Tesco Mobile

Response to Ofcom consultation

Wholesale mobile voice call termination

Preliminary consultation on future regulation

Submitted : 29 July 2009

Introduction

This document sets out Tesco Mobile's response to the proposals contained in Ofcom's consultation document, *'Wholesale mobile voice call termination'*, published 20th May 2009.

Tesco Mobile is a telecoms service provider. Tesco Mobile offers customers a prepaid and, more recently, postpaid mobile services. Tesco Mobile operates as a mobile virtual network operator (MVNO) on the O2 network.

Tesco Mobile delivers high levels of customer satisfaction. A recent Which? Magazine survey published in May 2009 found that Tesco Mobile was the favourite mobile operator for prepay mobile services, with customers nominating the network for services including its wide handset range, affordable tariffs and exceptional customer service.

In June 2009 Tesco Mobile won the Credit Crunch Award at the Mobile Industry Awards for the brand's Triple Your Credit tariff. The award was for the company that had delivered best value to customers in the current economic climate, and was judged on three criteria - most outstanding value, value that resonates with customers, and clear communication.

Tesco Mobile is now the seventh largest mobile operator in the UK.

Key points

Tesco Mobile believes that reducing mobile call termination charges below long run incremental costs will have a significant impact on the structure of the UK mobile market and in particular on certain groups of customers. Changing where common costs may be recovered will have implications for pricing structures.

As Tesco Mobile is a MVNO it has no detailed knowledge of the cost of running the technical aspects of a mobile network. Tesco Mobile can not comment on the long run incremental or long run marginal cost models that Ofcom proposes to produce. It can though consider the impact of changing revenues from terminating calls on Tesco Mobile's overall business plan.

Tesco Mobile is still predominantly focussed on serving the prepay market. This aspect gives it particular insights into the needs of customers who find prepay attractive. Such customers value the ability to remain in charge of their mobile expenditure. There are many such customers who use a mobile sparingly and are not in a position or do not wish to commit to larger monthly subscriptions.

From a demographic point of view we can expect that the less well off in society will be strongly represented in the prepay customer base. Although such customers make careful use of the mobile, research indicates that a mobile phone is in many cases the only form of telecommunications that they will have.

Customers with low usage have specific calling patterns. It has been asserted by some that new entrant mobile operators will have more outgoing calls than incoming calls. In other words, there is a net payment by the new entrant to other operators. This is not Tesco Mobile's experience. Rather we find that the ratio of outgoing to incoming calls is dependent upon customer usage. Customers who make frequent use of a mobile phone will initiate more calls than they receive. Conversely customers who use the mobile phone infrequently will on average receive as many calls as they make, and in some cases will receive more calls than they make.

Mobile operators who have chosen a high spending customer segment, typically on a pay monthly contract, are indeed likely to have a net outflow of calls. But this effect is nothing to do with being a new entrant. Ofcom should consider carefully the impacts on customer segment rather than this spurious impact on new entrants.

As mobile termination charges reduce there will be a need to rebalance call tariffs for retail customers, that is, some retail charges will have to increase. Should outgoing call charges increase in order to recover the lost incoming revenue there would be a tendency to encourage customers to explore their opportunities to arbitrage the call prices.

Ofcom's consultation document minimises the effect of call arbitrage. We show that there are companies offering call arbitrage services in jurisdictions which are similar to the call structures that are proposed for the UK. The services work by substituting outgoing calls for incoming calls. The customer requests a incoming call which is connected through to the desired destination.

If call arbitrage becomes at all significant it will be necessary to put in place mitigation schemes. Such structures are common in the US where customers have to pay minimum daily charges or commit to monthly fees. We could expect something similar in the UK.

It is hard to explain the specific drivers for the lower penetration rate in the US compared to the UK. We do know that penetration in the UK grew rapidly with prepay specifically when competition led to the withdrawal of the equivalent of monthly fees. There is a likelihood that if monthly fees were to be reintroduced in some form for prepay customers, many of these people may decide that a mobile phone was no longer attractive.

Tesco Mobile is not in a position to forecast accurately the impact of changing mobile termination fees on low use prepay customers. There are though strong indicators that adverse effects would result.

Ofcom needs to consider carefully the impact of its proposals on all customers, and, most particularly, those who only have access to a mobile phone and who might consider stopping their use of this service. In a world where consideration is being made to encourage all citizens to have access to modern telecommunications it would be a retrograde step to move in the opposite direction for certain segments of our society.

Tesco Mobile sees that mobile voice call termination rates will decline in any case as data services continue to increase in popularity. The cost models will inevitably allocate more cost to data causing call termination rates to fall.

Ofcom should take the prudent approach of continuing with the current methodology rather than making a step change into an uncertain world which may well have adverse effects for less privileged customers.

Customer types

Tesco Mobile is mainly a prepay operator. Prepay services have been offered since 2003 whereas postpay has only been available from 2008. Currently Tesco Mobile serves a particular customer demographic which is primarily interested in the benefits that prepay can offer.

The annex provides details of customer numbers and revenue by value band, and an analysis of the customer profile.

Compared to the overall UK mix Tesco Mobile has an emphasis on the less well off household. This is an important customer segment which increasingly uses mobile as its main telecommunications service.

Ofcom has produced some value market research on the use of telecoms by different socio-economic groups. As the chart below shows 23% of DE customers only use a mobile. As demonstrated in the annex, these customers form an important part of Tesco Mobile's customer base.

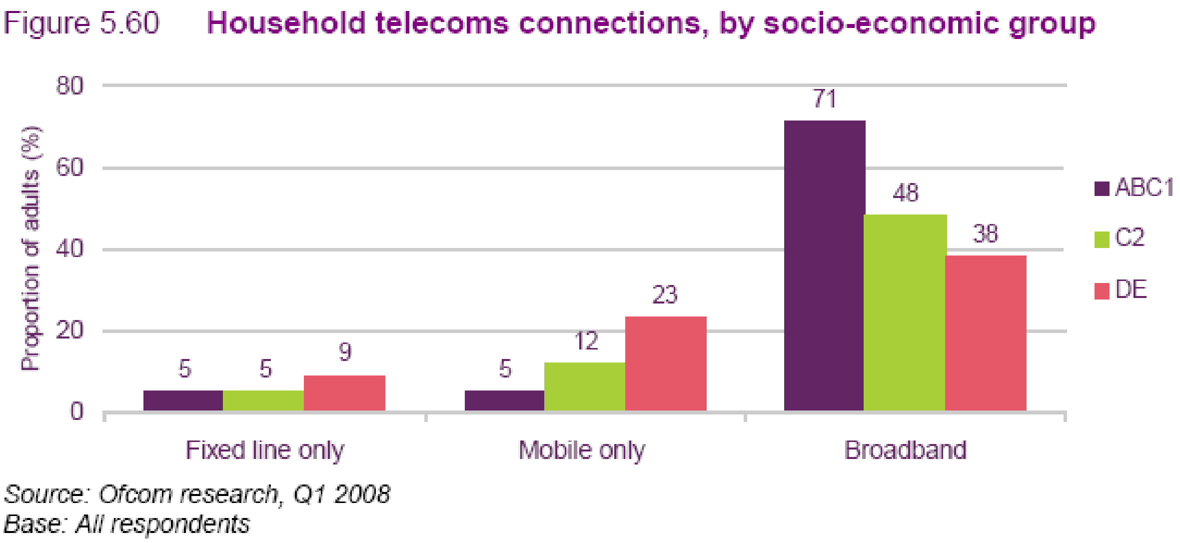

Figure 1 : Household telecoms by socio-economic group[1]

Ofcom in the same report also demonstrates that the use of mobile only is not caused by a lack of fixed infrastructure.

[1] Ofcom Communications Market Report August 2008

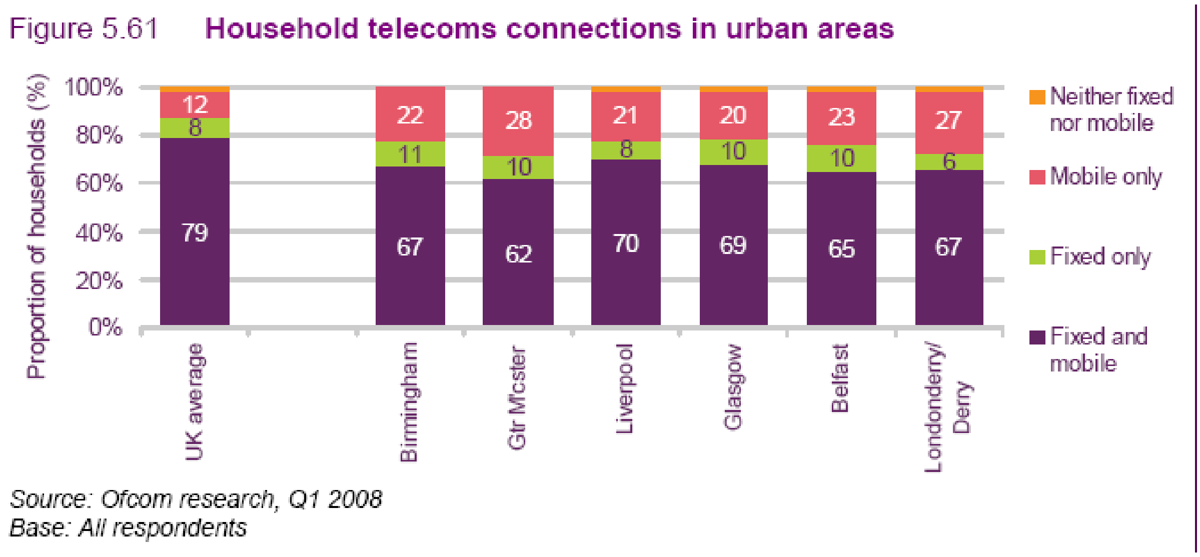

Figure 2 : Household telecoms connections in urban areas

Up to a quarter of households in some urban areas only use mobile. There can be no doubt that these households could have fixed service if they wished to. If we were able to look at the cross cut of the two charts above i.e. the proportion of socioeconomic group DE living in urban areas who only use a mobile we could expect to see a figure exceeding one third. This is a large group of people who have their own specific needs.

As Ofcom highlights in its recent Mobile Sector Assessment Second Consultation, it is increasingly important for all members of UK society to have access to telecoms.

> In the future, mobile devices will increasingly be used to receive content and applications, including access to public services, democratic opportunities (such as engaging with political candidates), health opportunities (such as receiving text reminders about appointments), and opportunities to engage with social networks. This will make access for all who want it even more important.[2]

Tesco Mobile plays an important part in serving customers who only have access through a mobile device.

[2] Ofcom Market Sector Assessment July 2009 Para 1.33

Customer calling behaviour

The European Commission and others have argued that new entrants have to deliver more traffic to other networks and thus suffer a net outpayment.[3] Tesco Mobile does not have this experience. The chart below provides the average number of calls outgoing and incoming for Tesco Mobile customers in different value bands.

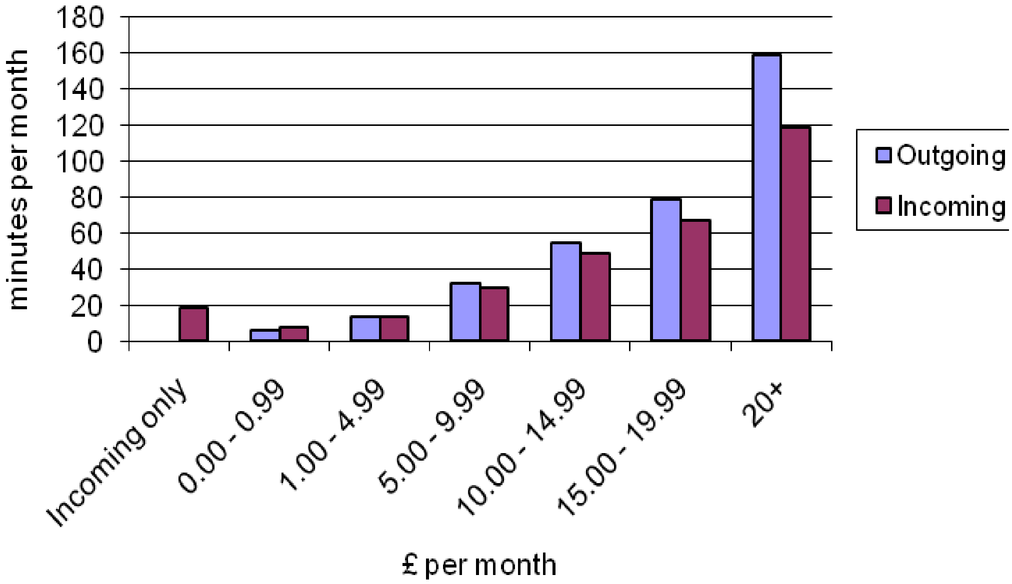

Figure 3 : Outgoing / Incoming calls per value band

It can be seen that for customers who spend more than £20 per month there is a greater number of outgoing calls than incoming. As the amount spent per month reduces the ratio of outgoing to incoming tends towards parity. For the lowest spending customers the ratio is reversed such that they receive more calls than they make.

There are customers who do not make any outgoing calls but receive a significant number.

[3] 'Late entrants argue that due to large traffic imbalances and on-net/off-net price differentiation they cannot compete effectively at the retail level. A large proportion of calls originated on late entrant networks is terminated on other networks, i.e. offnet. If new entrants pay a regulated termination charge in excess of actual costs they effectively give a transfer to the large network. As a result, their ability to offer retail rates comparable to the retail rates of an established operator, which terminates a majority of its calls on-net, is impeded.' Para 2.2 Draft explanatory note published 2008

Regulatory options

Tesco Mobile agrees with Ofcom's assessment that mobile termination charges will continue to decrease. It sees no prospect of taking the deregulatory approach at this time.

Financial impact

Tesco Mobile is not in a position to comment on detailed network costings as it does not run its own mobile network. We can not calculate the actual numbers that are likely to apply under long run incremental costs or long run marginal costs.

It is though possible to estimate the possible outcomes for the different scenarios that Ofcom presents in its consultation document. We have considered the financial impact of a range of mobile termination rates from the current charge to zero. As Tesco Mobile pays out for call termination as well as receiving termination charges we have calculated the net impact.

Details are provided in the annex.

As the termination charges reduce Tesco Mobile has a noticeable reduction in its earnings before interest and tax. It is not possible to sustain such a reduction in contribution without making up for the shortfall in revenue by other means.

Options

Tesco Mobile has a small market share compared to the major mobile operators. Tesco Mobile can not shape the market by itself. Any moves to redistribute revenues i.e. to make structural price changes, would need to be done in the light of changes in the overall competitive market.

Options which would be available to all operators include the following.

a) Reduce the handset subsidy. Customers would have to pay closer to the full retail price of a new handset. It would mean that the new fully functioned handsets would be available for those willing to pay. Customers on more limited means would have to restrict themselves to basic mobile devices.

b) Increase outgoing charges. It is not desirable to increase outgoing prices. As outgoing prices increase relative to calls from fixed phones to mobiles the risk of price arbitrage increases. We explore the arbitrage options in more detail below.

c) Charge for incoming calls. This is standard practice in those countries which have low termination charges for mobile calls. Customers are charged for each minute. This would be a major change for UK customers who are unlikely to welcome the move. For postpay customers with large bundles of minutes there may be limited impact. For prepay customers who see their credit reducing as someone else has called them there will be dismay.

d) Require a minimum monthly spend. This is similarly common practice in the United States. For customers who have already committed to a postpay contract there would be no effect. On the other hand for prepay customers, who appreciate the control on their finances that prepay provides, an automatic deduction each month regardless of how much the phone has been used would be off-putting. A substantial number of Tesco Mobile's low end customers would end up paying more money.

e) Require a minimum daily amount when the mobile is used for outgoing or incoming calls. A typical approach would be to charge a minimum, say £1 a day, for each day that the phone is used whether for making or receiving a call. For customers making a number of calls there would be no impact. For those making or receiving the odd call there would be a substantial increase in charge. The infrequent call would become expensive.

Call arbitrage

Calls can be established from a mobile to a fixed destination or from a fixed destination to a mobile. Once set up the call is identical for the two users apart from who is paying for the call. The price in either direction may well be different.

As mobile termination charges are reduced the price of an outgoing call from a mobile becomes relatively more expensive. If rebalancing of revenues is required then the differential can widen further. In this situation it becomes more attractive to substitute an outgoing call for an incoming call.

Various callback mechanisms have existed for many years. With international calls, callback was instrumental in reducing the high charges that had previously existed. Customers would ring a given number which would automatically ring them back. The customer would then enter the required international destination number and make the call at a lower price.

Callback would be technically straightforward to establish with mobile phones. In Canada Yo-Ho Communications[4] and Axagen Telecom[5] offer call back services specifically for mobiles. (In this context the comment in the Analysys Mason report prepared on behalf of Ofcom that 'regulatory staff did not consider there to be any arbitrage opportunities currently being exploited' is a little strange.) In Singapore Pfingo Bounce offers callback service.[6]

Tesco Mobile is of course in favour of lower priced calls but not when these calls can be priced at artificially low levels. Should some form of long run marginal cost be instituted for the pricing of mobile termination, none of the network and business overheads can be recovered from an incoming call. Where a customer receives a preponderance of incoming calls or indeed only incoming calls the service is financially unsustainable for the mobile operator.

In the United States low mobile termination charges have always been standard practice. To avoid callback problems mobile operators charge for incoming calls, have minimum daily charges, and have vouchers which expire after a certain period.

It is likely in the UK situation that similar methods would need to deployed should callback become prevalent.

Tesco Mobile agrees with Ofcom that charging for incoming calls would be unpopular with customers. The importance of callback arbitrage is that it may necessitate this very step which all parties agree is unpalatable. Where inbound calling becomes the predominant service and no one is making payments to recover common costs, i.e. the move from LRIC+ to LRMC, the service becomes commercially untenable.

[4] http://en.yohocanada.com/index.php?option=com_content&task=view&id=13&Itemid=28

[5] http://www.axagentelecom.com/addon-services/mobile-call-back.php

[6] http://www.pfingobounce.com/portal/index.php

Customer impact

Should those customers who receive more calls than they make become commercially less attractive, there will inevitably be a focus of acquisition activity away from low spending customers to pay monthly and guaranteed income customers.

In 1999 prepay customer numbers suddenly increased dramatically. Prepay had been available in the previous two or three years but had been accompanied by vouchers which had automatic expiry dates i.e. any unused credit expired after 30 or 90 days. Competitive pressures in 1999 caused voucher expiry to disappear and there was a rapid growth in prepay attractiveness. As indicated below customer numbers have continued to increase ever since.

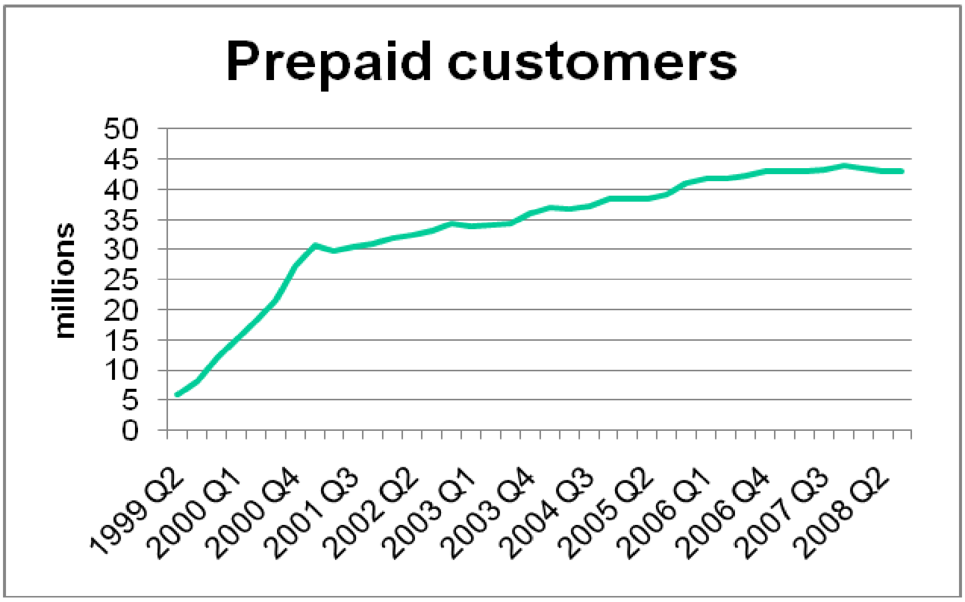

Figure 4 : Prepaid customers - Source Ofcom market data

Putting restrictions back into the use of prepay will not encourage prepay use. It will make the service less attractive particularly to low usage customers.

In the US penetration is now approaching 90%.[7] The UK has a penetration of over 120%. There will be many reasons for this difference in penetration levels, but a key reason could well be the popularity of prepay in the UK where prepay has never been significant in the US.

We note that the CEG paper sponsored by Ofcom[8] reports a positive relationship between the level of MTRs and the number of SIMs in the population. Reducing MTRs in a step jump could lead to a negative impact on penetration.

Affluent subscribers in the UK will continue to make extensive use of mobiles. Low end prepay use could decline which may well reduce penetration levels.

[7] 274 million customers in June 2009 in a population of 306 million – 89.5%

[8] Wholesale Termination Regime, Termination Charge Levels And Mobile Industry Performance 20 April 2009

Regulatory impact assessment

Ofcom commented on the European Commission's proposals on mobile termination charges. Ofcom's views are very similar to Tesco Mobile's.

> A likely source of additional cost recovery for operators includes higher subscription charges. One of the expected benefits of lower termination rates at the wholesale level is the anticipation that this will lead to lower call prices at the retail level. Indeed, some consumers might well be willing to pay more for subscription in return for lower call charges. However, this scenario may favour high-usage customers, because their aggregate call charge savings are likely be higher and may therefore offset increased subscription charges. Low-usage customers in this scenario might be relatively worse off, because their aggregate call charge savings are likely to be small relative to the increased subscription charge. In our view it would be helpful for the Commission to consider:
>
> - the direct welfare implications for low-usage customers who potentially face a subscription price increase that they might not be able to afford; and
> - the welfare implications for the market as a whole if higher subscription prices result in some marginal subscribers giving up their telephony subscription.[9]

It is unfortunate that the European Commission appears not to have heeded Ofcom's request for a detailed consideration of the welfare implications of the Commission's proposals. The need for this assessment is still valid.

Tesco Mobile encourages Ofcom to carry out its own welfare assessment of the proposals on mobile termination. There are strong indications that reducing mobile termination charges in a radical manner could have unwanted consequences for the more disadvantaged in our society.

There will be some consumers who will benefit from reduced mobile termination charges. Conversely there will be some citizens who are likely to have their access to mobile services constrained. Ofcom with its duties to both citizens and consumers needs to weigh the balance of these two opposing forces.

Ofcom should also consider in more detail whether callback arbitrage is likely to commence. These mechanisms had powerful effects in international calling and may require operators to introduce adverse charging mechanisms to protect the viability of the service they are offering.

We note Ofcom's proposals that broader consumer protection measures may be required in parallel with changes to the termination regime. Should these measures be required they must be in place before the termination changes are made. Introducing protective measures once harm has occurred will not ameliorate the situation. A precautionary principle should be employed.

[9] Para 3.14 Ofcom technical annex to BERR Ofcom comments on the draft Commission Recommendation on the regulatory treatment of fixed and mobile termination rates in the EU – 10 September 2008

Conclusion

Tesco Mobile accepts that mobile voice termination charges will continue to decline as data services become an increasing component of mobile usage. Such a decline will happen with the existing long run incremental cost models.

Changing from LRIC+ to some form of long run marginal cost will reduce termination charges yet further. To recover common costs, charges on retail prices will have to increase or some form of regular subscription charged. It is likely that such a move will have adverse consequences for low end prepaid users.

With mobile termination charges falling in any case it would be better to stay with the existing methodologies. This will enable the competitive markets to adjust dynamically and in a controlled manner to the changes in one revenue stream. A radical change which may have undesirable effects should be undertaken with caution.

Ofcom should prepare a detailed welfare assessment of the different proposals. If Tesco Mobile may have information which might assist in this analysis it would be pleased to be helpful.

Regulation of mobile termination charges should not hinder the progress towards access and inclusion which is being made elsewhere by Ofcom and others.