NARROWBAND MARKET REVIEW

RESPONSE BY COLT

1 Introduction

Colt welcomes the opportunity to respond to Ofcom's Narrowband Market Review. In this short response, rather than replying to Ofcom's specific questions, we comment only on the two major aspects of the decision that are of direct relevance to Colt. These are:

- Choice of "pure LRIC" as the basis for setting the FTR
- Timing of the introduction of the proposed charge controls

We of course recognise that the choice of pure LRIC is consistent with the applicable EC Recommendation, and further, that Ofcom favours symmetrical treatment of the fixed and mobile sectors. Nevertheless, due to the multiplicity of business models in the fixed sector (some based predominantly on inbound revenues, while others are based predominantly on outbound revenues), the choice of pure LRIC is prejudicial against some business models and in favour of others. We therefore suggest that the retention of LRIC+ approach remains a more equitable solution.

Secondly, these proposals as they currently stand will result in a dramatic and precipitous reduction in revenues. This translates to a substantial net-impact for businesses based which are primarily dependent on inbound revenues. On this basis, consistent with Ofcom's previous decisions, we would suggest a glide path approach in order to avoid the discontinuity and disruption that would result from the "cliff-edge" favoured by Ofcom.

We have no disagreement with the market definitions, or the SMP designations that Ofcom proposes.

2 Choice of Pure LRIC as the basis for setting the FTR

The choice of "pure LRIC" for the fixed market, notwithstanding its compatibility with the EC Recommendation, is prejudicial to the success or failure of different business models in a way that that regulation should never be.

Although Ofcom undoubtedly wishes to treat the fixed and mobile sectors symmetrically (namely by implementing pure LRIC), we believe it has not sufficiently considered the fact that the asymmetry in the practical impact. This is because the fixed sector incorporates a wide diversity of business models, many of which are linked to different services or applications. Some business models (call centres and conferencing for example) are based primarily on inbound services as a form of revenue while for others (over-the-top internet services for example) are predominantly outbound. The diversity in business models that exists in the fixed sector is in our opinion greater than that in the mobile sector, with the implication that there is a stronger scope for a material net impact. The "waterbed effect", is a dynamic that undoubtedly plays a part in the mobile sector due to the linkages between inbound and outbound services: changing termination rates affect incentives at the margin but has only a limited impact on revenues over time, because competitive dynamics depend more on ARPU than on the prices for individual services. This is not the case in the fixed sector, as some business models are based on only (or predominantly) outbound services while others are based on only (or predominantly) inbound. Furthermore, since the volume of mobile-to-fixed calls substantially exceeds the volume of fixed-to-mobile calls, the impact of pure-LRIC is asymmetric as between the two sectors.

The key here is to understand that each of the business models existing in the fixed sector is legitimate, value adding and serves a particular economic and/or social need. Yet each business model (whether predominantly inbound or outbound) uses shared assets. The application of pure LRIC involves in one case amounts to the inefficient arbitrage of shared costs, while in another, is likely to lead to stranded assets.

We would argue that a business that has invested capital should have an expectation that – at the very least – economic regulation will not prevent the recovery of efficiently incurred costs. Penalising carriers who have made investments in infrastructure designed to support a mostly inbound business model (UK based call and customer service centres for example), who as a result of this change will see a portion of their costs stranded, should never be the object or effect of regulation. By the same token, regulation should not have as its object or effect, the artificial subsidy and therefore, the potentially inefficient entry (or expansion), of internet based service providers who as a result of this change in regulation will be able to benefit from the existence of assets without making a full contribution to their costs.

2.1 Consistency with other regulatory decisions (particularly the BCMR)

It is worth noting that Ofcom extensively uses arguments based on inefficient arbitrage in order to justify its position on changes to regulation that it does not wish to enact. For example, in the recent BCMR, Ofcom chose to run counter to general European practice by denying UK business service providers access to passive infrastructure. It justified this position on the grounds that doing so would involve an inefficient arbitrage of BT's cost allocation model by allowing business service providers to "cherry pick" high value customers without making a full contribution to the shared costs of such infrastructure.

In the particular circumstances of the BCMR, we fundamentally disagree with Ofcom's position. We consider it to amount to "the regulatory tail wagging the market dog", a micromanaging of the market, and acting as a powerful blockage to much needed investment in infrastructure. However, our rationale for disagreeing with Ofcom's stance is not based on a lack of understanding or a full appreciation of the importance of the principle on which it is based; namely, the impact of regulatory arbitrage on market structure, competitive behaviour, entry conditions and dynamic efficiency. In the BCMR, we see the so-called arbitrage problem as primarily a cost allocation issue, and not a valid reason to deny the market a worthwhile entry platform in perpetuity.

It is curious – to say the least – that in one market, Ofcom declines to allow a market entry platform on the grounds of a putative arbitrage problem (which if material, could be solved through adjusting the cost allocation model), yet specifically seeks to introduce another form of arbitrage, which cannot be solved with any amount of cost reallocation.

3 Timing of the introduction of the proposed charge controls

If faced with such a precipitous change in economic conditions – particularly one that, as here, has a material impact on service providers' cash flows – we believe that Ofcom should allow the market time to adjust. As mentioned above, Ofcom's proposals will have a significant impact on operators whose business is net inbound, and thus, we consider that in line with Ofcom's previously stated policy, at the very least, it should propose a glide-path (say, three years).

We note that the use of glide paths is consistent with Ofcom policy, because inter alia, they avoid discontinuities and allow a smooth adjustment to the new prices. Glide paths have been extensively used in other contexts, for example, previous NCCs, MTRs and most recently, in the BCMR. In the most comparable market review – mobile termination – Ofcom adopted a glide path approach, so it would be reasonable to expect a similar approach in relation to FTRs.

As an example, in its NCC determination 15 September 2009, Ofcom stated (para 4.107) that its preferred approach is to "to align charges to FAC at the end of the NCC period using a glide path without an initial one- off adjustment". Ofcom explained the basis for its preference on grounds of improved efficiency incentives and consistency with previous decisions.

Furthermore, in the WLR and LLU consultation Draft Statement in February 2012, Ofcom stated (para 3.104), that:

> *"the benefit of the glide path approach is that it more closely approximates the workings of a competitive market in which excess profits tend to be gradually eroded as rivals improve their own efficiency (compared to one-off reductions). The glide path approach also avoids discontinuities in prices over time and leads to a more stable and predictable background against which investment and other decisions may be taken, by both suppliers and customers, in the telecoms market. We noted that this approach also has greater incentives for efficiency improvement compared to immediate adjustment of charges to CCA FAC levels as it allows the firm to retain the benefits of cost reductions made under a previous charge control for longer."*

In the BCMR statement, paragraphs 18.100-18.103 use similar wording:

> *The benefit of the glide path approach is that it approximates more closely to the workings of a competitive market than one-off reductions, where excess profits are gradually eroded as rivals improve their own efficiency. It also avoids discontinuities in prices over time and leads to a more stable and predictable background against which investment and other decisions may be taken, by both suppliers and customers.*
>
> *This approach also has greater incentives for efficiency as it allows the firm to retain the benefits of cost reductions made under a previous charge control for longer. This means that cost reductions feed into price reductions with an intentional regulatory lag. One-off*

adjustments to prices would reduce the effective regulatory lag, and hence the incentives to reduce costs.

Whilst the above discussions relate to one-off reduction to prices, one-off increases would similarly raise concerns about incentives for efficiency. Allowing a rapid rise in charges (i.e. via one-off price adjustments) would signal to BT that cost increases would quickly be followed by price rises. Therefore, if cost increases resulted in swift price increases this could reduce the incentive to control costs. Indeed, one-off adjustments upwards could create an expectation that other one-off adjustments – up or down – will be made in future, and this could also have adverse effects on incentives.

Given these clear statements in different but comparable contexts setting out Ofcom's preference for glide paths, we would strongly urge Ofcom to adopt a similar approach in this context.

This proposal by Ofcom presents dramatically different commercial conditions to the market. On this basis we would strongly suggest that the only equitable approach to implementation is via a glide path (say, 3 years).