly impacted; operators might be expected to seek a continual revenue stream, perhaps by implementing time expired credit. There is likely to be pressure to introduce charges for receiving calls. Ofcom's own research suggests that 5½ million pre-pay customers would stop using mobiles in these circumstances. The effect on welfare would be significant, particularly bearing in mind that almost a quarter of the lowest income households, who mainly use pre-pay, rely on mobiles for their communications needs.

11. But it is not just pre-pay customers who would be adversely affected. Contrary to Ofcom's assertion, medium-usage consumers and some, if not all, high-usage consumers are also likely to be worse off, insofar as they are likely to experience an increase in their average monthly bills, as mobile operators rebalance tariffs in an attempt to recover lost termination revenue.

History suggests that fixed consumers would not see any benefits, in fact the opposite

12. Although Ofcom says that low termination rates would facilitate greater retail price flexibility, there does not appear to be a problem in mobile that needs to be addressed at all. As Ofcom concedes, prices continue to fall (including off net prices), competition is fierce and there is plenty of innovation in retail tariffs.

13. As for fixed, recent experience suggests that reductions in mobile termination rates would not be reflected in cheaper calls to mobiles prices. In 2007, when mobile termination charges fell significantly, both BT's and Virgin Media's (cable) average retail prices actually *rose*. Mobile termination charges fell again, significantly, from April 2009, but this has had no effect on BT's and Virgin Media's standard retail charges; they remain stubbornly high. If there is a problem in fixed retail markets, it is not one that lower mobile termination rates would solve.

Ofcom's approach to regulating MCT should place a greater emphasis on investment, consistent with the objectives laid out in the Mobile Sector Assessment

14. The effect of reducing termination charges below cost would be a net transfer of funds from mobile to fixed, effectively an unfair subsidy paid by mobile customers to BT and other fixed operators. This would not be efficient, economically, as it could damage the incentives to invest at precisely the time that operators might need to increase capacity to deal with increased call volumes. If retail calls to mobiles prices did fall (as Ofcom intends), there is likely to be an increase in such calls and the mobile networks would need additional investment to provide the extra capacity to carry them. However, if operators are unable to replace the net termination revenue streams, investment in mobile networks is likely to suffer.

The requirements of the regulatory regime

15. O2 believes that Ofcom could not implement charge controls that do not allow mobile operators to recover their efficiently incurred costs in supplying termination services. We are firmly of the view that such an approach is inconsistent with European and domestic law.

16. In our view, if termination markets are found to be not effectively competitive, and if it is right to implement another series of charge controls, Ofcom should continue to set cost oriented charges, based on the LRIC+ approach.

17. Ofcom itself notes that the continuation of LRIC+ based charge controls is likely to see termination rates continue to fall. Such a significant decline in net termination revenues should be phased in over the life of a subsequent charge control, allowing mobile operators sufficient time to adjust. Sudden and dramatic changes to termination

rates introduce a risk that the retail markets would be affected in a way that could harm, and not benefit, consumers.

18. In conclusion, the mobile market has been extremely effective in providing customers with what they want. Competition has provided investment, innovation, low prices, and near ubiquitous take up of mobile services. O2 believes that the effect of Ofcom's proposals would be to risk all of that for no real benefit.

19. In the remainder of this response, we set out in more detail why we think Ofcom would be wrong to change its approach to mobile voice call termination. O2's answers to the specific questions raised in the consultation document can be found in the attached Annex.

Approach to regulation

20. O2 agrees with Ofcom[2], that the starting point for considering the regulatory approach to voice call termination rates should be Ofcom's general and Community duties. However, since the consultation document is about the way in which charge controls might be formulated, Ofcom should also be mindful of the statutory provisions relating to the setting of conditions generally[3] and SMP conditions, in particular[4].

21. While Ofcom notes its principal duty, to further the interests of citizens and consumers when carrying out its functions, section 3 of the Act goes on to direct Ofcom to have regard to other factors, as well. In particular, sub-section 4 requires Ofcom to have regard, if relevant in the circumstances, to (amongst other things):

- The desirability of promoting competition;
- The desirability of encouraging investment; and
- The needs of persons on low incomes

22. In O2's view, these criteria are highly relevant to the issue of voice call termination.

23. Further, the Government has announced its intention to amend the Communications Act to make the promotion of investment in communications infrastructure one of Ofcom's principal duties alongside the promotion of competition, to meet its overarching duties of securing the interests of citizens and consumers in the provision of communication services[5]. In O2's view, Ofcom should be mindful of the Government's policy when considering mobile voice call termination – there is a distinct possibility that primary legislation will be amended before a decision on wholesale mobile voice call termination is made.

24. O2 also notes the fourth Community requirement[6], which requires Ofcom to carry out its functions in a manner which, so far as possible, does not favour one form of electronic communications network over another.

25. Since the present consultation document is concerned with the approach to setting charge controls (on the assumption that operators continue to be found to have significant market power, and that a charge control is appropriate), it is as well to consider the legal framework for setting SMP conditions.

[2] Paras 6.7 – 6.8 refer
[3] Sections 45 – 50 of the Communications Act
[4] Sections 78 – 92 of the Communications Act
[5] Para 67 of the report refers: http://www.culture.gov.uk/images/publications/digitalbritain-finalreport-jun09.pdf
[6] Section 4(6) of the Communications Act refers

27. In particular, section 47 of the Communications Act sets out the test that must be satisfied before conditions are set or modified. Broadly, they must be objectively justified, not discriminate unduly, proportionate and transparent. O2 also notes the requirements of sections 88 (1) and (2), which give effect to much of Article 13 of the Access Directive. These prevent Ofcom from setting price controls except where they promote efficiency and sustainable competition, and confer the greatest possible benefits on end-users. Ofcom must also take into account the extent of investment in (in this case) the provision of voice call termination services.

Strategic policy issue

28. In paragraphs 6.5 of the consultation document, Ofcom describes what it calls a critical strategic policy question:

> *"should we adopt a policy of reducing termination rates as far and as fast as we reasonably can, within the boundaries of sound economic policy and the legal framework, whilst recognising underlying cost differences between fixed and mobile networks. An objective of such a policy could be to allow greater flexibility at the retail level, facilitating innovation."*

29. This issue, whether to set voice call termination price controls with a view to some desired outcome in other (retail) markets does, indeed, permeate the consultation document. For example, the six options that Ofcom has set out are evaluated, partly, on this basis.

30. Before answering the question, O2 observes that this appears to be a new and novel consideration. In previous market reviews, the justification for charge controls was that, in their absence, mobile operators were likely to set termination rates above cost, and that (broadly) this would result in efficiency and distributional problems. Indeed, this is summarised in section 5 of the present consultation document.

31. The established approach[7] differs subtly, but importantly, from the one suggested by Ofcom's strategic policy question. Under the existing approach, it has been the role of Ofcom to do the job of the market, in the absence of effective competition for the provision of voice call termination. That is, Ofcom's role has been to set a charge control at a level that an effectively competitive market would generate; it was a proxy for a competitive price. The LRIC+ methodology has always been selected to do this job because, in the words of Ofcom:

> *"The LRIC of voice termination is the additional cost an MNO incurs to provide termination. This can also be seen as the cost that the firm would avoid if it decided not to provide voice termination, taking a long-run perspective. It corresponds more closely to the charges that would prevail in an effectively competitive market than accounting based measures of cost; it is a fundamental goal of price regulation to mimic the effects of a competitive market and this consideration underpins the use of LRIC."* [8]

32. Hence the notion of setting a charge control to mimic a competitive market and the use of LRIC+ are inextricably linked (as we explain in more detail, below).

[7] Which has been endorsed by the Competition Commission and, in the context of individual notifications, the European Commission

[8] Annex 5 of Mobile Call Termination, September 2006: http://www.ofcom.org.uk/consult/condocs/mobile_call_term/new_mobile.pdf

No change in legal basis

33. In setting LRIC+ based charge controls in the past, Ofcom has satisfied itself that it has complied with the relevant legal requirements set out in the Communications Act[9]. There has been no change in those legal requirements, with regard to retail prices – but O2 notes that these legal requirements may change in order to place greater weight to investment. It is therefore not on legal grounds that Ofcom brings forward its new "strategic question"; the law has not changed since the last charge control and the direction of travel in its regulatory considerations more broadly is towards having a greater regard for investment (than has historically been the case). The benefits of investment were made clear in the Government's Digital Britain report:

> *"The Government has concluded that there is a case for broadening Ofcom's primary statutory duties. For Britain to become a leading Information Society economy, and for our international competitiveness, we will need leading edge infrastructure. That will require a climate and a set of governmental and regulatory frameworks that are conducive to investment, while retaining a competitive market for consumers and business users. Ofcom needs to place the desirability of having a strong infrastructure, in the round, at the centre of its vision and strategy alongside its other core duties."*[10]

34. Ofcom welcomed the report:

> *"Ofcom Chief Executive Ed Richards said: 'Ofcom welcomes the publication of Digital Britain and is pleased that the report places the future of the digital infrastructure and economy at the heart of the public debate.*
>
> *'The report builds on many of Ofcom's proposals which are designed to provide a spur to the UK's digital economy and benefit citizens and consumers."*[11]

and reiterated its position in the recent Mostly Mobile consultation document:

> *"Given the current challenging economic conditions, we are keen to do all we can to ensure that UK citizens and consumers continue to benefit from efficient investment in networks. This is also consistent with our duties."*[12]

[9] See, for example, paragraphs 10.41 – 10.55 of Mobile call termination statement, http://www.ofcom.org.uk/consult/condocs/mobile_call_term/statement/statement.pdf
[10] Paragraph 66 of Digital Britain, Cm 7650 refers: http://www.culture.gov.uk/images/publications/digitalbritain-finalreport-jun09.pdf
[11] See: http://www.ofcom.org.uk/media/features/digfinal
[12] Paragraph 5.1 of Mostly Mobile refers: http://www.ofcom.org.uk/consult/condocs/msa/msa.pdf

35. Regulatory certainty and consistency has a role to play in providing investors with necessary confidence as Ofcom noted in its statement, A new pricing framework for Openreach:

> *"We considered that setting charges by means of a glide path so that charges were in line with the cost standard after four years would be most in consumers' interests. In general, we favour glide paths because they smooth changes and avoid any dislocation in the market and because they place stronger cost efficiency incentives on regulated companies. Moreover, we considered that by employing a methodology consistent with our previous practice, our approach would give investors confidence in the predictability of the regulatory regime in the future.[13]"* (emphasis added)

36. A renewed focus on investment does not just apply to BT's plans to build fibre assets, it is applicable (in light of Ofcom's duties to act without preference to one platform or another[14]) to all investments; fixed, mobile, broadcasting, historical or future. Today's future investments are tomorrow's sunk costs and so Ofcom needs to consider the appropriate treatment of historically incurred fixed and common costs with an eye to a consistent regulation of such costs in BT's regulated product set going forwards. Whilst BT has the luxury of arguing inconsistent positions, Ofcom does not.

Economic efficiency is the overarching objective

37. It is also important to note that, in setting historical charge controls, Ofcom did not think that it was essential to demonstrate that lower termination rates necessarily led to reductions in calls to mobiles retail prices[15] or any "greater *flexibility at the retail level*". For example:

> *"A7.3 Assuming an effective level of competition, we may expect in this context that fixed operators will adopt an approach consistent with Ramsey principles47, whereby price is set above marginal cost such that fixed costs are recovered in inverse proportion to the (super) elasticities of service. Thus, a reduction in unit costs for one wholesale input may not be fully passed through into lower retail prices for the corresponding downstream product, as operators use the reduction in input costs to reduce prices on other services.*
>
> *A7.4 From the perspective of economic efficiency, this approach has advantages over a situation where 100% of the reduction in the wholesale cost of a service is passed through directly into a lower retail price for that service. This is because operators will target price reductions at customers with the most elastic demand*

[13] Paragraph 5.9 refers: http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/
[14] Section 4(6)(a) of the Communications Act 2003 refers
[15] This is just as well, because, as we demonstrate below, they haven't.

thus maximising potential demand and revenues across the full range of services." [16]

38. Instead, charge controls were justified on the strength of economic efficiency and beneficial distributional effects. It was enough to reduce voice call termination charges to levels that a competitive market might generate, and leave originating operators to set retail prices, accordingly.

39. The strategic policy question amounts to a proposal to replace the established and accepted objective (to seek to mimic a competitive price for call termination) with another, namely: to set termination rates as low as possible to foster *"greater flexibility at the retail level"* (within the constraints of *"sound economic policy and the legal framework"*). The implication is that the new objective would mean the replacement of LRIC+ with some other approach, designed to generate lower mobile wholesale voice call termination charges. It strikes O2 that Ofcom has provided no reason at all to replace its *objective* (to mimic the effect of a competitive market).

40. Furthermore, whereas Ofcom has made the case that SMP conditions formulated under the established approach, including the use of LRIC+ (to mimic competitive prices), satisfy the various statutory requirements, we think that the proposed new approach would be likely to fall foul of them. For reasons that we set out below, we do not see how the requirements of the Communications Act can be met by Ofcom's proposed new objective.

[16] See Annex 7 of Mobile Call Termination: http://www.ofcom.org.uk/consult/condocs/mct/summary/mct.pdf

Ofcom cannot address problems in retail markets through adjustment of mobile termination rates

41. O2 is strongly of the view that, in addressing the effects of significant market power in the narrowly drawn voice call termination markets, Ofcom should continue to, and, in fact, may *only* consider remedies that address problems only in those markets. Ofcom is simply not permitted to seek to influence outcomes in other markets, for example, fixed and mobile retail markets, by manipulation of voice call termination charges.

42. Furthermore, even if Ofcom was allowed to influence markets other than voice call termination markets by regulating mobile termination charges (which, in O2's view, it is not), its approach would be constrained. Firstly, in O2's view, charge controls are required, by law, to be based on costs. Secondly, as a matter of logic, Ofcom should not seek to set a price control at a level too low to occur in a competitive market; this would not be permitted under the regulatory regime, because it would not lead to a sustainable outcome, or take account of the extent of the investment necessary to provide voice call termination services. Finally, as a matter of economic efficiency, it should not set price controls below a level that would allow mobile operators to recover their reasonably incurred costs[17].

The legal basis for regulating charge controls

43. Sections 87 and 88 of the Communications Act govern the setting of price controls on dominant providers. These provisions implement the relevant parts of the Framework and Access Directives[18]. Article 16 of the Framework Directive describes the process that National Regulatory Authorities (Ofcom in the UK) must adopt in order to analyse relevant markets. Paragraph 4 of that Article requires that national regulatory authorities must impose on undertakings with significant market power appropriate specific regulatory obligations referred to in paragraph 2. Paragraph 2 records that where a national regulatory authority is required to determine whether to impose, maintain, amend or withdraw obligations, under Articles 7 or 8 of the Access Directive, it must determine whether a relevant market is effectively competitive.

44. Article 8 of the Access Directive governs the imposition, amendment or withdrawal of obligations. Paragraph 2 requires that the obligations set out in Articles 9 to 13 of that Directive, shall be imposed on operators designated as having significant market power. Paragraph 4 of Article 8 reads as follows:

[17] unless it can demonstrate the existence of externalities that could be captured only by setting prices in that way.
[18] http://ec.europa.eu/information_society/topics/telecoms/regulatory/new_rf/documents/l_10820020424en00330050.pdf and http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:108:0007:0007:EN:PDF

Obligations imposed in accordance with this Article *shall be based on the nature of the problem identified*, proportionate and justified in the light of the objectives laid down in Article 8 of Directive 2002/21/EC (Framework Directive). Such obligations shall only be imposed following consultation in accordance with Articles 6 and 7 of that Directive. (emphasis added)

45. In O2's view, national regulatory authorities, including Ofcom, are therefore constrained in the obligations they may set. Specifically, paragraph 4 of Article 8 permits the setting of smp conditions only to the extent that they are based on the nature of the problem identified. In the case of wholesale mobile voice call termination markets, the problem that has been identified by Ofcom is that, in the absence of charge controls, charges for wholesale voice call termination would be too high[19]. Accordingly, under paragraph 4 of Article 8, Ofcom may seek to impose a price control in order to address *that* problem; that is the problem of wholesale mobile voice call termination charges being too high in the absence of such a price control.

46. However, in asking the strategic policy question, Ofcom appears to have misinterpreted its powers. Ofcom has asserted that there is *another* problem in *other* markets (insufficient flexibility "at the retail level") that might be addressed by setting price controls in wholesale mobile call termination markets at a certain level.

47. We set out later in this response why we think that Ofcom's concern about "flexibility at the retail level" is misguided. However, it is clear from Article 8 of the Access Directive, that Ofcom *cannot*, in any event, set price controls on wholesale mobile call termination charges, with a view to addressing a problem in other markets ("retail markets"). SMP conditions, including price controls, must be *"based on the nature of the problem identified"*. And, as we have set out, the nature of the problem identified by Ofcom is that, in the absence of a price control, wholesale mobile call termination charges would be too high.

48. The very basis of the common regulatory framework is to define discrete product markets and where SMP is found implement remedies to moderate effects <u>*in*</u> those discrete product markets.

<u>*Sustainable competition and inconsistency of seeking to set termination rates below marginal cost to address problems in other markets*</u>

49. Without prejudice to the above, Ofcom must ensure that any SMP condition it sets is appropriate for the purpose of promoting *sustainable* competition[20]. In O2's view, this cannot be achieved by seeking to set termination rates below the level that could exist in a competitive market. In addition, it would also be inconsistent to seek to

[19] See paragraphs 2.10 and 2.11, for example
[20] S 88(1)(b)(ii) of the Communications Act 2003 refers

suppress termination rates below costs in order to solve “problems” in the outgoing markets.

50. Under the current regulatory framework, charge controls can be implemented only in circumstances where a provider has been found to be dominant; that is, where a market is not effectively competitive. Furthermore, in competitive markets, prices cannot be less than marginal costs[21], and would, furthermore, be likely to be higher, making some contribution to common and fixed costs[22], in particular where it is desirous for the provision of such services to be sustained over the long run.

51. Accordingly, it would be inconsistent to seek to impose charge controls at a level lower than that which could exist in an effectively competitive market (to address “problems” in other markets), on the premise that the market is not effectively competitive. One only needs to consider the consequences of termination markets moving to a state of effective competitiveness, rendering SMP regulation redundant, to appreciate this. In that case, termination rates would necessarily increase (from a level below marginal costs, to at least as high as marginal costs), resulting in the re-emergence of the “problem” in retail markets that Ofcom refers to in the consultation document. As well as being logically inconsistent, such an approach would fail to satisfy section 88 (1)(b)(ii) of the Communications Act 2003[23], because the “problem” in the retail markets would be “fixed” by setting prices below that which could occur in competitive termination markets. This approach cannot be “sustainable”, because if termination markets became effectively competitive, the termination rates kept artificially low by regulation would necessarily rise, and the “problem” in the retail markets would re-occur.

52. In addition, Article 13 of the Access Directive clearly states that charge controls must be cost based:

> *“A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations relating to cost recovery and price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access, in situations where a market analysis indicates that a lack of effective competition means that the operator concerned might sustain prices at an excessively high level, or apply a price squeeze, to the detriment of end-users. National regulatory authorities shall take into account the investment made by the operator and allow him a reasonable rate of return on adequate capital employed, taking into account the risks involved.”*

[21] Other than in the short term, in certain circumstances
[22] On the basis of relative demand elasticities
[23] “s 88(1) Ofcom are not to set an SMP condition falling within section 87(9) except where….(b) it also appears to them that the setting of the condition is appropriate for the purposes of…(ii) promoting sustainable competition

53. We set out later in this response the adverse effect on investment of a reduction of termination rates.

54. Furthermore, setting termination rates below cost (plus an allowance for fixed and common costs), would be economically inefficient. It would represent a net subsidy of fixed services by mobile, resulting in an inefficient over consumption of the former, and under consumption of the latter. In addition, a reduction in termination rates resulting in a fall in corresponding retail charges (which would appear to be Ofcom's proposed objective), would lead to an economically inefficient volume of calls to mobiles. Both of these outcomes would be inconsistent with Ofcom's general duties and Community obligations, as well as the statutory provisions governing the imposition of SMP conditions[24].

[24] See, for instance paragraph 20 of Ofcom's written submissions for the CMC on 4 and 5 December 2008, in BT V Ofcom. Competition Appeals Tribunal, Case No. 1085/3/3/07: *"Further or alternatively, Ofcom could not, consistent with the provisions of s.88(1)(b), set a price control at a level below the efficient charge level. Insofar as BT seeks a prospective adjustment to a level below the Year 4 (adjusted if appropriate by the CC), this would not be permitted under s.88(1)(b)."*

The use of LRIC+ to determine charge controls

55. It is a point that is not made very clear in the consultation document, but one which, in O2's view, is worthy of note, that Ofcom has, to date, used LRIC+ as the appropriate methodology to determine both for fixed and mobile voice call termination charge controls[25]. Where other EU NRAs have used economic models to set charge controls, LRIC+ has similarly been the gold standard. Other NRAs have benchmarked to Member States where LRIC+ has been used. To date, the European Commission has not questioned the use of LRIC+ when reviewing remedies decisions by NRAs.

56. The reason for Ofcom's reliance of LRIC+ to set charge controls has been explained on a number of occasions by Ofcom itself, for example:

> *"A5.1 In the previous market review of 2G mobile voice termination (see June 2004 Statement), Ofcom used a Long-Run Incremental Cost (LRIC) model to derive the cost to a 2G network operator of providing 2G voice termination services. The LRIC of voice termination is the additional cost an MNO incurs to provide termination. This can also be seen as the cost that the firm would avoid if it decided not to provide voice termination, taking a long-run perspective. It corresponds more closely to the charges that would prevail in an effectively competitive market than accounting based measures of cost; it is a fundamental goal of price regulation to mimic the effects of a competitive market and this consideration underpins the use of LRIC.*
>
> *A5.2 LRIC is widely used as a regulatory costing technique, for example by other NRAs in Europe and by the FCC in the US. It has also been identified as the most appropriate methodology to use for setting interconnection charges by the European Commission in its 1998 Recommendation on Interconnection. For further details, see The Use of Long Run Incremental Cost (LRIC) as a Costing Methodology in Regulation, 12 February 2002, http://www.ofcom.org.uk/static/archive/oftel/publications/mobile/ctm_2002/lric120202.pdf. Furthermore, the Competition Commission (CC) agreed with the use of LRIC as the appropriate costing methodology for setting termination charges, as stated in paragraph 2.251 of the CC's 2003 Report (see footnote 13 above).*
>
> *A5.3 Ofcom continues to hold the view that a LRIC methodology constitutes the most appropriate means of determining the efficient levels for charges on mobile voice call termination services."* [26]

[25] O2 acknowledges that Ofcom has also imposed CCC FAC based charge controls on some BT products as an alternative to a LRIC based approach, on the grounds of practicality and transparency. See, for example, paragraph A4.6 of A new pricing framework for Openreach Annexes: http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/annexes.pdf Importantly, like LRIC+, CCC FAC also seeks to mimic prices in competitive markets.

[26] In Mobile Call Termination, September 2006: http://www.ofcom.org.uk/consult/condocs/mobile_call_term/new_mobile.pdf

and

> *"In Ofcom's view, the relative levels of fixed network and mobile network termination charges should reflect the respective costs of the two types of network, derived in a consistent manner. Ofcom's charge controls achieve this. For both fixed and mobile networks, termination charges are currently set to reflect LRIC plus a mark-up for common costs (and in the case of mobile networks, also a network externality surcharge – see section 3.8). In contrast, H3G's alternative proposal would move mobile termination charges away from the consistent cost standard used to determine fixed termination charges. Therefore, the price differential between fixed and mobile networks would be distorted, as it would not reflect the relevant cost differential (see Figure 6.1 below)."* [27]

Mobile call termination appeals - price control issues

Figure 6.1 H3G's NPZ proposal and alternative proposal in comparison to Ofcom's overall approach to setting charge controls

Type of Call		Ofcom	H3G NPZ	H3G Alternative
Mobile to Mobile	2G/3G MNOs	LRIC+markups	Zero	LRIC+markups
	H3G	LRIC+markups	Zero	LRIC+markups+further differential based on traffic imbalance
Fixed to Mobile	2G/3G MNOs	LRIC+markups	0.4ppm ("marginal cost")	
	H3G	LRIC+markups	Either 0.4ppm ("marginal cost") **or** 0.4ppm+ further differential based on traffic imbalance	
Mobile to Fixed / Fixed to Fixed	2G/3G MNOs	LRIC+markups	LRIC+markups	LRIC+markups
	H3G	LRIC+markups	LRIC+markups	LRIC+markups

57. While it is, of course, the case that Ofcom is able to change its approach to regulatory issues if circumstances change, it is also well established that it may do so only on the basis of objective reasoning[28].

58. In O2's view, none of the reasons that Ofcom offers in its consultation document is grounds for jettisoning LRIC+, nor has Ofcom providing an adequate evidential basis

[27] In Mobile call termination appeals - price control issues. Submission to Competition Commission, February 2008

[28] See, for example, paragraph 123 of http://www.catribunal.org.uk/documents/Judgment_1094_180908.pdf

to support these grounds. That is because it is accepted that LRIC+ is the best means of mimicking a competitive price, and that it has always been, and should remain, the objective in formulating price controls.

59. It should be clear from the above that O2 is strongly of the view that Ofcom's policy approach to regulating mobile call termination should not change, albeit we believe that the consequent calculations based on LRIC+ would lead to a change in the allowable charges. Indeed, we would respond to Ofcom's strategic policy question with one of our own: if the *goal* of achieving "greater flexibility at the retail level" is so important, now, why was it not in 2007, when Ofcom set the previous mobile voice call charge controls? Or in 2004, when charge controls were set before? Or, to put it another way, what has changed since 2007 to justify the removal of the well established *objective* of seeking to mimic the effect of a competitive market and the retention of the LRIC+ approach?[29]

60. If these questions appear rhetorical in nature, that is because they are; in O2's view, the development of communications markets described by Ofcom do not constitute justification for replacing this fundamental regulatory *principle*. Rather, they are factors to be taken into account in setting charge controls using the established methodological framework.

61. Ofcom's role in setting charge controls should continue to be to set cost oriented charges. As we have set out, above, the LRIC+ methodology has always been used by Ofcom to do this job, and we are firmly of the view that it remains the appropriate methodology to employ in the future.

[29] Assuming that operators are found to have SMP and that the imposition of charge controls satisfies the various legal requirements.

Allocation of fixed and common costs and Ramsey pricing

62. As Ofcom has stated in the past[30], although efficiency is maximised when prices are set at marginal cost, the presence of fixed and common costs means that prices must be set higher, if firms are to break even. Consequently, regulated charges have been higher than marginal cost; in the words of Ofcom[31]:

> *"…there are economic efficiency reasons for allowing regulated charges to contribute to the recovery of these* [fixed and common] *costs (i.e. adding a mark-up above marginal or incremental costs)"*

63. Ramsey pricing allocates fixed and common costs on the basis of the inverse of price elasticity; the greater the price elasticity of demand, the lower the allocation of fixed and common costs. This maximises efficiency because output is higher than for other methods of cost allocation.

64. Despite its theoretical attractiveness, Ofcom has refrained from using a Ramsey model to allocate fixed and common costs in setting charge controls, explaining in 2007 that:

> *"Ofcom considers that the use of Ramsey pricing to set regulated charges is not appropriate for the following reasons:*
>
> - *In order to estimate the level of welfare-optimal termination charges, it is necessary to account not only for the impact that prices have on demand, as in a basic Ramsey model, but also for a variety of other important factors such as externalities, imperfect competition and price discrimination (in particular second degree price discrimination in the form of non-linear pricing). Developing a reliable applied modelling framework that captures all these relevant features, however, cannot be done robustly, in Ofcom's view, due to the difficulties and uncertainties inherent in dealing with such complex market environments*
>
> - *In addition to the difficulties in developing an appropriate modelling framework, it has not been possible to derive robust estimates of common costs and of demand, which are necessary to derive welfare-optimal MCT charges*

[30] See, for example, Annex 17 of the March 2007 mobile call termination statement: http://www.ofcom.org.uk/consult/condocs/mobile_call_term/statement/statement.pdf
[31] See paragraph 3.5 of Technical Annex to BERR-Ofcom comments on the draft Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU: http://www.ofcom.org.uk/telecoms/ioi/eutermination/annex.pdf

- *The Ramsey approach was rejected by the Competition Commission in 2002."* [32]

65. Accordingly, in its 2007 mobile termination decision, Ofcom allocated fixed and common costs on the basis of routing factors (for network costs) and network cost share of total cost (for non-network costs).

66. The issue of the allocation of fixed and common costs is important, because, as Ofcom notes, one of the two key differences between LRIC+ and LRMC, is that the latter does not involve the allocation of fixed and common costs to voice call termination.

67. The implication of Ofcom's previous position is that this would be economically efficient only if the price elasticity of demand for termination services is infinitely high. Even then, Ofcom would need to allocate fixed and common costs using Ramsey principles, which it has declined to do, in the past.

68. O2 believes that allocating no fixed and common costs to voice call termination, in accordance with the LRMC approach, would be arbitrary and result in inefficient pricing and outputs, unless it can be demonstrated that demand for termination services is perfectly elastic and that adopting Ramsey pricing principles is beneficial. Otherwise, we are firmly of the view that charge controls set on this basis would fall foul of the statutory tests for setting smp conditions. In particular, they:

- would not be objectively justifiable[33] (because cost allocation would be arbitrary);
- are likely to be unduly discriminatory[34] (because termination rates would be lower, unfairly subsidising call originators);
- would not be appropriate for promoting efficiency, sustainable competition or conferring benefits on end-users[35] (because voice call termination charges would be lower than in a competitive market, resulting in higher, less efficient charges elsewhere); and
- would not reflect the necessary investment for the service[36]

69. Ofcom cannot adopt an asymmetric approach to Ramsey pricing. Historically, Ofcom has argued that it cannot adequately model Ramsey pricing in order to allocate a higher level of common and fixed costs. It cannot now argue that because it cannot model Ramsey accurately, it is entitled to allocate no fixed and common costs to termination. That would smack of a *"heads I win, tails you lose"* approach to regulation.

[32] Paragraph A17.15 of the March 2007 statement refers
[33] Section 47(2)(a) refers
[34] Section 47(2)(b) refers
[35] Section 88(1)(b) refers
[36] Section 88(2) refers

Externalities

70. As Ofcom observed in its response to the proposed European Commission recommendation, the existence of externalities might justify departures from marginal cost pricing, in the name of maximising welfare[37]. So, for example, Ofcom had, in the past, added a network externality surcharge to call termination costs, to reflect the social benefit of a higher number of subscribers that would otherwise not have subscribed[38].

71. In our view, the principle of cost based pricing, with differences reflecting externalities, remains the right approach.

72. In the consultation document, Ofcom suggests that the existence of call externalities (ie the benefit a subscriber enjoys from receiving a call) might justify termination rates lower than marginal costs (plus a mark up for fixed and common costs)[39]. O2 accepts the point, in principle. However, we would observe that the case for call externalities has yet to be made; an empirical assessment has not been undertaken. Ofcom itself acknowledges this[40].

73. It is simply not good enough to seek to mark down termination rates on the basis that call externalities might exist. If Ofcom is minded to go down this road, it must demonstrate that they do, in fact, exist, quantify them, and the extent to which they are "internalised". On the issue of internalising any call externalities that might exist, O2 notes Ofcom's conclusions on the empirical studies, that it seems likely that for most calls, call externalities would be internalised by consumer behaviour[41]

74. Furthermore, other externalities would need to be quantified. For example, if call externalities result in the reduction in termination rates, and operators responded by increasing other charges which led to a reduction in the number of mobile subscribers (as we explain, later in this response, it would be likely to do), then there would seem to be a network externality which would need to be captured by the reintroduction of the network externality surcharge on mobile termination rates.

75. In the meantime, O2 offers the following observations:

- the results of the Jigsaw Research survey[42] suggests that customers do not wish to pay for receiving calls, indicating that they do not attach value to them. For example, if charges were introduced for receiving calls, and these were offset by lower outbound call charges, 12% of pre-pay customers (equating to over 5½

[37] See paragraph 3.9 of the Technical Annex to BERR-Ofcom comments on the draft Commission Recommendation on the Regulatory Treatment of Fixed and Mobile
Termination Rates in the EU: http://www.ofcom.org.uk/telecoms/ioi/eutermination/annex.pdf
[38] Before it was removed by in the recent appeal of Ofcom's 2007 charge control decision
[39] See paragraph 6.108.1
[40] See paragraph 6.151
[41] Paragraph 26 of Annex 6 refers
[42] Reproduced as Annex 10.2 of the consultation document

million subscribers[43]) said that they would stop using their mobile. This result suggests that there are no significant call externalities that may be captured by reducing mobile termination charges;

- in Annex 9 of the consultation document, Ofcom suggests that since the costs in the US for making and receiving calls are the same, the implication is that consumers value receiving calls as much as making them. If consumers valued receiving calls less, operators would have an incentive to reduce the price. The corollary is that if the calling party had to pay for the entire call, there would be an externality[44].

  However, this ignores the fact that, absent a charge for incoming calls, there exists an arbitrage opportunity involving the setting up of two incoming calls, instead of a conventional call involving a calling party and a called party. If incoming calls are free, and there are no wholesale termination charges, it is possible to establish a service that allows calling parties to effectively become called parties. The service provider sets up two calls: one to the original "calling party" (prompted by that party), and the other to the called party; and connects the calls. Under this arrangement, no payment is made for the use of either network, either by the end users, or by the service provider. In this sense, there is a "free rider" problem. Furthermore, these services do, in fact, exist in territories where there is no charge to customers to receive calls, and no termination charges[45].

  Accordingly, operators are incentivised to charge customers for receiving calls, even in circumstances where customers attach little value to this. Thus the existence of charges to receive calls in countries where termination rates are low or zero is not evidence that call externalities exist in other countries where calls are free to receive.

  A corollary is that such call back services would seem to constrain mobile operators in circumstances where termination charges are reduced to below cost. In the consultation document, Ofcom acknowledges that mobile operators would need to introduce charges to compensate for a reduction in mobile termination revenues. Ofcom appears to assume that, in these circumstances, operators are unlikely to introduce retail charges to receive calls, because of the consumer reaction[46] and the assertions of some in the market that they would not introduce such charges. This assumption seems to discount the experience in the US (to which, otherwise, Ofcom attaches great weight). More importantly,

[43] Based on a pre-pay base of 47.2m, reported in Mobile Citizens, Mobile Consumers: http://www.ofcom.org.uk/consult/condocs/msa08/msa.pdf
[44] Paragraphs A1.28 – A1.30 refer
[45] See: http://en.yohocanada.com/index.php?option=com_content&task=view&id=13&Itemid=28 and http://www.axagentelecom.com/addon-services/mobile-call-back.php
[46] Paragraph 6.44

Ofcom does not seem to have appreciated that, in circumstances where it costs subscribers more to make a call, than to receive one, if operators are not permitted to levy cost oriented charges, then an arbitrage opportunity exists, and operators would seem to be obliged to charge identical prices for receiving and making calls in order prevent that arbitrage. This explains the paradox that consumers are unwilling to pay to receive calls, yet, in countries with low or zero termination rates, are required to do so.

- If call externalities exist in mobile, then presumably they do in fixed, as well. Consequently, Ofcom would need to revisit the issue of fixed termination rates. To cut mobile termination rates for mobile on the premise of call externalities, but to leave fixed termination rates untouched would be discriminatory, unfairly favouring fixed over mobile, in breach of the Communications Act.

Consequences of preventing mobile operators from recovering their reasonably incurred costs

76. We have set out, above, why we think that Ofcom's objective in regulating termination rates should continue to be to mimic the outcome of a competitive market, and set cost based charges controls[47]. The LRIC+ approach meets this objective and has been used to set mobile termination charge controls in the past (and for other charge controls). In O2's view, it should continue to be used. Furthermore, it is economically efficient that termination charges should continue to cover a share of fixed and common costs. The use Ramsey pricing principles to allocate such costs has been rejected consistently by Ofcom in the past, and if it is to be used in the current review, Ofcom needs to explain why that is now appropriate, and undertake the appropriate empirical analysis to implement it. Finally, while a departure from cost based pricing to reflect externalities is, in O2's view, right, in principle, further work is needed to establish whether they exist, in practice, the extent to which they may be internalised, and whether other externalities arise if termination rates are reduced to try and capture them.

77. O2 is firmly of the view that any departure from the above approach would be inconsistent with the regulatory regime.

78. Nevertheless, Ofcom has suggested that there may be advantages in seeking to reduce mobile termination rates. Specifically, Ofcom asserts that lower mobile termination rates would lead to greater pricing flexibility at the retail level, generally be in consumers' interest, and address competition concerns.

79. O2 believes that a reduction in mobile termination rates is likely to have an impact on retail pricing and on competition (but not necessarily in the way that Ofcom envisages), and also on investment and, ultimately, consumer welfare. We do not agree that a reduction will generally be in consumers' interest.

80. We discuss this, below. However, before we deal with the various issues, we would observe that Ofcom's assessment of the various options for regulating mobile termination rates is not one that should be carried out in isolation, but needs to be comparative exercise. That is, the question is not: whether regulating termination rates using any particular approach generates benefits not realised if rates are unregulated; but: whether one form of regulation generates benefits over and above those not realised by employing another form of regulation.

81. Furthermore, since the methodological approach used to date has been LRIC+ and that approach has (in O2's view, uniquely) attractive conceptual properties, Ofcom should use that as the "counter-factual", when considering other approaches to mobile voice call termination.

[47] In circumstances where the markets are not effectively competitive and charge controls are proportionate

Retail price flexibility

82. Throughout the consultation document, Ofcom asserts that lower mobile termination rates are likely to benefit consumers, overall, because operators will have greater retail pricing flexibility[48].

83. In reaching this preliminary view, Ofcom has relied on the studies commissioned for its review (by CEG and Analysys Mason), as well as on its own data analysis. O2 notes that this approach compares countries where low or zero termination rates were introduced some time ago, when those markets were developing. It is not immediately obvious that similar market outcomes would occur in the UK following a step change in the regulation of termination rates. Furthermore, Ofcom explains that the external studies it has commissioned show that there is consensus over the relationship between a mobile termination rate regime and market outcomes, once other key determinants of take up and usage are controlled. Conversely, it places weight on its own data analysis in Annex 5 of the consultation document in order to substantiate its emerging conclusions, even though this is less robust than the studies it commissioned.

84. It is not entirely clear what Ofcom means by "greater pricing flexibility", nor how this is to be assessed or measured. Ofcom appears to be suggesting that lower mobile termination rates would result in larger and more comprehensive call bundles, but that is not the same thing as greater pricing flexibility. For example, presently, consumers are able to choose from a wide range of mobile retail packages, including traditional pre-pay and post-pay deals and SIM only offers. If mobile termination rates are reduced, mobile providers might seek to recover the lost net revenues by pushing up call charges or by increasing or, in the case of pre-pay, introducing some form of subscription or access based charging. If this happened, it seems to O2 that, rather than providing greater retail pricing flexibility, the reduction of call termination charges would lessen retail pricing flexibility. Ofcom needs to explain the reasoning behind its assertion, and provide the requisite evidence.

85. However, even on the narrow assessment, that is, whether a reduction in termination rates would result in larger and more comprehensive call bundles, it seems to O2 that Ofcom needs to consider the matter in more depth.

86. As we have set out above, Ofcom's assessment of the various options is a comparative one. In our view, the LRIC+ methodology ought to be considered in its own right and as the benchmark against which the other approaches should be measured. Accordingly, the exercise that Ofcom should be conducting, to assess the effect of lower termination rates on the extent to which operators are provided with greater flexibility as regards retail pricing, is comparing the position if LRIC+ is retained, with each of the other proposals. Ofcom says[49] that the retention of LRIC+ as the methodological approach for the regulation of voice call termination from 2011, would result in lower

[48] See, for example, para 1.16, first bullet point
[49] See para 6.34

termination rates than today. If other approaches would lead to lower rates still, and if Ofcom wants to assess the impact of lower rates on retail pricing flexibility, it follows that it needs to compare the effect on pricing flexibility of the retention of LRIC+, with the other methods. Only once that exercise has been undertaken could Ofcom draw any conclusions.

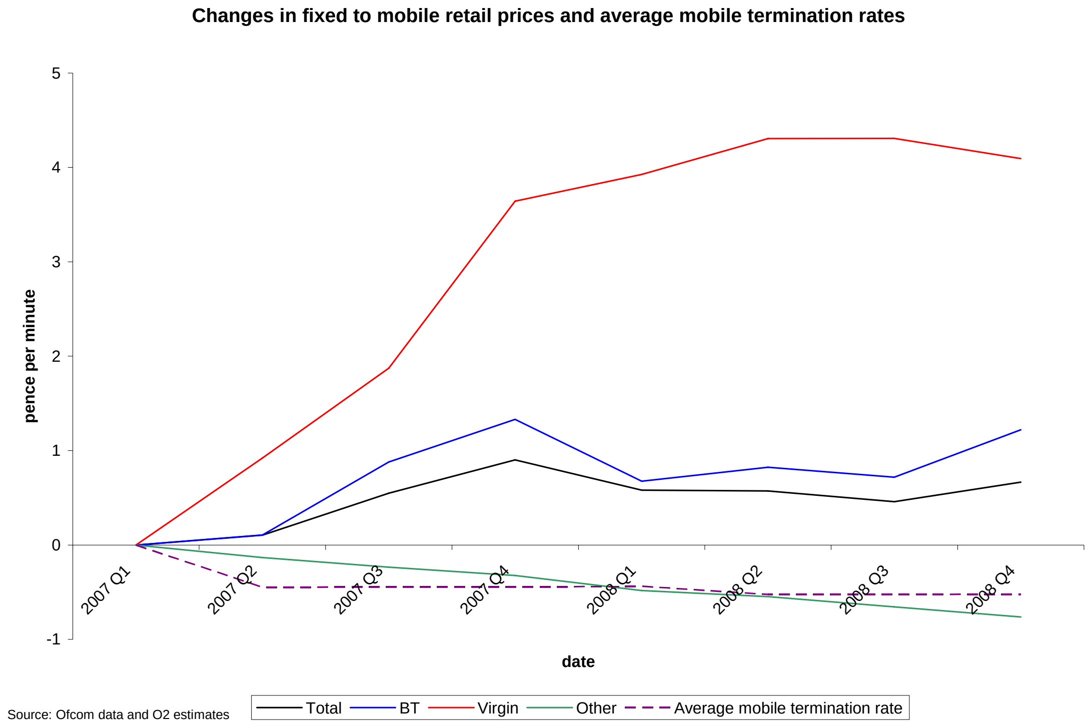
87. O2 looks forward to reviewing Ofcom's analysis of this issue. In the meantime, we would make the following observations on the issue of tariff innovation.

Fixed line retail price innovation

88. Ofcom will, presumably, wish to consider empirical evidence of the effect of reductions in mobile termination rates on fixed to mobile retail prices, as a correlation in the past might provide the basis for future expectations. O2 has attempted to undertake this type of analysis by recreating the approach that Ofcom took in Annex 7 of its March 2006 consultation document on mobile call termination[50]. Specifically, O2 has calculated the average fixed to mobile retail prices of BT, Virgin and other providers, using Ofcom call volume and revenue data, for 2007 and 2008. O2 has also sought to calculate average termination rates using the regulated termination charges, and published and (in the case of H3G) estimated subscriber numbers[51]. Ofcom will be in a better position to estimate average termination rates. In the meantime, we are happy to disclose our calculations.

89. The results of our analysis are set out in the following graph, which reflects quarterly changes in average prices and wholesale termination rates, compared to the beginning of the period (Q1 2007):

[50] See: http://www.ofcom.org.uk/consult/condocs/mct/summary/mct.pdf.
[51] For Q1 of 2007, we have had to estimate the "uplift" in actual termination charges owing to the "blending" of the then unregulated 3G charges. Although such blending was, subsequently, struck down by the Competition Appeals Tribunal, we have made an adjustment to the regulated 2G rates because the blended charges were the actual charges levied at the time.



90. Ofcom will note that over the period, average termination rates have declined, while the fixed to mobile retail charges of BT and Virgin, and the average fixed to mobile charges, have, in fact, increased (in the case of Virgin, substantially). In particular, the introduction of the present regime, in April 2007, saw a marked reduction in termination rates. Yet the average fixed to mobile retail prices of both BT and Virgin actually increased, significantly, until the end of 2007.

91. O2 believes that the outcome of BT's appeal against Ofcom's decision on mobile termination rates is similarly instructive. Ofcom revised the SMP conditions on 2 April 2009, reducing termination rates significantly, by around 1ppm, on average. Furthermore, such reductions were foreseeable following the Competition Commission's report of 16 January 2009, over six months' ago. However, as far as O2 is aware, neither BT nor Virgin has responded to these reductions by "innovating" to reduce their retail calls to mobiles retail prices. Furthermore, it is quite clear that BT has the capability to anticipate reductions in wholesale charges and reduce corresponding retail rates. For example, it managed to anticipate the reduction in wholesale charges for calls to 0870 numbers and reduce corresponding retail charges, a couple of months *before* Ofcom made a decision to remove the regulatory regime which supported revenue share at the wholesale level, in respect of those numbers. In conclusion, although BT has had over six months to respond to a substantial reduction in wholesale mobile termination rates, it does not appear to have innovated at the retail level, either to reduce retail calls to mobile prices, or to introduce new call bundles, or in any other way.

92. The following table sets out BT's and Virgin's current standard calls to mobiles prices[52]:

	Daytime (ppm)	Evening and weekend (ppm)
BT	12.234	7.34
Virgin (to O2, Orange, Vodafone and T-Mobile)	15.68	10.79
Virgin (to H3G)	27.42	20.57

93. To put these charges into context, H3G's is the highest average termination rate in the UK, currently, at 5.83 ppm, which is just 21% of Virgin's daytime retail call charge. O2's average termination rate of 4.71ppm constitutes just 38.5% of BT's daytime charge.

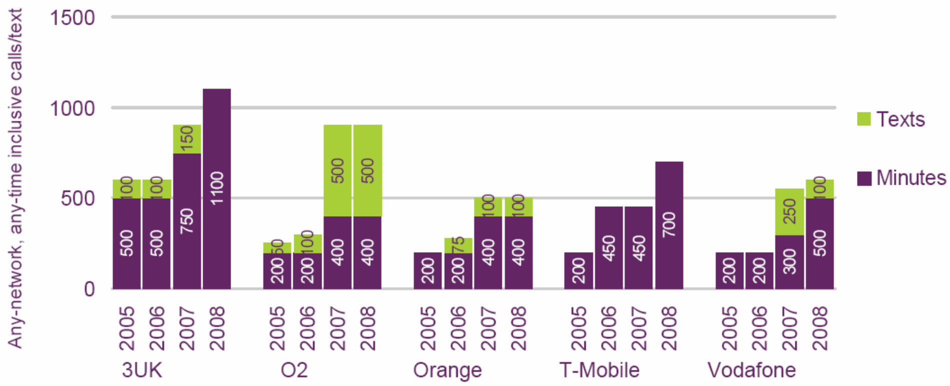
94. O2 is not presenting this evidence to Ofcom as a means re-opening the "pass through" debate (although we may wish to refer to it later in the consultation process). However, we believe that it is highly pertinent given Ofcom's assumption that lower mobile termination rates would result in greater pricing flexibility. The empirical evidence is that, for fixed services, retail calls to mobile prices have actually increased following significant reductions in mobile wholesale terminations charges, in the past. Furthermore, Ofcom appears to offer no evidence to suggest why further reductions in termination rates in the future would feed into lower fixed retail prices. On that basis, seeking to reduce termination rates in order to "allow greater flexibility at the retail level" could not be said to be objectively justifiable.

Mobile retail price innovation

95. Unlike the fixed retail market, in mobile, there has been plenty of tariff innovation, as Ofcom recognised in its mobile sector assessment[53]. We have already referred to the proliferation of pre-pay, post pay and SIM only tariffs. In respect of larger comprehensive call bundles, O2 notes Figure 11 in the mobile sector assessment, recreated here:

[52] See: http://allyours.virginmedia.com/pdf/002697_Residential_Cable_Phonebook_1_1july.pdf and http://www.productsandservices.bt.com/consumer/consumerProducts/pdf/UKInternationalprices.pdf
[53] http://www.ofcom.org.uk/consult/condocs/msa08/msa.pdf

Figure 11: Anytime, any network allowance within £30 mobile contracts



Source: Ofcom / tariff data from Pure Pricing
Notes: Standard tariff selected which offers highest number of anytime, any network minutes for £30 or less on an 18-month or 12-month contract; excludes tariffs only available online or direct; excludes specific promotions; excludes SIM-only deals; some variation between 2006 and 2007 is caused by greater availability of 18-month contracts; this table is indicative of inclusive any time, any network minutes only (and texts when they are additional to the maximum number of minutes) and should not be used to compare overall pricing as many additional factors are excluded, such as handset, on-net calls, off-peak calls, data bundles and metered pricing

96. The continual innovation in retail pricing and increase in call bundle sizes reflect the intense competition in the mobile market. Further, there is no reason to believe that this will not continue, absent any changes to the regulation of mobile termination rates in the future.

Competition

97. Ofcom reports that H3G has argued that Bill and Keep ought to be introduced and that, in the meantime, its termination rates should be higher than other mobile operators'. That is because other operators have higher off net prices than on net prices and, in order to compete, smaller providers, like H3G must set their off net prices to compete with the other operators' on net prices. However, if MTRs are higher than on net prices, this would be unprofitable. Furthermore, the smaller operators' low off net prices necessarily results in a net outfow of traffic and, if termination rates are symmetric, they are at a disadvantage.

98. O2 does not agree with H3G's analysis. Firstly, the scenario H3G depicts does not capture the dynamic nature of competition; it is a static analysis. So, for example, as a result of the reduced prices off-net and on-net prices of the new entrant, the existing operators would be expected to lose customers (because their off-net prices would be higher). In order to compete with the new entrant, they would be forced to bring their off-net prices down. Thus the market would correct itself and, in so doing, alleviate the problem that H3G appears to be concerned about.

99. Secondly, if the market mechanism described above failed to occur and the setting of retail prices by existing operators amounted to a competition problem, *that* is the problem that would need to be addressed head on (rather than "ameliorated" by allowing new entrants to charge termination rates in excess of cost, or by preventing mobile operators from recovering their efficiently incurred costs in proving termination services).

100. Thirdly, and as Ofcom itself notes, off net prices are, in fact, converging with on net prices, and there appears to be little difference between the two, in practice[54].

101. Finally, the extent to which an operator experiences a net outflow of traffic is a function of its commercial decisions (ie is an endogenous factor). For example, it may choose to attract customers that make more calls than they receive (in which case, the operator might experience a net outflow of traffic), or it may choose to attract customers that receive more calls than they make (in which case, the operator might experience a net inflow of traffic). This is a commercial decision for the operator; it is not bound to follow any particular strategy. [✂]

102. This raises a related point: regrettably, Ofcom does not appear to have considered the position of MVNOs in the consultation document. This is unfortunate because, as Ofcom reports in the recent mobile sector assessment consultation document, MVNOs can stimulate innovation in the mobile market[55]. It seems to O2 that

[54] See paragraph 6.108.3
[55] See paragraph 4.39 of Most Mobile: http://www.ofcom.org.uk/consult/condocs/msa/msa.pdf

any policy shift in respect of mobile termination rates that was harmful to MVNOs is likely to be bad for consumers.

103. In summary, then, lower termination rates might be commercially more attractive to some smaller providers, but not to others. It is certainly not a generalisation that can be made.

104. In O2's view, it is important to bear in mind that termination rates are regulated to allow providers to cover their reasonably incurred costs in providing termination services. They are not a "bounty"[56] to be used to fund retail activities. A proper appreciation of this reveals the problem with H3G's position: if it chooses to attract customers that make more calls than they receive, it ought to be prepared to meet the reasonably incurred costs that *other* operators face in terminating those calls. Otherwise it would be free-riding on the investment of other mobile operators. O2 is emphatically of the view that termination rates should not be regulated to complement H3G's commercial strategy – that would amount to the tail wagging the dog, and would be entirely inconsistent with the regulatory regime.

105. We also note the argument that BT seeks to make about termination rates being set above incremental costs. Presumably, BT believes that the LRIC+ methodology permits mobile operators to levy charges in excess of their reasonably incurred cost. However, as Ofcom notes, BT's regulated charges are also set using the LRIC+ approach (or an analogous approach). O2 presumes that BT believes that its charges are, therefore, too high and that BT will be reducing them in mindful, as it will be, of its dominant position.

106. BT also argues that technological improvements allow operators to terminate calls at a lower cost. That is essentially a question of fact, not principle. It seems to O2 that whether or not that assertion is true is a matter that Ofcom is well placed to determine in the market review. For now, O2 would observe that regulation should provide an incentive on operators to become more efficient, such efficiency savings being passed to consumers through competition and, if appropriate, through a reduction in subsequent regulated charges, in precisely the same way that such innovations affect the charge controls of BT – on 21CN for example.

[56] As suggested in paragraph 6.108.5

The impact of low termination rates on different customer groups

107. Ofcom has asserted that a reduction in termination rates will, in general, be good for consumers because it would lead to lower call usage charges[57]. As we note, above, Ofcom draws mainly on international comparisons to reach this conclusion.

108. However, it has not considered in great detail what would happen in the UK market if termination rates are reduced to below cost. In O2's view, Ofcom would need to consider this in some depth in order to draw any firm conclusion.

109. [✂]

110. [✂]

111. [✂]

112. [✂]

113. [✂]

114. In conclusion, O2 believes that if operators were not permitted to recover their reasonably incurred costs in terminating calls, low usage customers are almost certainly

57 See paragraph 6.35

to be worse off, either paying more or leaving the market altogether. Again, it is difficult to quantify the number of mobile customers who would leave the market, but Ofcom's research has indicated that over 5½m existing pre-pay customers would not use mobiles if they faced charges to receive calls. Earlier Ofcom research estimated that 7.7m pre-pay customers do not make outgoing calls[58]; it remains to be seen whether the industry could continue to offer these customers a service, in circumstances where the main source of revenue – termination charges for incoming calls to such customers – was reduced. This is entirely consistent with one of the few robust findings in the research that Ofcom has commissioned. In Annex 7 of the consultation document, CEG reports that:

> the results on the **take-up** of mobile services, measured as the number of SIM cards per capita, provide the most consistent set of results of this study. We find that the take-up of SIM cards will tend to be higher, (i) the higher the level of MTRs and (ii) if a country has adopted a CPNP regime rather than a B&K regime.

115. The implication is clear: there is substantial evidence that if termination rates are reduced, consumers currently using mobile phones will no longer do so. Ofcom suggests that other arrangements could be made for these customers, such as a social tariff. We discuss this later in this response.

116. In addition to low user customers, we consider that it is likely that medium usage customers and some high usage customers are also likely to be worse off, since they are likely to face higher monthly bills, as mobile providers seek to make good the lost voice call termination revenue. This is at odds with Ofcom's preliminary view, that only low usage customers would be worse off.

[58] See page 334 of The Communications Market, Part 5 Telecoms: http://www.ofcom.org.uk/research/cm/cmr08/telecoms/telecoms.pdf

Investment

117. Ofcom says that if termination rates were reduced, the impact of investment is difficult to estimate, but that regulators in countries with low or zero termination rates do not report problems with levels of investment.

118. O2 believes that a reduction in termination rates is bound to have an impact on investment. In Mostly Mobile[59], Ofcom recognises the relationship between net revenues and investment. If termination revenues fall, it must be assumed that that there will be a knock-on effect on investment (to the extent that termination revenues cannot be replaced by other revenue streams).

119. Ofcom's interpretation of other regulators' comments on investment levels needs to be informed by the facts. For example, coverage levels in the US are significantly lower than in the UK and other European countries[60]. Lower coverage levels might not be regarded as a problem for Americans by the FCC, but, in Mostly Mobile, Ofcom expressed its desire to increase coverage beyond its currently high levels[61].

120. Finally, Ofcom has recognised the important role it has to play in providing a stable and predictable regulatory regime in which investment may be made:

> *"We believe that the best contribution we can make to timely and efficient investment in the mobile market continues to be to promote competition and ensure that any regulation we impose does not hinder or delay investment. We also recognise the important role regulatory certainty has for investment decisions in a sector with long investment horizons"* [62].

121. O2 is firmly of the view that preventing operators from recovering their efficiently incurred costs in providing wholesale termination services runs counter to this aspiration. Advocates of amending the regulatory regime to this effect, to reduce their cost base, after years of investment made by the mobile operators, might be regarded as *ex post* opportunists rather than self-styled "mavericks".

[59] In section 5, see: http://www.ofcom.org.uk/consult/condocs/msa/msa.pdf
[60] See figure 39 in Mostly Mobile: http://www.ofcom.org.uk/consult/condocs/msa/msa.pdf
[61] See section 8 of Mostly Mobile: http://www.ofcom.org.uk/consult/condocs/msa/msa.pdf
[62] See paragraph 5.7 of Mostly Mobile: http://www.ofcom.org.uk/consult/condocs/msa/msa.pdf

Welfare analysis

122. In analysing the effects of different methodological approaches in regulating termination rates, O2 believes that Ofcom should undertake a welfare analysis. The model used by Ofcom to arrive at its 2007 decision is, in O2's view, unlikely to be appropriate for this task, because it was designed to evaluate whether termination rates should be regulated at all. It was highly sensitive to changes in a number of key parameters, and some of the simplifying assumptions, such as the use of a single demand curve for mobile telephony, are unlikely to capture some of the key effects in the market that may arise from a change in approach.

123. One of the key issues that would need to be modelled is the distributional impact of a change in regime. Ofcom has reached the preliminary view that low users are likely to e adversely affected by a reduction in termination rates, whereas high usage customers would benefit. An important consideration is whether an analysis of welfare would need to weight the gains and losses of the various groups differently. There are at least two reasons why this approach would be desirable:

1. Ofcom's statutory duty to have regard to the needs of low income consumers[63]. To the extent that low users are predominantly on pre-pay tariffs and that low income consumers mainly use pre-pay low[64], Ofcom will want to consider weighing potential welfare losses to this group more highly. This is particularly the case given that almost a quarter (24%) of the lowest income households rely on mobile for their communications needs[65]; and

2. The well established economic principle of the diminishing marginal utility of money suggests that the welfare loss a low income user experiences in being charged £1 more for his mobile service is greater than the welfare gained owing to a similar reduction in price for a high income consumer.

124. In the consultation Ofcom appears rather sanguine about what it views as the likely adverse impact on low income consumers[66]. In our view, it is not Ofcom's role to support (without evidential or legal basis) such a detrimental self-serving position put forward by some fixed operators and one mobile operator. The marginal impact of price increases will be felt most keenly by those least able to afford them – Ofcom cannot act as the anti-Robin Hood and maintain the confidence of consumers going forwards.

[63] S 3(4)(i) Of the Communications Act refers
[64] Which, is the case, according to Ofcom; see paragraph 4.55 of Mobile citizens, mobile consumers: http://www.ofcom.org.uk/consult/condocs/msa08/msa.pdf
[65] See Figure 30 in the Consumer Experience Research Report: http://www.ofcom.org.uk/research/tce/ce08/research.pdf
[66] Paragraph 6.49 refers

Other issues

Unwanted and nuisance calls

125. Ofcom acknowledges that, in circumstances where the cost of calls to mobiles are reduced, there may be a problem with unwanted and nuisance calls. Ofcom suggests that the solution to this is to review the enforcement of the Telephone Preference Service[67].

126. It seems to O2 that, in practice, the majority of mobile customers would want to retain their privacy and not be contacted[68], so would register with the Telephone Preference Service. The TPS, and its customers, would need to be able to be able to cope with, and fund, a vastly expanded list of numbers. Ofcom does not appear to have considered the cost of expanding the scheme in this way.

Social tariffs

127. Ofcom's preliminary view is that low users might be worse off if termination rates were reduced. It speculates whether a social mandatory tariff might be the best vehicle to address any problems in take up that might arise.

128. As we noted above, if mobile operators are not able to recover their reasonably incurred costs through wholesale termination charges, charges for receiving calls at the retail level might need to be introduced, to recover the resulting shortfall and prevent any arbitrage opportunity that effectively "free rides" on mobile networks. The evidence available today, obtained by Ofcom's own research and international comparison analysis commissioned by Ofcom suggests that several million customers might decide to stop using mobile services. Ofcom therefore needs to be sure that a mandatory social tariff is capable of plugging the gap.

129. O2 awaits Ofcom's detailed proposals with interest. In the meantime, we make the following observations:

1. Mobile services do not form part of a UK Universal Services Order, and nor are they likely to, as the Commission has said recently that it does not intend to extend the scope of the Universal Services Directive to mobile, because there is no concern about affordability:

> ***"Conclusion****: This latest analysis reaffirms the conclusion in the first review that the competitive provision of mobile communications in the EU has resulted in consumers already having widespread affordable access*

[67] See paragraphs 6.51 – 6.52
[68] The recent experience with the Connectivity 118800 service supports this view

to mobile communications. The considerations for including mobile communications within the scope of universal service (as set out in Annex V of the Directive) are therefore not fulfilled." [69]

2. Unlike fixed services, customers attach great importance to mobile handsets themselves. Any mandatory social tariff scheme would therefore need to take account of this; any tariff offering an undesirable handset is unlikely to be successful and O2 doubts that Ofcom is sufficiently well resourced to specify, source and support a "people's handset". In addition, there would need to be monitoring of end users in order to ensure that a secondary market did not emerge in commercially subsidised handsets using "the people's tariff";

3. Ensuring that only those that qualify for a mobile social tariff will be a consideration. For example, 40% of customers that used BT's Light User Scheme were thought not to satisfy the eligibility criteria[70]. Similarly, part of the rationale for the Competition Commission's rejection of the network externality surcharge was a concern about targeting only marginal customers[71]

[69] See page 5 of http://ec.europa.eu/information_society/policy/ecomm/doc/library/communications_reports/universal_service/572_final_en.pdf

[70] See: http://www.guardian.co.uk/money/2007/jun/10/internetphonesbroadband.observercashsection

[71] Or "leakage", in the language of the report. See paragraph 4.168 of the Competition Commission's report: http://www.catribunal.org.uk/files/CC_Determination_1083_H3G_1085_BT_220109.pdf

Conclusion

130. O2 is strongly of the view that the objective of regulating mobile voice call termination should remain to mimic the competitive market, by ensuring that charges are cost based and include an appropriate allowance for fixed and common costs. We believe that this is consistent with regulatory law and sound economic analysis. Accordingly, if termination markets are found not to be effectively competitive, and charge controls, proportionate, then they should be based on the LRIC+ methodology.

131. If, however, in the face of legal and economic arguments, Ofcom's position is that termination rates *are* a legitimate policy tool to foster innovation in retail markets, then it should model the effect of the various approaches for mobile termination rates set out in the consultation document, decide what is the "right" level of retail price innovation, and which approach is most likely to lead to the desired outcome, whilst also taking into account the possible effects on other prices, modelling the impact on welfare resulting from any distributional effects, take up of mobile services, the design of any mobile social tariff, investment, etc.

132. O2 looks forward to this analysis, which should meet the appropriate threshold of being able to withstand "profound and rigorous scrutiny"[72].

[72] See paragraphs 35 – 49 of the judgment at http://www.catribunal.org.uk/documents/Judgment_1094_180908.pdf

Annex

Answers to specific questions raised in the consultation document

Question 3.1: Do you agree with our preliminary view on market definition? Has anything changed, or is anything likely to change within the period of the next review, which would materially impact on the definition of the market(s)?

Ofcom discusses the possibility of mobile calls being delivered via cheaper means than existing GSM and UMTS networks, eg through the use of femtocells[73]. [✂]
Indeed, O2 understands that only one mobile operator has launched femtocells to date.

An important consideration for the period under review is the emergence of new providers. Ofcom has previously defined markets in terms of termination services offered by individual operators. If this continues to be the case, then new mobile providers will enjoy a 100% market share. Ofcom should include the new operators in its market review.

Question 5.1: What are likely to be the main sources of detriment to consumers of excessive termination rates in the period 2011 to 2015?

Ofcom needs to be clear about what it is seeking to achieve by regulating termination rates. The traditional role of a regulator is to set charge controls in to mimic competitive prices, where competition is not effective. LRIC+ is best suited to achieve this.

Ofcom should not prevent operators from recovering their reasonably incurred costs in supplying termination services, to try and fix some perceived problem in fixed and mobile retail markets. This would lead to an inefficient set of prices and outputs, which would not be in consumers' interests. Furthermore, the available evidence suggests that there is no problem in mobile retail markets, and, to the extent that there is in fixed, it is not one that lower mobile termination rates would solve.

[73] See paragraphs 3.24 – 3.25

Question 6.1: Should our policy approach to regulating MCT change? For example, given the possible benefits, should we adopt a policy of reducing termination rates as far and fast as we reasonably can, within the boundaries of sound economic policy, and whilst recognising underlying cost differences? If our policy approach did change, what do you think are the relevant factors for us to consider in deciding on the best future policy to regulating MCT?

The answer to this question is an emphatic: "no". Should mobile operators be found to have smp and charge controls deemed an appropriate remedy, operators should be allowed to recover their reasonably incurred costs, including an allowance for fixed and common costs.

Further to our response to Question 5.1, we believe that any other approach other than LRIC+ would not be consistent with European and domestic law.

Question 6.2: Are there additional options (other than the six set out in this consultation) that we should consider? If so what are they and what advantages/disadvantages do they offer?

In O2's view, if Ofcom determines that termination markets are not effectively competitive, and that charge controls are proportionate, these should be based on the LRIC+ methodology.

Question 6.3: Do you agree with our preliminary views set out for each of the options? If not, what are the additional factors that we should take into consideration, and why are the relevant to our analysis?

Ofcom states that the economic case for and against each of the options is mixed, both in theory and in evidence. O2 disagrees; in its view, only LRIC+ is theoretically sound, because it seeks to mimic prices in competitive markets. It is a key part of the regulatory environment that has provided for a vibrant competitive market, to the benefit of consumers.

Question 6.4: Do you agree with our preliminary view of the De-regulatory option? If not, what are the additional factors that we should take into consideration, and why are the relevant to our analysis?

Under the regulatory framework, Ofcom is required to determine whether the recommended markets are effectively competitive and, if not, whether charge controls are appropriate. These legal obligations would seem to constrain Ofcom's approach.

Question 6.5: Do you agree with our preliminary view of the LRIC+ option? If not, what are the additional factors that we should take into consideration, and why are the relevant to our analysis?

Ofcom has painted an overly negative picture of LRIC+, citing three "limitations":

1. "the reduction of pricing flexibility imposed by LRIC+ on mobile network operators". O2 takes this to refer to the "price floor" argument. However, as Ofcom has found, mobile off net retail prices have actually fallen and are now substantially similar to on-net prices. Fixed operators have chosen to keep retail calls to mobiles prices high, even when mobile termination rates have fallen. O2 does not seek to comment on the state of competition in fixed retail markets but, to the extent that there is a problem, there is no evidence to suggest that it could be solved by reducing mobile termination rates below cost;

2. "risk of regulatory error (setting LRIC+ price controls is subject to some uncertainty)". O2 takes this to refer to the need to exercise some judgement in estimating long term demand and allocating fixed and common costs. However, regulators are required to exercise judgement – that is their job. As long as they do so within the bounds of the law and good regulatory practice, O2 sees no problem here. Furthermore, judgement would need to be exercised in order to implement many of the other options; and

3. "the regulatory burden imposed on stakeholders". O2 takes this as a reference to the various appeals that previous decisions have spawned. However, a key part of the regulatory regime is the ability to appeal decisions. If decisions are sound, appeals fail. Furthermore, there is no reason to believe that the other options would be less contentious. Indeed, given the likelihood that they would result in regulated charges below costs, there is every reason to believe that they would be more so.

Ofcom also says that LRIC+ assumes that there are no call externalities. O2 disagrees with this assertion. In the past, LRIC+ based charge controls have diverged from costs, on the basis of externalities. The issue in the present consultation is whether, in fact, call externalities (and other externalities) actually exist, and the extent to which are internalised. Charge controls, based on LRIC+, can be set, accordingly.

Ofcom also says that an assumption that rates set using LRIC+ will not lead to competitive distortions needs to be considered. In O2's view, distortions would be introduced if LRIC+ was abandoned, since charges would no longer be cost oriented. This would result in inefficient prices and output levels, which would operate against consumers' overall interest.

It is important to note that none of the above constitutes a new development. They were all present when Ofcom previously set charge controls, using a LRIC+ methodology. It is difficult to see why any of them would justify a departure from this approach, now.

The only new factor that Ofcom refers to is "service convergence and technological developments". Ofcom is not terribly clear what Ofcom means by this but, for the record, expects that the [✂]. O2 believes that new developments do not, in themselves, justify abandoning LRIC+, but, instead, would need to be incorporated into the cost model and/or considered as potential adjustments.

Question 6.6: Do you agree with our preliminary view of the LRMC option? If not, what are the additional factors that we should take into consideration, and why are they relevant to our analysis? In addition what do you expect the costs of a move to this option to be?

Ofcom has neglected to refer to its own comments on the Commission's proposed use of LRMC[74]. We agree with the theoretical problems that Ofcom and BERR identified in that paper. In particular, LRMC would prevent operators from recovering an element of fixed and common costs in termination fees. This flies in the face of economic theory and previous charge controls. Charges would be set below the competitive level, leading to an inefficient set of prices and outputs.

Question 6.7: Do you agree with our preliminary view of the CBC option? If not, what are the additional factors that we should take into consideration, and why are they relevant to our analysis? In addition what do you expect the costs of a move to this option to be?

The fundamental problem with capacity based charging is that it would set the incremental price for termination at a very low level. However, most of the costs that operators incur in terminating calls are, as Ofcom points out, proportionate to the volume

[74] See: http://www.ofcom.org.uk/telecoms/ioi/eutermination/annex.pdf

of traffic. Accordingly, it is likely to result in an inefficiently large volume of calls to mobile operators.

O2 does agree with Ofcom, however, when it says that CBC would be difficult to implement in practice. In our view, it should be left to operators to decide, commercially, whether or not to introduce this *method* of wholesale charging (we acknowledge the point made by Ofcom, that it would still be required to determine the *level* of charges).

Question 6.8: Do you agree with our preliminary view on mandated Reciprocity? If not, what are the additional factors that we should take into consideration, and why are they relevant to our analysis? In addition what do you expect the costs of a move to this option to be?

Question 6.9: Do you agree with our preliminary view of the B&K option? If not, what are the additional factors that we should take into consideration, and why are they relevant to our analysis? In addition what do you expect the costs of a move to this option to be?

O2 objects to both of these proposed approaches, on the basis that they are not cost oriented and, thus, essentially, arbitrary. They would result in economically inefficient prices and output levels, which would not be in consumers' interests. In our view, neither approach would be consistent with European and domestic law on a number of grounds (set out in more detail in our response).

On a specific points raised, Ofcom suggests that mandated reciprocity might be appropriate if the technology used to provide fixed and mobile services may become increasingly similar over the next few years, citing "possible widespread femtocell deployment". However, Ofcom has presented no evidence on this at all. For O2's part, currently, we see femtocells as a niche product only, and we are firmly of the view that the vast majority of traffic will continue to be handled by conventional GSM and UMTS networks.

Ofcom sees call externalities as the main rationale for adopting bill and keep, yet presents no evidence for their existence (and, in fact, presents consumer research inconsistent with the idea). Call externalities were not an issue at all when the 2007 charge controls were formulated, which begs the question: what's changed?