KCOM Group PLC

Review of the fixed narrowband services market

Response by KCOM

2 April 2013

Introduction

KCOM welcomes the opportunity to respond to Ofcom's consultation on the fixed narrowband services market.

Although we do offer services outside of the Hull area through our businesses Kcom and Eclipse, our response to the Call for Inputs is focused on the services provided by KC in the Hull area. Rather than responding to each question posed in the consultation, we focus on a number of key areas which are of particular concern to our business.

In general we welcome Ofcom's proposals which will have the effect of significantly reducing the regulatory burden on our business in Hull. However, we do have a number of concerns about the impact which changes to fixed termination rates will have on our business. In summary:

- We are very supportive of the proposal to remove remaining retail level regulation in the fixed narrowband services market;
- We believe that a move to a "fair and reasonable" obligation in respect of geographic call termination rates is a pragmatic and proportionate approach;
- The market in Hull has unique characteristics which may justify KCOM setting rates which are above the benchmark rate;
- There is a need to implement the move to pure LRIC termination rates through a glidepath to avoid unintended negative effects and disruption for customers.

Retail Regulation

KCOM agrees with Ofcom's assessment that ex post competition law remedies are sufficient remedies for the retail narrowband market in the Hull area. We consider the current retail SMP conditions an outdated form of regulation that is an unnecessary burden given the wider regulatory and market context.

Competition law addresses the two key concerns over hypothetical incumbent behaviour in the Hull retail market. KCOM is prevented from excessive pricing causing consumer harm and we are prevented from pricing too low thereby foreclosing competitive entry. As Ofcom rightly identifies in Table 4.2, our pricing in Hull is competitive against the larger UK-wide providers. Indeed our internal customer usage statistics show that on average our residential customers pay less with KC than they would with the same line rental and calls usage on any of the largest residential CPs elsewhere in the UK[1]. On competitive entry, our retail-minus based wholesale products ensure that other providers can enter the Hull market with the ability to make an acceptable margin. In addition our wholesale SMP requirement to allow network access on reasonable request provides a proportionate remedy for any provider that may wish to enter the market making use of our network on a different basis. We would also note that in any event, complementary to the legal restrictions, we have strong commercial incentives to price in a way that would not otherwise raise competition law concerns.

Our internal compliance process takes account of competition law and all proposed pricing has to be signed off accordingly. We consider Ofcom's robust powers as a competition authority should give comfort to stakeholders in the Hull market upon lifting retail SMP obligations, as should the fact Ofcom has not to date had cause to open either a competition law or breach of SMP obligations investigation into KCOM.

KCOM considers that any additional flexibility we would have following the withdrawal of the retail SMP conditions in this market would have no impact on the potential for competitive entry in the Hull area. Where we think it will make a difference is in greater flexibility for KCOM to offer retail products in a similar way to the rest of the UK market and to the benefit of consumers, without being prevented or delayed from doing so through an unintended quirk of the regulation. Consequently, we strongly believe Ofcom's proposals can only benefit consumers and businesses in the Hull area.

In KCOM's response to the Call for Inputs and in a subsequent submission to Ofcom referenced in the consultation, we argued that least cost routing over ISDN and leased line services has an impact on our market share in the Hull business calls market. We also

[1] http://www.kc.co.uk/changes

argued that likely disproportional VoIP and mobile substitution in Hull also impacts our market share in both the residential and business markets.

While these arguments become somewhat academic in light of Ofcom's view that ex post competition remedies are sufficient, we continue to believe that they are valid. If it were necessary to explore these issues further, we believe that targeted consumer research in the Hull area[2] and a formal information request of MS3 Communications to build a greater understanding of the likely market developments in the coming three years would be appropriate.

Wholesale Regulation

In responding to this consultation our comments are focused on the regulation of KCOM in the Hull area and the general regulatory obligations which Ofcom is intending to impose. We make no comment on the approach to cost modelling which Ofcom has taken or the detail of the model itself. We will be considering the model further when reviewing our termination and origination rates as discussed below.

Approach to call termination and origination rates

KCOM understands the need for Ofcom to consider the EC Recommendation and the reasons for proposing the introduction of a pure LRIC approach to the calculation of fixed termination rates based on NGN costs. However, these proposals represent a significant change for our business. Currently, the calculation of fixed termination rates by KCOM for its business in the Hull area is carried out on a different basis than the calculation of fixed termination rates of other UK providers. Unlike BT, KCOM is not subject to a charge control and KCOM's termination rates within Hull are subject to a basis of charges obligation rather than the "fair and reasonable" obligation applied to the termination rates of other providers.

As such we are very concerned to ensure that any change in the basis of calculation does not impose a disproportionate burden on our business and enables us to recover our costs. As you are aware, KCOM has had extensive discussions with Ofcom in the past regarding the cost basis for our termination rates, the key driver for those discussions being to ensure that the imposition of a cost orientation obligation was proportionate and did not impose overly onerous obligations our business. In this regard, Ofcom has previously recognised the disproportionate burden that requiring a provider of KCOM's size to use a full LRIC

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[2] As we discussed in our answer to Question 4.2 in the our Fixed Access Market Review CFI response http://stakeholders.ofcom.org.uk/binaries/consultations/fixed-access-markets/responses/KCOM_Group_PLC.pdf

methodology would impose. As a result KCOM's termination rates are calculated using an agreed alternative to a full LRIC methodology.

We believe that Ofcom's proposal to impose a "fair and reasonable" obligation in respect of KCOM's call origination and termination rates is a pragmatic and proportionate solution, subject to the comments we make below with regard to what level a "fair and reasonable" rate might be given the distinctive characteristics of the market in Hull. In this respect it is absolutely essential that we should be able to recover our efficiently incurred costs. We also welcome the proposal to significantly reduce the regulatory burden by removing a number of other conditions which currently apply to call origination and termination.

A move to rates at the level proposed by Ofcom in the consultation is likely to have a significant negative impact on the ability of our business in Hull to recover its costs. There are two key reasons for this. Firstly, we have a substantial imbalance between incoming and outgoing geographic calls. Information which we provided to Ofcom in response to an s135 request prior to the consultation being published showed that in the 2011/12 FY we terminated approximately ✂ minutes to geographic numbers in Hull in respect of which we received a termination payment, while outgoing geographic minutes which we were required to pay termination in respect of totalled approximately ✂. In contrast in the same year we originated ✂ minutes of local traffic. More recent figures show that we continue to have this imbalance.

Secondly KCOM provides very low levels of external call origination to other CPs which means that any rebalancing of costs between termination and origination charges has a significant impact on our ability to recover costs. The figures we provided in our response to Ofcom's s135 notice requesting information about indirect access and our calls and access reseller products show that call origination provided externally amounts for less than ✂ of our total call origination.

We have carried out some calculations to assess the likely impact of the reduction in termination rates over the 3 year period of the charge control. These calculations have taken into account both outgoing and incoming termination minutes and external call origination provided to other CPs. Ofcom's base case would result in a revenue decrease of approximately ✂. We estimate the low case revenue impact to be circa ✂ and the high case impact to be ✂. Clearly there figures are significant at ✂% of our relevant revenue in the Hull area[3].

As a result we are extremely concerned about whether Ofcom's current proposed rates would enable KCOM to recover its costs. We have reviewed Ofcom's Guidance on Fair and

[3] Based on KCOM's 2011/12 RFS http://www.kcomplc.com/docs/regulatory-pdf/final_statements_2012.pdf

Reasonable Charges for Fixed Geographic Call Termination and the proposed updated guidance which Ofcom intends to issue at the end of the current consultation process. Prior to the 1 October 2013 implementation date we will be carrying out further analysis in order to establish:

- our efficiently incurred costs in respect of call termination;
- whether the proposed rates would enable recovery of those efficiently incurred costs; and
- whether charging a higher rate than the proposed benchmark rate would have a demonstrable consumer benefit

We also note Ofcom's discussion on whether a glidepath is appropriate at paragraphs 8.92 – 8.96 of the consultation. Ofcom concludes that it does not consider there to be any strong reason for KCOM to have a different trajectory to LRIC-based rates (unless higher termination rates are justifiable according to the three-stage test) to other CPs affected by the change.

We fundamentally disagree with the approach that had led Ofcom to this conclusion. Ofcom's view is based on a simple comparison of KCOM and BT's termination rates with no assessment of the impact that the imbalances between incoming and outgoing traffic we have described above might have. KCOM's call origination profile is also markedly different from BT's, not least because of the significantly lower external call origination through which we could recover costs no longer recoverable through call termination.

More generally we are concerned about the industry impact of a one-off reduction as significant as the one which Ofcom is proposing. We believe there may well be unintended effects which Ofcom has not explored as providers seek to rebalance their tariffs across their entire portfolios in order to ensure efficient cost recovery in respect of the voice services impacted by the change. This is not a small exercise. It is likely to take some considerable time to bed down and has the potential to be extremely disruptive for industry and customers. While we appreciate that that the Commission Recommendation suggests that NRAs should be compliant by the end of 2012, we believe that Ofcom's desire to move as quickly as possible to a pure LRIC model is unjustified. We would urge Ofcom to implement a glidepath for rate reductions in order to allow providers to take a measured and gradual approach to any tariff changes necessary and in particular to address the types of issues we have highlighted above where significant traffic imbalances mean that recovery of common costs will be problematic.

Finally, we agree with Ofcom's proposal to link regulation of call termination to allocation of geographic numbers.

Other issues

We are comfortable with the removal of the indirect access obligation with a 12 month sunset clause. At the current time we do not envisage any major changes to our indirect access offering given we will still be subject to a general network access obligation, however, we will of course need to review our call origination rates in light of Ofcom's proposed changes and our comments above.

With regard to interconnect circuits, we are comfortable with Ofcom's proposed approach to regulation of these services in the Hull area. We already offer the services which will be mandated and publish a reference offer and therefore do not envisage having to make any major changes. This reference offer also covers call origination.

We are also comfortable with the proposal to move to a 56 day notice period for changes to call origination and interconnect circuit charges. However we do have concerns regarding the proposal to waive the notice requirement for call origination charges for the period starting 1 October 2013 and ending 26 November 2013. This specifically relates to price changes for non-geographic call services. Because of the more complex customer relationships and an anticipated increase in call origination costs notice is required in order to make the appropriate changes to our customer arrangements.