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Consumer Policy
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14 May 2008

Dear Sarah,

Ofcom review of additional charges

I have pleasure in attaching Hutchison 3G UK Ltd's ("3") response to Ofcom's review additional charges.

3 would be happy to meet to discuss our submission prior to Ofcom issuing final guidance. In the meantime please do not hesitate to contact me if you have any questions or points of clarification.

Yours sincerely,

Julie Minns
Head of Regulatory and Public Policy



Ofcom review of additional charges

Response by Hutchison 3G UK Ltd (“3”)

1. 3 was the UK's first 3G network offering national coverage for calls and texts, and has over 90% population coverage for 3G services. As we consolidate our radio access network with T-Mobile we expect to reach almost complete UK population coverage for 3G by the end of 2008. 3 has over 3 million active customers in the UK and over 16 million worldwide.
2. 3 was licensed by the UK government in 2000 specifically to stimulate competition in the mobile market. Since launch 3 has successfully delivered new and innovative products and services, and challenged established tariff and pricing models to deliver greater value to the mobile consumer.

Policy

3. 3 shares Ofcom's wish to ensure consumers are able to make informed choices that enables them to get the value that arises as a result of a high degree of competition. However we do not believe the development of policy to achieve this necessitated the use of Ofcom's section 135 (S135) powers.
4. Ofcom's S135 powers should, under the Communications Act 2003 (“The Act”) be reserved for instances where Ofcom believes there to be non-compliance with a General Condition or where Ofcom intends to carry out a market review. In both instances the request should be proportionate to the uses to which the information is to be put. The original S135 did not state that it was Ofcom's intention to use the information gathered to draft guidance on the Unfair Terms in Consumer Contracts Regulations 1999 (the ‘Regulations’). 3 therefore strongly questions how the original information was proportionate to the purpose, namely to publish guidance, when guidance on the Regulations exists already.
5. Furthermore 3 is concerned by the apparent inconsistency in Ofcom's interpretation of the Regulations. Ofcom examined 3's Minimum Contract Periods (MCP) and Early Termination Fees (ETF) in early 2006 as part of an investigation into 3's customer terms under the regulations. Ofcom concluded the 2006 investigation following a number of amendments being made to 3's customer terms which were specifically agreed with Ofcom, including terms relating to MCP/ETFs. We would therefore welcome clarification as to what has changed – given the regulations have not – that has resulted in Ofcom now proposing significant changes to the application MCP/ETF when the undertakings



required of 3 in 2006 did not include undertakings that would be required were Ofcom to raise an enquiry following the publication of the guidance. In addition, a number of other terms in 3's customer terms were, during the investigation by Ofcom in 2006, alleged to be unfair and potentially causing consumer harm. As part of 3's response to Ofcom's investigation, 3 prepared a document highlighting similar terms in competitor customer contracts to those which Ofcom alleged were unfair in 3's customer terms and requested that Ofcom deal in a consistent manner with all competitor terms so as to avoid the consumer harm that Ofcom had alleged was caused by such terms given that all of 3's competitors have larger customer bases which would result in even greater consumer harm being caused by such terms due to the sheer number of consumer subject to such terms in competitor customer contracts. It is disappointing that Ofcom has once again chosen to ignore such terms in competitor contracts when drafting its guidance for the communications industry.

6. 3 questions why the draft guidance goes further than the requirements of advertising regulation in relation to the promotion and marketing of mobile contracts, for example, A5.39 of the draft guidance proposes a form of words to be used in marketing material.
7. During the course of the consultation period the Office of Fair Trading (OFT) published a discussion paper titled 'Interactions between competition and consumer policy'¹. 3 welcome the discussion paper and trusts that Ofcom will consider the paper before publishing a final statement. In particular 3 would ask that Ofcom consider the following and address these points when issuing a final statement;
 - *"if consumers are over-protected in their market transactions, 'moral hazard' may ensue and they may not pay sufficient attention to making the best choices"* and that *"consumers may not develop the market skills to defend themselves against future exploitative conduct"*, further that *"excessive 'consumer' protection' may be inimical to the development of market skills in consumers"*
 - Finally, and of particular relevance given the focus in the consultation on the distributional effects of additional charges, the OFT paper concludes that *"some of the more interventionist consumer policies are explicitly aimed at benefiting vulnerable consumers at the expense of sophisticated consumers. It would be worthwhile to investigate if there is indeed a valid role for redistribution via consumer policy"*.

¹ OFT Economic discussion paper April 2008



8. It is unclear from the consultation whether Ofcom has considered the proposals against the recommendations of the report by the Better Regulation Executive and National Consumer Council².
 - Recommendation 5 of this report suggests that "*Government and consumer groups to work in partnership to develop a scheme to incentivise policy-makers and business to provide innovative approaches to communicating with consumers*". As a communications provider 3 would be happy to discuss with Ofcom how customers can effectively receive and access relevant information and is disappointed that, rather than explore this, Ofcom is proposing to issue guidance prescribing best practice as to how communications providers communicate information to their customers.
 - Recommendation 6 of the same report suggests that "*All significant future regulated information provision requirements should be tested in a semi-final format with consumers before implementation*". Whilst Ofcom has carried out substantial research as part of the review, it is unclear whether the good practice identified in the guidance has been tested with consumers to see whether it is suitable or appropriate. For example the guidance suggests that in order for non DD, late payment charges, MCPs and itemised bill charges, to be regarded as core terms they would have to be displayed with equal prominence in all marketing and promotional material, as this would then enable the consumer to make an informed choice. 3 would welcome clarification from Ofcom as to whether this assumption has or is to be tested with consumers prior to Ofcom issuing a final statement.

9. Impact assessment

Section 2.61 of the consultation states that no impact assessment is required as Ofcom is not proposing to introduce new policy. However, the consultation then goes on to explain why guidance is regarded as necessary by referencing "Ofcom's policy perspective" and describes the proposal at times as a "regulatory intervention". For example in 3.117 the consultation states "*We do not expect that this intervention will have a big impact on a supplier's decision to offer either a full range of payment methods*", and 4.39 the consultation is more explicit stating "*without regulatory intervention, therefore, it is possible that one group of consumers.....will end up subsidising consumers more generally, causing consumer harm to those consumers who incur the charges*". It is therefore 3's view that the consultation is a policy decision by Ofcom and the failure to by Ofcom to undertake an impact assessment places it

² Warning: Too much information can harm. Better Regulation Executive & National Consumer Council report. November 2007.



in breach of its duties under Part 1 section 7 of the Communications Act 2003 ("the Act").

Furthermore part 1 Section 7 of the Act requires that Ofcom undertake an Impact Assessment where it expects its actions "*to have a significant impact on persons carrying on businesses in the markets for any of the services, facilities, apparatus or directories in relation to which OFCOM have functions; or to have a significant impact on the general public in the United Kingdom*". 5.67 of the consultation states that "*Ofcom accepts that any intervention to reduce the level of ETCs may give rise to suppliers reviewing other charges (such as upfront charges or monthly payments)*". Such a review would clearly have a significant impact on both suppliers and consumers and as such an impact assessment is required under the Act.

Evidence

- 10.3 are also concerned by the robustness of some of the research underpinning the recommendations in the consultation. For example;
- 3.86 of the consultation suggests that there is a poor awareness of non-direct debit charges amongst consumers. However Ofcom's own research found that 62% of customers were aware of these charges either prior to or at the time they signed their contract. Given that almost two thirds of mobile customers are aware it is difficult to understand how Ofcom conclude there is "*poor awareness of non direct debit charges*"³.
 - 3 are also concerned by some of the consumer based research that underpins the recommendations. For example 3.22 states that only 10% of consumers felt it was fair to charge more for non DD payments. In effect the question being asked is "do you think you should pay more money" to which the answer from most people is usually 'no', to use this as evidence that the charge is unfair is not a robust approach for an evidence based regulator such as Ofcom.
 - Ofcom cites the disproportionate impact that additional charges may have on low income consumers as evidence of the need for Ofcom to issue guidance. However Ofcom also acknowledges that for some additional charges (itemised billing for example) the availability of Pay as you go mobile contracts means some additional charges are relatively unimportant for low income consumers⁴. In fact, the majority of the additional charges reviewed by Ofcom (non-DD charges, itemised billing charges, late payment charges, minimum contract period, ETC & cease charges) do not impact Pay As You Go customer at all. This means that Pay As You Go does present a real

³ Ofcom review of additional charges section 3.86

⁴ Ofcom review of additional charges section 8.38



alternative for consumers who does not wish to be subject to the additional charges (including consumers on low incomes) particularly given that, under 3's current Pay As You Go service (Flat12), Pay As You Go customers pay the same rates for calls/texts as 3's contract customers on our Mix&Match contract plans.

11. Section 8.17 of the consultation suggests that "*those consumers on low incomes who do have mobile phone contracts may be more affected by these charges than those on higher incomes as they may be less likely to have access to on-line billing alternatives*". This is incorrect. All 3 customers have free access to on-line billing information via their handset on My 3. Therefore for 3 customers no distributional effect arises as a result of 3 charging for itemised paper bills. In addition, the fact that a consumer is on a low income, does not necessarily automatically preclude them from having a bank account or being able to manage their own budget and elect payment methods and whether they pay on the due date shown on the bills.
12. A5.3 of the draft guidance states that "*Ofcom believes that sector-specific guidance on a limited range of such issues will benefit suppliers..... services that it regulates*". However no evidence is provided to substantiate this statement. 3 believe that sufficient guidance is already available to suppliers and does not agree that sector specific guidance is required. Should Ofcom decide to proceed to issue guidance 3 would like to understand how Ofcom believe it will benefit suppliers. In addition, 3 would also like to understand why such guidance should be sector specific given that many of the additional charges (such as non-DD charges, late payment charges etc) are seen in a number of different sectors (such as utilities, finance/banking) and, if such charges cause consumer harm as alleged by Ofcom due to them being classed as potential unfair terms, this would de facto mean that consumer harm is occurring across a number of sectors, not just the communications industry and should therefore be dealt with by the OFT so that there is a consistent approach in relation to such charges.

Unfair Terms in Consumer Contracts Regulations 1999

13. Whilst we understand that Ofcom wishes to give guidance on its proposed approach towards assessing the fairness of terms under the Regulations to provide clarity, we do have a number of comments in relation to Ofcom's interpretation of the Regulations and the proposed guidance which are set out in paragraphs 14 to 17 below.
14. Ofcom's categorisation of subsequent MCPs as being a non-core term is not correct, particularly in the course of a handset upgrade being offered. Ofcom states (at para A5.77) that it believes it is unrealistic to



expect a reasonable consumer to consider the trigger for a subsequent minimum term to be part of the main subject matter of the contract. 3 does not agree with this as, the ability to upgrade a handset is often one of the most important considerations for consumers and therefore, consumers do not enter into a contract with just the initial fixed term in mind, but also the subsequent conditions that apply to handset upgrades such as a subsequent MCP. As such, we believe that the subsequent MCP should also be viewed as a core term as it will be one of the most important terms for consumers in the course of a handset upgrade and does form part of the main subject matter of the handset upgrade.

15. There are elements of the draft guidance (e.g. the guidance on when an itemised billing charge can be considered “core” – para A5.97) that appear to suggest that core terms must define the main goods and service being provided AND the price for these. This is not what is required under the Regulations and exceeds the requirements of the Regulations, as Regulation 6(2)(a) and 6(2)(b) are not conjunctive – this point was considered and accepted by the High Court in *The OFT –v- Abbey National plc and others* [2008] EWHC 875 (Comm – para 344). As such, the draft guidance should be amended.
16. The draft guidance is incorrect in relation to its interpretation of the core terms being in plain intelligible language as meaning that, not only does the term have to be transparent and prominent, but that it should be given the prominence and transparency which reflects its importance to the consumer. Whilst communications providers will assess the importance of a term to an average or atypical consumer when choosing how to satisfy the transparency/prominence requirements in relation to core terms, it is neither reasonable nor practicable to expect communications providers to make an assessment as to the importance to the consumers on a case-by-case basis as individual consumers may interpret the importance of terms differently. Provided reasonably sufficient notice of contractual conditions is given to consumers (in accordance with both the Regulations and common law requirements relating to standard form contracts) to ensure that the transparency/prominence requirements are met, this should suffice.
17. Ofcom’s “fairness” assessment of non-core terms (such as non-DD charges, late payment charges and payment failure charges) and the elements required to be met in order to demonstrate fairness is not correct in its conclusion that only direct costs can (as a rule) be included in such charges. The amount/magnitude of the charges is not specifically addressed in the Regulations (save only in Schedule 2(1)(e) which is a secondary obligation only), which means that it is not automatically unfair to have a term imposing charges which are higher than direct costs. In *The OFT –v- Abbey National plc and others* [2008]



EWHC 875, the High Court acknowledged that the Regulations “stop short of intruding upon parties’ freedom of contract to the extent of introducing a mechanism of quality or price control” (para 26). As a result, it is not correct for the guidance to suggest that only direct costs can be included in such charges when assessing the fairness of non-core terms relating to such charges. The correct position is that a case-by-case analysis of the terms/charges in question should be undertaken in relation to the individual communications providers’ terms in order to assess fairness of non-core terms imposing such additional charges.

Early termination fees

18. Section 5 of the Consultation sets out Ofcom’s proposed approach (and potential guidance) towards assessing the fairness of Early Termination Fees (ETFs). 3 consider that the proposed approach is: flawed; based on fundamental misunderstandings about the relevant costs and how competition works; and would lead to greater competition distortions within the mobile sector.

19. Ofcom’s approach is conceptually flawed

Ofcom’s broad approach, of stating that the fairness of ETFs should be assessed in terms of the minimum contractual payments outstanding minus variable and appropriate shared network costs, is divorced from the commercial reality of competition in retail mobile markets. 3 welcome the recognition in the Consultation that operators should be able to recover the costs of subsidising handsets through minimum contractual terms and the associated contractual payments. However, Ofcom’s proposed approach fails to recognise that, in practice, operators will assess the profitability of individual customers over their “lifecycle” as a customer. The recovery of customer acquisition costs (which include any handset subsidy) is assessed over the whole minimum contract term. This is an economically efficient approach which benefits customers by effectively spreading expensive up front costs over the period of the minimum contract.

20. Confidential

21. Ofcom’s approach to core network costs is flawed

Section 5 of the Consultation also sets out a proposed approach to treatment of what are termed “core network costs” in calculating any cost “savings” to be taken into account in setting fair ETFs. 3 consider that the approach to these specific costs is also fundamentally erroneous, even if the broad overall approach is considered appropriate (which 3 considers is not the case as set out in the previous subsection).

Ofcom’s broad approach is to use a costing methodology to identify network costs not incurred which should be subtracted from outstanding minimum contractual payments. Ofcom explicitly suggests using the so



called “Long run incremental cost” (“LRIC”) model used by Ofcom to set the appropriate level of call termination charge controls in the mobile sector. This approach is inappropriate for a range of reasons.

- 3 considers that the LRIC approach is conceptually no longer an appropriate way to assess costs in the mobile sector. It effectively converts what are fixed and common costs into per minute costs on an essentially arbitrary basis. As Ofcom is well aware, this approach is currently being appealed by both BT and 3 on different grounds. It would therefore be an extremely unsafe basis on which to base any guidance on ETFs at least until these appeals are resolved.
- 3’s primary case in its own appeal on mobile call termination rates is that such rates should be reduced significantly (ideally to zero) to avoid competitive distortions and that costs are therefore recovered from retail charges. Were 3 to prevail on this point, it is not clear how the proposals in the Consultation would be enacted. Would Ofcom continue to maintain the LRIC model solely for the purpose of assessing the fairness of ETFs? How would the modelling approach be adjusted to take account of the radically different way in which operators would then recover costs? Even if 3 does not prevail on this aspect of its appeal, it is not clear (and the Consultation provides no justification for) why a long run network cost model which is concerned with the recovery of costs over timescales measured in decades is an appropriate methodology for assessing costs saved in particular months.
- Quite apart from those on-going appeals, the LRIC basis is conceptually an inappropriate basis on which to judge whether any costs are supposedly “saved”. Allocating a portion of fixed and common costs to savings from losing individual customers, on the basis that this frees up capacity to provide service to other customers, is misconceived. It assumes that all networks are at capacity and at scale. 3 are not yet at scale. Therefore it has spare capacity and there is no sense in which losing one customer frees up capacity which can be used to provide service to another. Rather, 3’s fixed and common costs do not change at all, but simply need to be recovered from all remaining customers. Ofcom’s proposed approach will therefore have the effect of requiring 3 to increase prices to all customers to ensure that it can recover these costs from the totality of customers (given the risk the approach would introduce that some costs will never be recovered from customers leaving the network before their minimum contract term expires). It is misconceived and distortionary to assert that a network operator “saves” any costs when a customer leaves. This is not the reality, and in practice, total network costs will not be reduced or in any real



sense will the associated network resources be made available for use by another customer.

- The use of the LRIC model, which 3 considers is flawed, would lead to the counter intuitive result that, if more total costs are allocated to per minute termination charges, then a smaller amount of total costs would be recoverable when a customer leaves the network before the minimum contract term expires. 3 consider, for example, that an appropriate proportion of customer acquisition costs should be recovered from call termination. This is a matter before the Competition Commission currently. Were 3 to prevail on this point, this would increase the amount of costs which 3 was able to recover from call termination per minute charges (assuming Ofcom's basic framework for setting mobile termination rates is also confirmed by the current appeal processes). Under the proposals in the Consultation, this would lead to a lower amount being recovered from ETFs. There is no economic logic to this approach however. This would mean that the level of ETFs would mean that operators no longer recover a fair portion of total costs from customers who end their contract before the minimum term. The rather mechanistic approach which Ofcom is proposing fails to understand the basic cost recovery motivation and logic behind its own cost model.
22. Ofcom's approach is discriminatory and harms competition
- As well as being conceptually flawed, Ofcom's proposed approach would be discriminatory and harmful of competition in the mobile retail sector. For the reasons explained above, Ofcom's approach penalises operators which are sub-scale (by erroneously assuming that all networks are at capacity). 3 cannot save costs by having a smaller network because of:
- the commercial imperative to have competitive coverage;
 - the commercial imperative to minimise the amount of national roaming for which it needs to pay (as 3 considers that these rates have not been set in fully competitive environment and have not been subject to regulatory scrutiny); and
 - the regulatory requirement to maintain network coverage over 80% of the UK population enshrined in its 3G spectrum licence.
- 3 therefore has no choice but to remain more sub-scale than its competitors for at least the medium term. 3 would therefore be more adversely affected by the proposals than the four incumbent mobile network operators. By not taking account of 3's different circumstances, the proposals in the Consultation directly discriminate against 3.



Further, 3 suffers from an imbalance of incoming to outgoing traffic. 3 considers that this imbalance is caused by a number of regulatory and structural barriers in the retail mobile sector including the UK's poor mobile number portability solution and the structural competitive issues caused by the interaction of Ofcom's approach to mobile termination rates and retail on/off net price discrimination. There is a significant body of independent economic literature and regulatory precedent in other European member states which agrees with 3's analysis. As a result, the approach set out in the Consultation will lead to 3 would mechanically lead to 3 having to reduce its ETFs by a greater amount than its competitors, for reasons over which 3 has no control. By not taking account of the different commercial and regulatory impacts on 3, the proposals will have greater adverse impact on 3 and therefore be discriminatory.

The result of these effects is that 3 would be required to have smaller ETFs than its direct competitors on a like for like basis. Given the large amounts of fixed and common costs in the industry (and the fact that the proposals will not allow, in many circumstances, the total amount of handset subsidy to be recovered for the reasons set out above) this will lead to 3 having to increase its prices to its customers in general in order to ensure it makes a fair return on its total investment. This in turn will make 3 less competitive than the incumbent mobile network operators. First, such an effect would reduce competition in the wider retail mobile markets as 3 plays an important catalyst role in promoting competition in the sector.⁵ Second, by making 3 less competitive compared to its rivals, this will reduce the rate at which 3 can acquire customers and therefore mean that 3 is subscale for a longer period. This will therefore create a regulatory downward spiral as the approach proposed in the Consultation would then further penalise 3 for being even more sub-scale. This makes the proposed guidance untenable, disproportionate and counter to Ofcom's statutory duties.

23. Ofcom should take account of wider competitive picture

Taking the issues set out in this section of this response together, 3 strongly believes that Ofcom cannot institute the guidance it proposes in relation to the mobile sector until the wider competitive problems in that sector have been resolved. Greater competitive impacts and long term customer harm result from the distortions which are caused by the current inadequate mobile number portability solution and by the effect of mobile call termination rates which are significantly above marginal cost (and at the same time do not ensure that all operators are able to recover their efficiently incurred costs). Both of these issues are still to

⁵ Ofcom will be aware of why 3 considers this is the case through the evidence and research submitted as part of its appeal process of Ofcom's decision on mobile termination rate charge controls. Ofcom is referred to that work in this context.



be resolved and both are the subject of on-going appeals to the Competition Appeal Tribunal. Ofcom should not institute the proposed changes, which will exacerbate these wider problems, until these wider issues are resolved.

Not only would the approach in the Consultation make the existing distortions worse, but it would also risk becoming obsolete depending on how the relevant appeals are resolved. Ofcom must wait for the outcome of those appeals before addressing what guidance is appropriate in relation to the mobile sector on fair ETFs.

As Ofcom's own consumer research demonstrates, awareness of minimum contract terms is wide-spread in relation to mobile contracts and the level of consumer complaints on this issue in relation to the mobile sector is low. Much of the advertising in the sector explicitly refers to such terms and consumers are aware that pricing is set on this basis. It makes no sense that consumers should be assumed to consider that such terms can be broken without penalty. In addition, where the consumer is terminating their agreement with 3 due to an alleged failure by 3 to provide an adequate level of service in relation to its network services, the consumer would allege a breach of the agreement by 3 due to a failure to provide services (in accordance with their rights under the Supply of Goods and Services Act 1983) and, as such, would not pay the ETC where this was the reason for termination of the contract before the expiry of the MCP or subsequent MCP – so consumers are already provided with appropriate protection. As such, it is not clear that, in relation to the mobile sector, the consumer harm which Ofcom purports to have identified is not significantly outweighed by the competitive costs and distortions which would arise from Ofcom's proposals.



Responses to consultation questions

Question 1: Do you agree that it is helpful and appropriate for Ofcom to issue guidance on the application of the Regulations to consumer contracts for communications services?

No. As explained in point 11 above, 3 does not consider that Ofcom has provided sufficient justification for issuing sector specific guidance.

Question 2: Do you agree with Ofcom's proposed guidance regarding core terms and transparency?

Not entirely, please see comments under "Unfair Terms in Consumer Contracts Regulations 1999" section of our response.

Question 3: Do you agree with Ofcom's proposed guidance (including any administrative thresholds we have set) on non-core terms to which we apply the test of fairness?

Again, not entirely, please see comments under "Unfair Terms in Consumer Contracts Regulations 1999" section of our response.

Question 4: Are there any other issues that are covered by the Regulations which Ofcom should give guidance on?

3 do not believe it is necessary for Ofcom to be issuing any guidance on the regulations.

Question 5: Do you agree that three months is an appropriate period during which suppliers can adjust their terms and marketing practices to ensure they are in line with Ofcom guidance?

In the absence of an impact assessment it is difficult to assess on what basis Ofcom judged three months to be an appropriate period in which suppliers could adjust their terms and conditions. If Ofcom decides to proceed with introducing guidance then 3 consider a minimum of six months would be required to ensure a revision of all terms, a review of all marketing materials, an assessment of charges/costs and appropriate briefings to retail channels.