Three
Star House
20 Grenfell Road
Maidenhead
SL6 1EH
United Kingdom

T +44(0)1628 765000
F +44(0)1628 765001
www.three.co.uk

Three.co.uk

Response to Ofcom's Review of Cost Orientation and Regulatory Financial Reporting in Telecoms - Call for Inputs

December 2011

Non- Confidential

Introduction

Hutchison 3G UK Ltd ('Three') welcomes the opportunity to respond to Ofcom's call for inputs in its Review of Cost Orientation and Regulatory Financial Reporting in Telecoms, published on 8 November 2011.

As Ofcom is aware, Three has a joint venture called Mobile Broadband Networks Ltd ('MBNL') with Everything Everywhere ('EE'). MBNL is responsible for the operation of the joint EE and Three 3G radio access network (RAN). [✂] This response covers those products and services. MBNL will be replying separately in respect of the products it buys from BT for Three's and EE's joint Radio Access Network.

Executive Summary

Ofcom's call for inputs seeks to answer two main questions:

- Under what circumstances should we impose cost orientation obligations, with what objectives; how should those obligations be interpreted and, once imposed, how should they be applied in practice?

- How should BT's and Kcom's regulatory financial reporting obligations be set to best support our regulatory objectives, taking account of stakeholders' needs and the legitimate interests of the regulated companies (e.g. with regard to confidentiality and proportionality)?

Three's view is that Ofcom should continue to impose cost orientation obligations on BT to protect business purchasers (and eventually end users) from excessive charges. However, Three is concerned that Ofcom's interpretation of BT's cost orientation condition (and the wording of that condition) is excessively permissive. In particular, the use of Distributed Stand-Alone cost as the relevant cost ceiling provides BT with too much discretion in terms of how to allocate its (substantial) common costs to individual products.

For the reasons explained in this submission, Three supports the use of Distributed Long Run Incremental Cost (or, at most, Fully Allocated Cost) as the appropriate cost ceiling in cost orientation. In Three's view, any "appropriate mark up" for common costs must be narrowly defined and be explicitly set out in BT's cost orientation condition. Otherwise BT enjoys too much discretion in terms of how to allocate its common costs and can exploit its SMP position to levy excessive charges.

Three believes that regulatory financial reporting obligations are a very important tool for those purchasing regulated products from BT. Improving the way in which they are produced would be welcome. BT should maintain appropriate cost accounting systems to be able to demonstrate that it is complying with its charge control and cost orientation obligations.

Objectives of cost orientation

Q1. How important is cost orientation as a regulatory remedy in telecoms? Why is it important to you in particular?

Cost orientation is an important regulatory remedy. Unless individual charges are price controlled, cost orientation is a key tool for regulators to ensure that specific charges are not excessive or in other ways anti-competitive. It is therefore a key component of the set of potential remedies set out in the European regulatory framework for electronic communications. Effective use of cost orientation is important in a regulatory framework which promotes economic efficiency and protects purchasers of regulated products from the effects of BT's market power.

Ofcom's call for inputs may result in a new set of guidelines on cost orientation and a revised framework for regulatory financial reporting (paragraph 1.7 of Ofcom's call for inputs). Both of these outputs will have a significant impact on the regulation of charges that Three pays to BT.

[✂] Three understands that those products are subject to a cost orientation and financial reporting obligation. Ensuring that the corresponding charges are cost-reflective is very important to Three, given that BT enjoys Significant Market Power (SMP) in those markets and has an incentive to set excessive charges.

Q2. What should we seek to achieve with cost orientation and in what circumstances?

Three's view is that cost orientation should have two main aims:

- First, to protect customers – both business purchasers like Three and eventually end users – from monopolistic exploitation by BT. In particular, cost orientation should prevent BT from abusing its SMP position in the above markets through excessive wholesale charges (which eventually feed into higher retail prices);

- Second, to prevent competitive distortions between fixed and mobile – BT and mobile operators are vertically integrated and compete to some extent to provide retail call services. Although Ofcom has traditionally found that fixed and mobile calls are not closely substitutable, there is some degree of substitution between both types of call (e.g. between fixed-to mobile and mobile-to-mobile calls).[1] To that extent, BT has an incentive to raise mobile operators' costs by setting excessive wholesale charges.

In setting a cost orientation remedy Ofcom is required to promote competition and the interests of consumers (which involves considering both short and long run allocative, dynamic and productive efficiency).

Q3 – Q4. How should cost orientation interact with other remedies, such as charge controls or non-discrimination? Are there other remedies that could potentially avoid the need for a cost orientation obligation, and if so what would you propose?

[1] See for instance Oftel's views on market definition for fixed and mobile services, page 3.
http://www.ofcom.org.uk/static/archive/oftel/publications/mobile/ctm_2002/definitions0502.pdf

As with all ex ante remedies, cost orientation needs to be considered in light of its effectiveness and proportionality in fulfilling Ofcom's statutory duties when compared with the other remedies available. Cost orientation can be used as a complement to, and as a substitute for, charge controls.

Three agrees with Ofcom's practice of using cost orientation to complement charge controls, particularly when a charge control is set for a basket of products. Cost orientation can then constrain the price of individual services and prevent BT from taking advantage of its pricing flexibility to recover excessive common costs on individual products. As Ofcom has noted, compliance with a charge control does not require that each and every one of BT's charges are cost oriented.[2]

Three believes that great care needs to be taken in using cost orientation as a substitute to charge controls, however. Where there is an absence of effective competition in an input market due to SMP, a charge control is likely to be required and cost orientation should only substitute it where there are strong and compelling reasons to do so.

<u>Current use of cost orientation</u>

Q5 – Q8. How well defined is our implementation of the basis of charges obligation? How useful are the current guidelines, and why? Which elements of our implementation of cost orientation are least clear / clearest? How well do you understand how BT / Kcom demonstrate compliance with the basis of charges condition? Why is that? How do the cost orientation obligations in place on BT and Kcom, and our interpretation of them, compare with your understanding of cost orientation obligations on telecoms operators in other countries, particularly elsewhere in Europe?

The wording of BT's basis of charges (i.e. cost orientation) condition is standard and requires it to ensure that:

"Each and every charge offered, payable or proposed is reasonably derived from the costs of provision based on a forward looking long-run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed".

Ofcom's broad policy in relation to cost orientation is well understood and has been in place for a number of years. However, Three believes that it would be beneficial to have greater clarity about the status of Ofcom's Guidelines and its interpretation, and crucially implementation, of cost orientation (as explained below).

Three understands that the implementation of BT's cost orientation condition is based on Oftel's 2001 Network Charge Control Guidelines. To assess whether an individual charge is cost oriented, Ofcom applies a 'first order test' based on 'floors' and 'ceilings'. Our understanding of the rationale for this approach is as follows: economic theory states that a multi-product firm in a competitive retail market will not price a service below its Long Run Incremental Cost (LRIC) or above its efficient Stand-Alone Cost (SAC):

- **LRIC floor –** The LRIC of a service is the additional cost the firm incurs in the long run to provide a particular service, or the cost it would avoid by not providing it. LRIC sets a

[2] See for instance Annex 14 of Ofcom's Review of Wholesale Fixed Narrowband Markets.

floor because a price below LRIC would be loss-making and cannot be sustained – by definition, the regulated firm would increase profits by not supplying the service in question**;**

- **SAC ceiling –** The firm could not charge more than efficient SAC, or the cost that would be incurred by an efficient entrant to produce that service alone, including common costs. SAC sets the ceiling – by definition, any higher price would bring new entrants to the market and lower the price.

To mimic the effects of a competitive market, a regulator should use LRIC and SAC to set the permissible boundaries for cost oriented prices. Strictly, to ensure that common costs are recovered but not over-recovered, price floors and ceilings should apply not only to each individual service but to every combination of services which share common costs ('combinatorial tests').[3] This is because a price for a single product which lies between LRIC and SAC may still allow BT to charge below cost or over-recover its common costs.

In practice, Ofcom has considered that combinatorial tests may not be practical because too many BT products share common costs.[4] It is then necessary to allocate common costs in a 'reasonable' manner. Hence, the cost orientation condition allows "an appropriate mark up for the recovery of common costs". To determine what an "appropriate" mark up is, Ofcom's 'first order test' checks whether a cost oriented charge is between Distributed LRIC (DLRIC) and Distributed SAC (DSAC), both of which allocate common costs to individual products. Ofcom does not apply the test mechanistically and considers other factors, such as the magnitude and duration of any charge in excess of DSAC, or whether charges above DSAC could have caused economic harm to BT's customers.[5]

In light of the above interpretation, Three considers that there are four main areas where Ofcom's review could lead to greater clarity or to an entirely new approach to cost orientation. In particular:

- the status of the Guidelines and Ofcom's interpretation of cost orientation could be usefully updated and clarified in light of the Competition Appeal Tribunal's ('CAT') judgment in the recent Partial Private Circuits ('PPC') dispute between BT and other operators;[6]

- The way in which cost orientation is enforced could be clarified;

- Ofcom's current interpretation of cost orientation may not sit well with the European Commission's ('EC') recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU;[7]

---

[3] Baumol, Panzar and Willig *Contestable Markets and the Theory of Industry Structure* Harcourt Brace Jovanovich, 1982.

[4] Paragraph 5.56 of Ofcom's PPC Determination.
http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

[5] Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT's charges for partial private circuits (Oct 2009). Paragraph 1.21.
http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

[6] http://catribunal.org/239-7046/Judgment-.html

[7] http://ec.europa.eu/governance/impact/ia_carried_out/docs/ia_2009/sec_2009_0599_en.pdf

- In Three's view, stand-alone cost concepts (such as DSAC or SAC) provide too much discretion to BT and should not be used as a ceiling in cost orientation (see response to questions 10-13 on cost standards).

First, in the PPC dispute the CAT found that the wording of BT's cost orientation condition does not stipulate a particular method of allocation of common costs, save to say that the mark-up must be "appropriate". In the CAT's view, there is no single correct way of allocating common costs. In the first instance, it is for BT to decide how to allocate common costs, provided that it does so appropriately and can demonstrate this to Ofcom's satisfaction. Only if BT is unable to do so can Ofcom then consider how compliance must be tested, by applying its cost floors and ceilings (DLRIC and DSAC respectively).[8]

In summary, the CAT found that the current wording of the condition does not entitle Ofcom to impose an allocation method upon BT, provided BT allocates its common costs "appropriately". The CAT's finding appears to allow BT to adopt an "appropriate" cost allocation method which yields a charge above Ofcom's DSAC ceiling and still comply with the cost orientation condition. Three is therefore concerned that the current wording of the cost orientation condition provides BT with too much discretion in terms of how to allocate its common costs to individual products. Our view is that Ofcom's review should encompass both the wording of BT's cost orientation obligation and its interpretation in a new set of Guidelines.

Second, the way in which cost orientation has been enforced could also be clarified. For example, if the floor and ceiling approach is to be a 'first order test', then greater clarity would be useful on what subsequent tests would be used. In the PPC judgment, the CAT did not consider the term 'first order test' to be a helpful one. On the contrary, the CAT found that BT's cost orientation condition contains no separate requirement (or 'second order test') to establish that economic harm to consumers would result from charges in excess of DSAC.[9]

Third, the EC recommendation on Fixed and Mobile Termination Rates adopts pure LRIC as the relevant cost benchmark for fixed and mobile call termination charge controls. Ofcom has adopted pure LRIC in its Mobile Call Termination Review Statement (with Three's support)[10] but not in respect of BT's fixed call termination charges, which are currently based on Fully Allocated Cost ('FAC').[11]

Fixed call termination is currently subject to both cost orientation and a charge control.[12] In Three's view, Ofcom should adopt pure LRIC as the right cost benchmark in fixed call termination in its next market review (concluding before September 2013), for the reasons set out in the EC recommendation (and to be consistent with its own Mobile Call Termination Review). But doing so may create an inconsistency with its current interpretation of cost orientation – fixed call termination charges set at LRIC for charge control purposes would be below Ofcom's DLRIC floor for cost orientation. This provides further support for Three's view that Ofcom should revisit the cost standards it uses to set permissible boundaries for cost oriented charges in fixed telecoms (see response to questions 10-13).

---

[8] Paragraphs 245-249, 285, 297.

[9] Paragraphs 297, 326.

[10] http://stakeholders.ofcom.org.uk/binaries/consultations/mtr/statement/MCT_statement.pdf

[11] Paragraph 4.67 of Ofcom's Review of BT's Network Charge Controls (Sep 2009) http://stakeholders.ofcom.org.uk/binaries/consultations/review_bt_ncc/statement/nccstatement.pdf

[12] Paragraph 12.106, Ofcom's Review of Wholesale Fixed Narrowband Markets Statement (Sep 2009). http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr_statement_consultation/summary/main.pdf

Options for cost orientation implementation

Q9. What are the credible alternative cost standards that could be applied in interpreting the basis of charges condition? (e.g. LRIC+, DSAC / DLRIC, FAC, etc).

Three believes that cost orientation should apply to individual charges in order to constrain the price of individual services and prevent BT from recovering excessive common costs on specific products or charging in a way which distorts competition (e.g. by charging below cost or above cost for input products on which its retail competitors rely). In theory, several cost benchmarks may be used to assess whether BT's charges are cost oriented.

- **Marginal cost** – Marginal cost is the additional cost of increasing output by one unit over a specified time period. It includes traffic-sensitive costs only, and makes no allowance for service-specific fixed costs (i.e. fixed costs incurred on behalf of the service in question) or common costs (i.e. costs which arise from the provision of a group of services but which are not incremental to any individual service);

- **LRIC** – As explained above, the LRIC of a service is the additional cost the firm incurs in the long run to provide a particular service, or the cost it would avoid by not providing it. It includes traffic-sensitive costs and service-specific fixed costs but makes no allowance for common costs. LRIC is the approach recommended by the European Commission for fixed and mobile cal termination rates;

- **DLRIC** – DLRIC first defines a product group which contains the product being priced. DLRIC equals the LRIC of the product plus a share of the intra-group common costs (i.e. costs which are common between individual products in the group), where common costs are typically allocated based on an equi-proportionate mark-up over LRIC. As a result, DLRIC normally exceeds LRIC for an individual product. As explained above, DLRIC sets the floor for cost oriented charges in Ofcom's Guidelines;

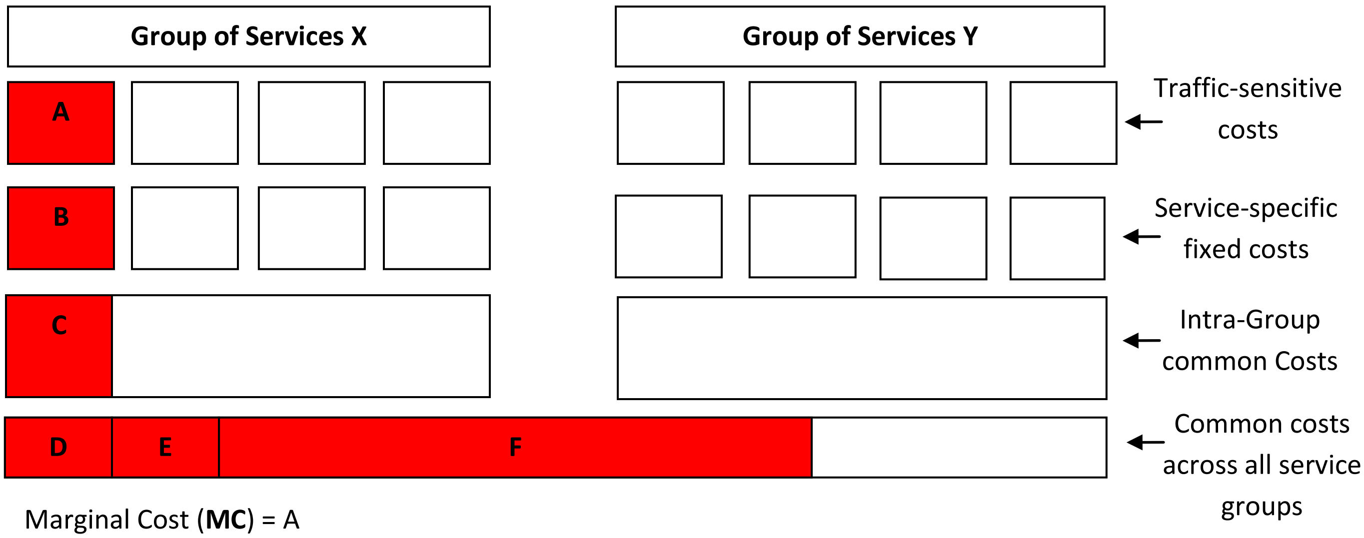
- **FAC** – FAC is an accounting measure designed to ensure that all of a firm's costs are attributed to its services. All costs – whether incremental or common – are distributed amongst a firm's various products according to a particular allocation method. If a firm sets its charges equal to unit FAC, it would then recover (but not over-recover) all its costs, including common costs. FAC is the cost measure used by Ofcom in fixed call termination;

- **DSAC** – like DLRIC, DSAC includes LRIC and a share of the intra-group common costs. The DSAC for any individual service also includes a proportion of costs that are common across all groups of services, calculated as an equi-proportionate mark-up over LRIC. As explained above, DSAC sets the ceiling for cost oriented charges in Ofcom's Guidelines;

- **SAC** – SAC is the cost of providing a product on its own, including all common costs which would be incurred in a single product firm but which in practice are shared with other products in a multi-product firm. Common costs incurred by the multi-product firm which would not be needed to provide the relevant product in isolation are not included in SAC.

Figure 1 shows that cost benchmarks towards the bottom of the list make an increasingly greater allowance for common costs than those above them.

Figure 1 – Potential cost benchmarks to interpret cost orientation



Marginal Cost (**MC**) = A
Long Run Incremental Cost (**LRIC**) = A + B;
Distributed LRIC (**DLRIC**) = A +B + C;
Fully Allocated Cost (**FAC**) = A + B + C + D;
Distributed Stand Alone Cost (**DSAC**) = A + B + C + D + E
Stand Alone Cost (**SAC**) = A + B + C + D + E + F

Q10 – Q13. What do you see as the advantages and disadvantages of the different approaches, both theoretical and practical? Which approach do you believe we should take, and in what circumstances? How does this depend, for example, on the state of competition and any other regulatory remedies imposed alongside cost orientation? What tests should we apply in assessing compliance with the basis of charges condition, for instance in disputes? How should this vary depending on circumstances, for instance different levels of complexity? At what level of aggregation (e.g. product level, market level, price list level) should cost orientation apply, and why?

As explained above, Three believes that cost orientation should apply to individual charges in order to constrain the price of individual products. Three agrees with Ofcom that combinatorial tests are generally impractical, given the large number of BT services which share common costs. Three's view is that Ofcom should use LRIC as a floor (to be consistent with the EC Recommendation and its own Mobile Call Termination Review) and DLRIC (or at most FAC) as the ceiling to set the permissible boundaries for cost oriented prices in fixed telecoms.

This is because, in our view, the current approach to cost orientation based on DSAC is not adequately effective in controlling BT's charges. As Ofcom has recognized, a significant proportion of BT's cost base for individual services consists of common costs.[13] In Three's view, stand-alone cost concepts (such as DSAC and SAC) provide too much scope for BT to over-

[13] Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT's charges for partial private circuits (Oct 2009). Paragraph 5.64. http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

recover common costs from its regulated charges. Figure 1 above shows that the scope for 'judgment' in the allocation of common costs becomes greater the closer the chosen benchmark is to SAC.

In particular, SAC and DSAC are based on the costs of an efficient hypothetical stand-alone operator and not on BT's costs. However, BT does not provide its products on a stand-alone basis. Its network and cost structure reflect the fact that it supplies a large number of products. As Ofcom recognized in its PPC Determination, BT would not have built so large and geographically spread a network to provide an individual product.[14] This reflects the fact that a network architecture and business structure which is the most efficient way of producing a large number of services is unlikely to be the most efficient way of producing each individual service.

Hence, both SAC and DSAC require Ofcom and BT to make highly complex judgments about the network and operating costs that would be incurred by a hypothetical stand-alone operator, in an industry in which such operators are unlikely to exist or be viable (due to the existence of large economies of scale and scope). This is because the SAC of product X allocates to product X only costs that an efficient hypothetical operator would incur to produce X in isolation (i.e. area F in Figure 1 does not cover all costs common across all services groups).[15] For example, the SAC and DSAC of a TISBO Low Bandwidth leased line product should take into account only the costs (including management costs and other overheads) that an efficient entrant would incur in providing TISBO at speeds between 2Mbit/s and 8Mbit/s and no other product.

Three's view is therefore that stand-alone cost concepts (such as SAC and DSAC) are generally inappropriate as benchmarks in cost orientation. They provide BT with too much discretion in terms of how to allocate its common costs when used as a ceiling in cost orientation. In Three's view, any "appropriate mark up" for common costs must be more narrowly defined and be explicitly set out in the cost orientation condition. Otherwise BT enjoys too much discretion in terms of how to allocate its common costs and can exploit its SMP position to levy excessive charges.

[14] http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf paragraph 7.107.

[15] In Ofcom's terminology, the efficient SAC will normally be lower than the sum of BT's incurred incremental and common costs. For instance, the SAC of a particular leased line product would not include the full salary of BT's executives, but only the salary of the executives that would be required to provide the leased line product in isolation. See Ofcom's Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT's charges for partial private circuits (Oct 2009). Footnote 284.
http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

Over-arching questions on cost orientation

Q14 – Q15. What impact, if any, should changes in technology have on our use and interpretation of cost orientation? E.g. the transition from copper to fibre in the access network, or the replacement of traditional telecoms network switching equipment with more modern equivalents? Are there any other factors or considerations we should take into account in our review of our guidance on cost orientation? E.g. demand patterns over time, or efficiency considerations.

Three understands that BT prepares its Regulatory Financial Statements (also known as the 'Current Cost Financial Statements') based on the principle of current cost, where assets are valued on the basis of replacement cost, or the costs of replacing an asset with a modern equivalent. It follows that any changes in technology (such as replacing switching equipment with more modern equivalents) should be incorporated and reflected in lower permissible charges, given that the adoption of modern technology tends to lower the cost of providing wholesale services. Further, great care needs to be taken in allowing any rise in legacy product prices due to a change in technology.

Q16 – Q34. Questions on financial reporting obligations

Three has not addressed the detailed questions in Ofcom's call for inputs on this area, but has the following comments which touch on many of the issues raised by Ofcom.

In general, Ofcom must impose regulatory financial reporting obligations (including wholesale and retail cost accounting and accounting separation) on BT and other dominant undertakings for two main reasons:

- to be able to monitor and enforce its remedies, such as cost orientation and price controls; and
- to resolve disputes and investigations more quickly and efficiently.

In the main, regulatory accounts are required where the other remedies imposed on an SMP operator require them, in circumstances where purchasers are not protected by a competitive market. Given the imposition of cost orientation conditions and charge controls for BT, Ofcom typically requires BT to maintain appropriate cost accounting systems that demonstrate that its obligations are being met. This enables Ofcom and other stakeholders to monitor compliance with BT's obligations and assists Ofcom in the resolution of disputes.

Three believes that BT's Regulatory Accounts are a very important tool for those purchasing regulated products from BT, and improving the way in which they are produced would be welcome. Although Three does not use BT's regulatory accounts extensively at present, MBNL does (as explained in MBNL's response). The purpose of these accounts should be to provide stakeholders with sufficient information that they are able meaningfully to engage with charge controls and make, at least first order, assessments of whether individual charges are cost oriented and non-discriminatory. Three considers that the accounts should retain sufficient detail on the relevant cost standards for individual products to make such assessments.

As part of this review, Three would therefore support Ofcom investigating and providing guidelines on the degree of detail at which BT is required to provide data. While there are clear benefits to aligning the regulated accounts (at least showing how they reconcile to) statutory accounts, the purposes of regulated accounts should be to allow a view to be taken about whether regulatory remedies are being complied with.

While at a pragmatic level BT will need to aggregate some products, Three is concerned that relatively low volume products – which are nonetheless commercially very significant for purchasers – can be aggregated in the accounts in such a way that purchasers such as MBNL can no longer assess whether BT is complying with its regulatory obligations. MBNL's specific concerns in this area were set out in its response to Ofcom's Business Connectivity Market Review Call for Inputs and are repeated it its response to Ofcom's call for inputs.

The level of detail of outputs of the accounts (i.e. cost benchmarks for individual products) needs to align with the products which are commercially significant and are purchased subject to regulatory remedies. Three also believes that Ofcom could usefully review the level of detail of the underlying assumptions and inputs which BT uses to compile the accounts. These are important to the degree of reliability which the accounts are seen to have by stakeholders. Key assumptions and how they change between each year should be clearly set out and not buried in the detail of multiple cost allocation methodologies for each product.

Three supports a review of the approach taken to compiling the accounts to ensure that the confidence which purchasing CPs have in the figures published is increased. This should ensure that the regulatory accounts become a more useful and relevant tool for stakeholders and improve their robustness. At this stage, Three does not have firm views on questions such as the audit standard, and process and high level principles by which the accounts are compiled beyond those stated above. However, Three would be happy to comment further on more specific proposals in these areas later in this review.