**OFCOM'S NARROWBAND MARKET REVIEW – CONSULTATION ON POSSIBLE APPROACHES TO COST MODELLING FOR THE NETWORK CHARGE CONTROL FOR THE PERIOD 2013-2016**

**RESPONSE BY BSKYB ("SKY")**

## Introduction

1. Ofcom is consulting on possible approaches to the next Network Charge Control ("NCC") should such a remedy be imposed upon BT subsequent to a significant market power ("SMP") finding during the forthcoming narrowband market review. The NCC caps BT's wholesale prices for fixed call termination and fixed call origination. BT's call termination rate is the *de facto* rate at which other operators charge for fixed geographic call termination on their networks. There are three key elements to Ofcom's proposed approach:

    a) Call termination charges should be set by reference to pure long run incremental costs ("pure LRIC") only (no common cost recovery). Sky does not support this approach;

    b) Costs should be based upon those of the modern equivalent asset ("MEA") i.e. a Next Generation Network ("NGN"). Sky supports this approach; and

    c) Use of a "bottom up" NGN cost model with its implied technology, scale and topology assumptions. Sky considers that Ofcom should base this model on BT's actual wholesale market shares[1].

## Setting call termination charges by reference to pure LRIC has no sound economic basis

2. While acknowledging that Ofcom is merely following EC guidance[2], there does not appear to be a sound economic basis for adopting a pure LRIC approach to setting call termination charges.

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[1] Sky intends to respond in more detail to aspects of this third element once it has compiled further technical and cost data as part of its response to the s.135 Request for Information which will be finalised later in November.

[2] *EC Recommendation on the regulatory treatment of fixed and mobile termination rates in the EU,* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF

3. Although, in principle, any level of common cost mark up could be efficient, in this case it is implausible that no mark up at all will result in efficient call termination prices. This is because, for no common cost mark up to be allocatively efficient, retail demand for call termination would have to be very elastic (which it is not) and significantly more so than other services that share the same common costs (which it is not).

4. The pure LRIC approach would be a departure from Ofcom's typical and established approach to charge controls where it set prices by reference to Fully Allocated Costs ("FAC"). A FAC based approach can strike the right balance in the trade-off between the risk of excessive pricing as a result of the exercise of market power and allowing SMP services to make significant, efficient contributions to common costs. Even where there are charge controls that require the aggregate prices of services within a basket to reflect the aggregate FAC of these services, the prices of individual services within that basket are often bounded additionally through a cost orientation condition in order to prevent prices merely reflecting incremental costs.

5. Other than Ofcom's legal duty to take the *utmost account* of the EC's recommendation, Sky is not aware of any other compelling argument or exceptional circumstances that would warrant a deviation from this tried and tested approach.

6. In fact, adopting pure LRIC for call termination is likely to be distortionary because it would result in other services making greater contributions to common costs than may be economically efficient. The presence of SMP and the incentive to set excessive prices do not mean that it is inefficient to recover <u>some</u> common costs through call termination charges. On the contrary, in the case of call termination, it is likely to be inefficient for it to make no contribution to common costs.

7. Moreover, in mobile markets, where Ofcom has previously applied the pure LRIC approach to termination rates, the other services which would be required to make increased common cost contributions are subject to strong competition from equally sized market players. Therefore, mobile operators have an incentive to minimise these costs. However, in the case of fixed line networks, the other services likely to make additional common cost contributions are not all subject to strong competition.

8. BT has been found to have SMP in several other wholesale markets where its regulated prices may have to make greater contributions to common costs in the future as a result of these proposals. Not only could all those services make further contributions to group-wide common costs such as corporate overheads but a subset of these services that also share common infrastructure with call termination could make additional contributions to some intra group common costs as well. Here, SMP services such as call origination (which shares ducts with call termination) would have to bear more of these costs as well as corporate overheads.

9. In addition to the potential inefficiency of recovering relatively more common cost from these other services, a further issue arises because the resulting increase (or relative increase) in BT's call origination prices would not represent an increase in

BT's costs (it would represent merely a reallocation in common costs from call termination) but it will raise incremental costs for its wholesale call origination customers. This could distort competition in downstream retail markets and may not lead to a reduction in overall retail prices (as the same level of common cost is recovered through wholesale charges).

**An MEA approach based upon NGN costs is correct but Ofcom also needs to align (i) its guidance of fair and reasonable termination charges and (ii) its view of appropriate porting conveyance charges to reflect this policy**

10. For the reasons outlined in its response to the 2009 NCC consultation, Sky agrees that Ofcom should adopt an MEA approach based on the costs of an NGN. In its response, Sky explained why it thought that the previous anchor pricing approach would act as a disincentive to the adoption by BT of more efficient NGN technology[3] and that, as a result, consumers would pay higher prices. Sky also considers that Ofcom's guidance on *Fair and reasonable charges for fixed geographic call termination*[4] (27 April 2011) perpetuates this disincentive[5].

11. Therefore, in addition to adopting a MEA approach, Ofcom's guidance on fair and reasonable charges for fixed geographic call termination also needs to change. This current guidance breaks with the long held "reciprocity" arrangements and, as a result, has allowed BT to introduce lower termination payments to operators like Sky (who interconnect with BT at the tandem layer and not at its local exchanges) while maintaining higher charges when selling call termination to those operators. Sky estimates that it will earn ✂ (annualised) less as a result of the introduction of lower Sky termination rates. This has resulted in Sky being disadvantaged relative to locally interconnected operators even though the EC and Ofcom both accept that it would be inefficient for an NGN operator to invest in local interconnection.

12. On the contrary, it is clear that the efficient network model for call termination is one that is based upon an NGN with fewer, more centralised points of (IP to IP) interconnection. Ofcom proposes 20 points of interconnection as the optimal number – even less than required today to achieve Single Tandem coverage and far fewer than the 655 possible points of local layer interconnection. Sky considers that the optimal number of points of interconnection nationally could be even lower than 20 but recognises that the proposed locations correspond to the established locations for wholesale bitstream interconnection with BT.

13. In Sky's view, Ofcom should change its guidance on termination charges immediately by making it clear that:

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3 §§19 – 24, *Ofcom Review of BT Network Charge Controls – Response by BSkyB*, June 2009, http://stakeholders.ofcom.org.uk/binaries/consultations/review_bt_ncc/responses/Sky.pdf

4 Ofcom, http://stakeholders.ofcom.org.uk/binaries/consultations/778516/statement/fair-reasonable-statement.pdf

5 For example, see §§3 – 6, *Response by British Sky Broadcasting Group Plc to Ofcom's Consultation Document "Fair And Reasonable Charges For Fixed Geographic Call Termination"*, November 2010, http://stakeholders.ofcom.org.uk/binaries/consultations/778516/responses/Sky.pdf

a) any operator wishing to interconnect via IP with BT at these 20 locations should be entitled to do so and to only pay local termination charges to BT;

b) BT should not be entitled to recover any interworking costs (should they arise); and

c) Nor should it be allowed to recover any subsequent conveyance costs that should properly be categorised as "local to tandem conveyance".

14. As part of the fixed narrowband market review and the NCC review itself, Sky agrees with Ofcom that any conversion costs should be borne by the TDM operator. Ofcom will also need to establish a price cap for IP interconnection circuits.

15. In Sky's view, as a result of adopting a MEA approach to the NCC, BT's Average Porting Conveyance Charge ("APCC") will also need to reduce. While the APCC is not formally part of the NCC, it is required to be cost oriented under General Condition 18. If it does not reduce to reflect only the NGN costs of porting conveyance (effectively the costs of conveying calls to ported numbers between any two of the twenty defined points of interconnection when required) and remained at its current level, then network operators would end up paying BT to receive geographic calls on their networks.

16. Sky has no choice whether to incur the APCC – it is a consequence of it winning telephony subscribers from BT who, given its large, but eroding, retail telephony subscriber base has most to gain from maintaining a high APCC. It is important for consumers to be able to switch telephony provider while retaining their telephone numbers should they wish and, as such, operators are obliged to offer this facility.

17. It would be inconsistent to set termination revenues by reference to pure LRIC and NGN costs while allowing the APCC, which is a cost of terminating calls to ported numbers that cannot be avoided by the terminating operator, to be set by reference TDM (and, possibly, even those of a hypothetical on-going TDM network) with a mark up for common costs.

## NGN BASED NCC MODELLING

18. As BT has not deployed fully a NGN, it is appropriate for Ofcom to adopt a "bottom up" approach to modelling the NGN based NCC[6].

19. However, the absence of BT-specific NGN cost data does not mean that there is not useful "real world" data that can be used as a basis for the NCC model. As Ofcom correctly identifies[7], both Sky and Talk Talk have deployed near-national NGNs

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[6] Even if BT had deployed a NGN for voice services, there may still be a case for a bottom up approach.

[7] §3.26, *Narrowband Market Review – Consultation on possible approaches to cost modelling for the Network Charge Control for the period 2013 – 2016,* 28 September 2013. http://stakeholders.ofcom.org.uk/binaries/consultations/narrow-band-market-review/summary/condoc.pdf

which are being used to supply fixed line voice services to millions of residential subscribers in the UK.

20. Sky will continue to provide to Ofcom information pertaining to its own NGN deployment and costs as required. As part of the process of compiling Sky's response to Ofcom's information request, Sky will be in a better position to make an informed response to the specifics of the NGN cost model proposed by Ofcom for the next NCC. Therefore, Sky intends to submit a short, additional response to the current consultation once it has completed its response to the latest information request (i.e. after 21 November 2012).

21. In the meantime, we offer the following high level observations on Ofcom's proposed modelling approach;

    a) Sky considers that the appropriate start date by which to assume the roll out of the NGN is c.2005. Ever since BT mooted its initial 21CN plans, it has been apparent that an efficient networking solution for the provision of voice services is one that is based upon an NGN. Subsequent deployment of NGNs by Sky and Talk Talk supports this view;

    b) Ofcom proposes, for the purpose of the NCC model, to assume a network which has a 25% market share. National Regulatory Authorities ("NRAs") that have adopted bottom up NGN based cost models to set call termination charges thus far have not settled on one method for scaling the size of the hypothetical NGN network. Given that BT's market share is much higher than this level, were it to have deployed fully a NGN it is likely that its unit costs would be lower than those produced by the model (due to scale economies). Ofcom may choose to model a market share that is more representative of BT's actual market share.

    c) Sky considers that the CSMG model[8] may introduce additional costs through over-engineering resilience / dual parenting, nodal gearing and interconnection topology. We will address these issues more fully in our second response which will be submitted once we have responded to the latest information request from Ofcom.

**Sky** **November 2012**

[8] *Fixed Narrowband Market Review: NGN Cost Modelling*, 27 September 2012, http://stakeholders.ofcom.org.uk/binaries/consultations/narrow-band-market-review/annexes/csmg.pdf