Review of the fixed narrowband services markets

Consultation on the proposed markets, market power determinations and remedies

Response submitted by TalkTalk Group

2 April 2013

TalkTalk welcomes to opportunity to respond to this consultation. Given that the proposals by Ofcom are largely in line with what TalkTalk has advocated in response to Ofcom's call for inputs and the subsequent proposals outlined by Ofcom in 2012, we have sought to restrict our comments to the areas where we feel Ofcom has either arrived at the wrong conclusion or has failed to reach a suitable conclusion where one would be required to ensure a smooth operation of these markets after 1 October 2013.

We have three specific comments or concerns with Ofcom's proposals.

1. Failure to adopt NGN as the MEA

We are disappointed that Ofcom has failed to adopt next generation networks (NGNs) as the modern equivalent asset (MEA). In support of its position, Ofcom argues that (i) not all voice-related services are yet replicated using NGNs; and (ii) robust comparison of the replacement costs of TDM networks and NGNs is very difficult.[1] We find these reasons difficult to comprehend.

As to the first reason, TalkTalk has been running an NGN since 2005 and have been able to replicate all necessary voice-related services, including all grade 5 services. That might not mean that all NGN-based voice services are identical to the TDM-based variety but they do in our view meet the same customer needs (whether residential or business customers).

As to the second reason, Ofcom itself admits that it will always be difficult if not impossible to achieve a robust comparison and cites one key reason for this being that TDM network equipment for new build no longer being available. It seems to us that the fact that TDM network equipment is no longer available is actually the very reason why NGNs should be used instead. Put another way, if this is the reason put forward by Ofcom, when would NGN be considered as MEA since TDM network equipment will surely never again be available for new supply? Ofcom's reasons in this regard are contradictory and flawed. We are concerned that Ofcom is simply trying to appease BT as the largest TDM legacy operator in the UK which has so far failed to convert to NGN in a timely and efficient fashion.

---

[1] Paragraph A11.80 of consultation document.

TalkTalk does not agree that it is sufficient, as Ofcom appears to believe, to merely base fixed termination and origination rates on NGN costs as a reasonable substitute for using NGN as the MEA. This is a wrong assumption.

Ofcom's proposal means that an NGN operator like TalkTalk would have to continue interconnecting at each of BT's DLEs to achieve the lowest possible (local) termination rate whereas in an NGN-to-NGN environment, TalkTalk would be able to hand over traffic as IP to BT at one of the NGN nodes (maybe 10-20 nodes in total) but still pay the same termination rate (or a slightly higher one).

In Ofcom's proposed model, TalkTalk would be unable to replicate the cost saving that would be achieved by a reduced number of handover points in an NGN-to-NGN environment. By way of illustration, if TalkTalk sought to hand over traffic at the tandem exchange in BT's TDM network (as the nearest possible substitute to NGN-based handover), TalkTalk would be required to pay BT the NGN cost-based (pure LRIC) local termination rate plus a TDM-based (LRIC+ common cost) local tandem conveyance leg element. BT has no incentive to provide the local tandem conveyance leg element on an NGN (pure LRIC) cost basis because no alternative operator would be able to provide any competitive constraint based on NGN cost-based local tandem conveyance.

Therefore, even though BT is required to provide local call termination based on pure LRIC NGN costs, Ofcom's proposed approach would introduce two significant inefficiencies: (i) it would allow BT to operate an inefficient TDM network with a reduced incentive to migrate to a more efficient NGN; and (ii) TalkTalk would have to continue incurring the additional and unnecessary expense of operating its own legacy TDM network until such time BT chose to migrate to NGN. Ofcom's proposed approach therefore falls short of promoting efficiency.

2. Failure to regulate the APCC in an NGN cost environment

We are very concerned that Ofcom has failed to regulate the average porting conveyance charge (APCC) on a LRIC NGN cost basis in the same way as fixed termination rates. The APCC is an unavoidable cost imposed by the number range holder under the current UK fixed porting regime (because originating operators are effectively required to route calls to the network of the range holder rather than the network to which the number may have been ported). TalkTalk believes that the APCC should be set at the cost of a single transit across a notional NGN node in BT's network (at LRIC with no recovery of common costs). Otherwise the APCC will create a competitive distortion between operators like TalkTalk who have imported telephone numbers to its network and BT who through their legacy position have not had to do this.

As recognised by Ofcom, differences in call termination rates can create a competitive distortion through the operation o f the "waterbed effect". Ofcom points out that call termination "*is part of a two-sided market, with the other side being the retail prices paid by fixed line customers. Therefore, a reduction in* *wholesale call termination rates would tend to cause prices on the "other side" to rise. This process is typically referred to as the 'waterbed effect'*".[2] The APCC has the direct effect of reducing the net termination rate that TalkTalk receives because we have had to import telephone numbers from BT's legacy customer base over the years in order to gain customers.

More specifically, the impact of the APCC means that the fixed termination revenue received by TalkTalk in practice will not be symmetric to that received by BT (who has not had to import numbers from TalkTalk to the same extent). When fixed termination rates are set based on NGN costs (a proposed 85% reduction as from 1 October 2013), this means that TalkTalk will be required to increase its retail prices to a greater extent than BT Retail (even if the waterbed effect is only partial and not complete). On the basis that TalkTalk's current APCC would potentially reduce TalkTalk's termination revenue to zero, we would expect the competitive distortion created by Ofcom's failure to regulate the APCC to be significant.

3. Failure to regulate IP-TDM conversion costs in an NGN cost environment

We note that Ofcom suggests IP-TDM conversion costs could be shared 50/50 between the IP and TDM operator (but that Ofcom does not make any decision or judgment on this point in the consultation document).[3] TalkTalk regrets that Ofcom has not been able to reach a definitive view on this subject. We believe this is a potential source of dispute between TDM and IP operators which is quite likely to generate a dispute that Ofcom would need to resolve in the near future.

In relation to conversion costs, TalkTalk would emphasise that it does not agree that these can be confined to the cost of media gateways but should also extend to the whole cost incurred by an IP operator when they are required to maintain their legacy TDM network in order to interconnect with TDM operators (typically BT).

We respond to each of Ofcom's questions in turn in the following.

Market developments in retail services excluding the Hull Area

Question 3.1: Do you agree with our assessment that both the business and residential retail fixed narrowband calls markets in the United Kingdom have remained competitive since 2009 and that we expect the same competitive conditions to continue during the period of this review as long as appropriate wholesale regulations remain in place? If not, please explain why.

TalkTalk would agree with Ofcom's assessment.

[2] Paragraph 11.41 of the consultation document.
[3] Paragraph A11.124 of the consultation document

Market developments in retail services in the Hull Area

Question 4.1: Do you agree with our assessment that no material changes have occurred in the retail markets in the Hull Area since the last review in 2009? If not, please explain why.

TalkTalk does not provide retail services in the Hull Area so is not in a position to comment.

Question 4.2: Do you agree with our assessment that ex post competition law remedies would now be sufficient to address any competition concerns identified during the period covered by this review and that it would no longer be appropriate to maintain regulation for retail narrowband call services in the Hull Area? If not, please explain why.

TalkTalk does not provide retail services in the Hull Area so is not in a position to comment.

Wholesale call origination

Question 5.1: Do you agree with our assessment that the relevant service market is “Wholesale call origination on a fixed narrowband network”? If not, please explain why.

TalkTalk would agree with Ofcom’s assessment.

Question 5.2: Do you agree with our assessment that there are two relevant geographic markets: “The United Kingdom excluding the Hull Area” and “The Hull Area”? If not, please explain why.

TalkTalk would agree with Ofcom’s assessment.

Question 5.3: Do you agree with our assessment that BT has SMP in the market for “Wholesale call origination on a fixed narrowband network” in the United Kingdom excluding the Hull Area? If not, please explain why.

TalkTalk would agree with Ofcom’s assessment. BT commands a significant market share on this market and it is unlikely that competitive constraints from new entrants would emerge over the short- to medium term.

Question 5.4: Do you agree with our assessment that KCOM has SMP in the market for “Wholesale call origination on a fixed narrowband network” in the Hull Area? If not, please explain why.

TalkTalk does not operate in the Hull Area so is not in a position to comment.

Question 5.5: Do you agree with the remedies imposed on BT in the market for "Wholesale call origination on a fixed narrowband network" in the United Kingdom excluding the Hull Area? If not, please explain why.

TalkTalk agrees that the remedies imposed on BT would be sufficient to curb any anti-competitive behaviour (if any potential breaches are investigated by Ofcom in a timely and efficient manner).

Question 5.6: Do you agree with the remedies imposed on KCOM in the market for "Wholesale call origination on a fixed narrowband network" in the Hull Area? If not, please explain why.

TalkTalk does not provide retail services in the Hull Area so is not in a position to comment.

Wholesale fixed geographic call termination

Question 6.1: Do you agree with our assessment that the relevant service market is "termination services that are provided by [named fixed communications provider] (CP) to another communications provider, for the termination of voice calls to United Kingdom geographic numbers which that CP has been allocated by Ofcom in the area served by that CP"? If not, please explain why.

TalkTalk would agree with Ofcom's assessment.

Question 6.2: Do you agree with our assessment that the relevant geographic market is determined by reference to the area in which the CP provides termination services and is not wider than the United Kingdom? If not, please explain why.

TalkTalk would agree with Ofcom's assessment.

Question 6.3: Do you agree with our assessment that each CP has SMP in the market for fixed geographic call termination to their number range? If not, please explain why.

TalkTalk would agree with Ofcom's assessment.

Question 6.4: Do you agree with the remedies imposed on BT in the market for fixed geographic call termination to its number range? If not, please explain why.

TalkTalk would agree with the proposed remedies.

Question 6.5: Do you agree with the remedies imposed on other CPs (excluding BT) in the market for fixed geographic call termination to their number range? If not, please explain why.

TalkTalk notes that the proposed remedies on other CPs are the same as currently apply. This seems reasonable. We note that Ofcom suggests IP-TDM conversion costs could be shared 50/50 between the IP and TDM operator (but that Ofcom does not make any judgment in this respect).[4] TalkTalk regrets that Ofcom has not been able to reach a definitive view on this subject. We believe this is a potential source of dispute between TDM and IP operators which is quite likely to generate a dispute that Ofcom would need to resolve in the near future.

In relation to conversion costs, TalkTalk would emphasise that it does not agree that these can be confined to the cost of media gateways but should also extend to the whole cost incurred by an IP operator when they are required to maintain their legacy TDM network in order to interconnect with TDM operators (typically BT).

Transit and conveyance services

Question 7.1: Do you agree with our assessment that there have been no material changes in the ST market since the 2009 review? If not, please explain why.

TalkTalk would agree with Ofcom's assessment.

Question 7.2: Do you agree with our assessment that ex post competition law remedies would now be sufficient to address the competition concerns identified during the period covered by this review in the ST market and that it would no longer be appropriate to maintain regulation in this market? If not, please explain why.

TalkTalk believes the existing SMP remedies in the ST market have very little apparent practical effect on BT's pricing of these services (there is no cost orientation or price control obligations). There would therefore seem to be few concerns about relying solely on competition law in constraining BT's behaviour in this market (assuming Ofcom is capable of carry out any competition law investigation in a timely and efficient manner).

Question 7.3: Do you agree with our assessment that the LTC/LTT market in the United Kingdom has remained competitive since 2009 and that we expect the same competitive conditions to continue during the period of this review? If not, please explain why.

TalkTalk would agree with Ofcom's assessment in this regard.

[4] Paragraph A11.124 of the consultation document

Price regulation of termination and origination markets

Question 8.1: Do you agree that we should cap FTRs at LRIC? Please explain your reasons.

TalkTalk agrees with Ofcom's proposal for the reasons outlined in the company's previous consultation responses, namely that FTRs above LRIC have the potential to distort competition because they are above marginal cost and also to remove competitive distortions compared to mobile termination rates that are now set at LRIC.

Question 8.2: Do you agree that wholesale call origination should be regulated on a LRIC+ basis where the "+" includes a mark-up to off-set the common cost recovery foregone from externally provided wholesale call termination on a LRIC basis? If not, please explain why.

TalkTalk would agree with Ofcom's proposal.

Question 8.3: Should the FTRs of CPs other than BT be presumed fair and reasonable where they are no higher than the Benchmark FTR? If not, please explain why.

TalkTalk would agree with Ofcom's proposal subject to our comments on conversion costs in response to Question 6.5 above.

Question 8.4: Should the FTR set by KCOM in the Hull Area be presumed fair and reasonable where it is no higher than the Benchmark FTR? If not, please explain why.

TalkTalk does not operate in the Hull Area so is not in a position to comment.

Question 8.5: Do you agree with our proposed approach to the regulation of wholesale call origination rates in the Hull Area? If not, please explain why.

TalkTalk does not operate in the Hull Area so is not in a position to comment.

Question 8.6: Do you agree that LRIC-based FTRs should not be adjusted for APCCs?

We believe Ofcom has either misunderstood or misconstrued the concerns around APCC expressed by TalkTalk in its response to the September 2012 consultation. We do not entirely understand why Ofcom has phrased the consultation question in this manner but TalkTalk has never requested that the LRIC-based FTR should be "adjusted for APCCs".

In contrast, TalkTalk has consistently emphasised that the consideration of the FTR must be made in conjunction with the APCC. For a terminating operator who has imported a telephone number, they are two sides of the same coin. The termination revenue received for calls to that number will always be reduced by the amount of the APCC and there is nothing that the terminating operator can do on their own to change this. The way in which fixed number portability has been implemented in the UK means that calls are always routed to the range holder who then has to transit the call to the third party terminating operator if the number has been ported. The terminating operator cannot in those circumstances avoid paying the APCC because otherwise the range holder operator could refuse to send the calls to them (because the range holder operator would not get paid for their network transit).

The current fixed porting regime puts the range holder operator in a position of an effective monopoly which has two important competition consequences:

(i) At the wholesale level, the range holder operator faces no competitive constraint on the provision of APCC services. The terminating operator cannot choose a different supplier if the operator considered APCC charges were excessive. The range holder operator is therefore able to set excessive APCC charges unless curtailed by regulation.

(ii) At the retail level, there is a separate competition consequence which is that the range holder operator does not face the same cost when it sets its own retail prices. The range holder does not incur any APCC charges when calls are made from third party operators to its numbers which gives it a cost advantage when setting its retail call prices to its own customers (because it does not face any reduction on call termination revenue). This imbalance is particularly accentuated in BT's favour because of its legacy position in telephony where most of its customers have been allocated telephone numbers from BT number ranges whereas new entrants like TalkTalk have had to port numbers from the BT network in order to gain new customers (because customers do generally expect to be able to port their telephone number in order to switch provider).

There is no obvious reason why Ofcom could not set the APCC charge as part of the current review of the fixed narrowband services markets. There is a clearly defined economic market (provision of APCC services) in which each number range holder (TalkTalk included) seemingly enjoys a position of significant market power (because no other operator could provide the number range holder transit service). We are disappointed that Ofcom has failed to carry out this analysis in its proposals and instead has chosen to step away from the controversy and simply fall back on the rather vague requirements set out in GC18.

It is correct of course that GC18 imposes a reasonableness requirement and a cost orientation obligation with regard to the structure and level of the APCC. However, problem is that the wording does not specify what costs and cost standard should be considered. TalkTalk is very concerned that BT will exploit the vagueness of GC18 by continuing to set its APCC based on legacy TDM costs (including recovery of common costs) which, as Ofcom in effect acknowledges, may lead to terminating operators effectively paying BT to terminate traffic on their networks.[5]

This would be a clearly absurd position and would put (relatively) new market entrants like TalkTalk at a further competitive disadvantage to BT Retail. At the very least, we would urge Ofcom to agree with the above concerns in its final statement and lay down some guiding principles as to how the APCC should be set as from 1 October 2013 when the new network charge controls are due to enter into force. Against the above background, it is logical that the principle should be that the APCC should be set on the basis of pure LRIC NGN costs. Otherwise, the competitive distortions caused by the APCC will only increase which ultimately will harm the consumer interest.

Cost modelling for call conveyance services

Question 9.1: Do you agree with our proposed approach to modelling the cost of fixed call origination and fixed call termination? If not, please explain why.

TalkTalk would generally agree with Ofcom's approach. We do not quite understand why the pure LRIC termination rate would increase with increased market share. Ofcom argues that *"[t]he inverse relationship between market share and LRIC is due to the greater amount of termination causing more asset capacity boundaries to be reached. This means that more assets will become incremental to termination."* This outcome conflicts with our own analysis of the cost model. Is Ofcom saying that more (as in different) asset types would become incremental to termination? This does not sound right. We would be grateful if Ofcom could explain its reasoning in more detail.

Interconnection

Question 10.1: Do you agree with our assessment that BT and KCOM should be required to provide interconnect circuits? If not, please explain why.

TalkTalk would agree with Ofcom's assessment.

Question 10.2: Do you agree with the obligations we propose to impose on BT in relation to the provision of interconnect circuits? If not, please explain why.

TalkTalk would agree that the proposed obligations seem appropriate.

Question 10.3: Do you agree with the obligations we propose to impose on KCOM in relation to the provision of interconnect circuits? If not, please explain why.

TalkTalk does not operate in the Hull Area so is not in a position to comment.

---

[5] Paragraph 8.113 of the consultation document.

Charge control specification

Question 11.1: Do you agree with our proposed glide paths? If not, please explain why.

Although TalkTalk believes the significant and immediate reduction in FTRs on 1 October 2013 is likely to cause some disruption for operators' carrier trading relationships, TalkTalk would agree that the proposed glide path is the best way forward considering all circumstances.

Question 11.2: Do you agree with our proposal to allow a six week implementation period for Fixed Termination Rates to be capped at LRIC? If not please explain why.

We are concerned that a six-week period will be too short to agree an implementation of pure LRIC NGN cost-based APCCs. As explained above it is vitally important that the APCC is reduced in accordance with the same cost principles as from 1 October 2013. If Ofcom maintains the six-week period, we would expect BT to engage in negotiations on an expedited basis in order to ensure that any dispute can be referred to Ofcom prior to 1 October 2013 (such that the APCC determined by Ofcom can be backdated to apply as from that date).

Question 11.3: Do you agree with our proposals relating to "Charge control design"? If not, please explain why.

TalkTalk does not have any specific comments on Ofcom's proposals which seem reasonable (assuming they do not allow for any gaming by BT that might create competitive distortions in other markets).