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Wholesale mobile voice call termination

BT's response to Ofcom's market review consultation of 1st April

23 June 2010

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BT welcomes comments, which should be sent by e-mail to
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Executive Summary

BT warmly welcomes the proposals set out in the Consultation. Ofcom's primary duty is to '*further the interests of citizens and consumers, where appropriate by promoting competition*' and its intention to bring mobile termination rates down to an average of 0.5 pence a minute will:

- re-balance the competitive playing field and enable fair competition between, on the one hand, fixed and mobile network operators; and on the other, the incumbent mobile network operators and newer entrants like 3;
- enable a fresh wave of innovation, both in pricing plans across the board and in services that bring together fixed and mobile communications; and
- benefit millions of UK citizens and consumers.

We are sure, therefore, that Ofcom is right to reject the status quo and instead to favour the adoption of the European Commission's Recommendation on the regulation of termination rates.

The fundamental change that this will bring about is that in future, mobile termination rates will be set to recover just the incremental costs of completing the calls, instead of also recovering, as they do at present, a share of the costs of providing access to the mobile network. This will lead to more calls being made to mobile phones and bring mobile termination rates in line with fixed rates - which have long been set to cover the incremental costs of completing calls with no allowance for access costs. This is an important and much needed change.

But while we sincerely welcome the proposals, we take issue with two points:

First, we disagree with Ofcom's assessment that the choice between continuing the status quo and adopting the EC Recommendation is "finely balanced". It is not. The current regime is massively unfair to fixed networks and their customers. As Ofcom's modelling now shows, charges have included huge allowances for the access costs of mobile operators for which there is no justification. Today, mobile charges are around 4.3 pence a minute, while the fixed equivalents are less than 0.3p. Such a disparity represents an unwarranted contribution by fixed customers to the mobile network operators' access costs. It greatly distorts competition and must be brought to an end.

Secondly, under the proposed implementation of the new approach it will take much too long for customers to see the benefits of reduced mobile termination rates. Indeed the average rate across the four year control period would be in line with that given by the status quo methodology Ofcom has rejected, and significantly higher

than would follow from the methodology Ofcom has endorsed. Exceptionally therefore, BT believes that in this case, there should be a three- not a four-year control period. This would also have the advantage of bringing the implementation of the new rates closer to the target date set by the EC and of aligning the review cycles for fixed and mobile rates.

Undoubtedly Ofcom's proposals will be fiercely opposed by the incumbent mobile network operators - subsidies are deeply addictive, especially subsidies on the scale that the incumbent mobile network operators have enjoyed from the current mobile termination rate regime.

Equally no doubt, the incumbent mobile network operators will predict dire consequences if the proposals are adopted, just as they forecast in earlier market reviews that reductions in mobile termination rates would lead to a fall in the number of mobile subscribers and much higher mobile origination charges. They were wrong then and any fresh doomsday forecasts will be equally wrong.

Clearly it is important that reductions in charges are passed on to customers. Here we make three points:

First, the fixed call origination market is competitive, with a number of strong players and no significant barriers to entry and expansion. So it is highly likely that competition will lead to the reductions in the marginal cost of calling a mobile phone being passed on to customers. To borrow a term, there is a "*waterbed effect*" in the fixed sector of the market that will ensure fixed users will benefit from the reductions.

Secondly, BT is committed to passing on the value of any reduction in mobile termination rates to its customers - just as it demonstrated to Ofcom's satisfaction it did during earlier mobile termination controls (when the fixed market was not deemed to be the competitive market it is today).

Thirdly, there has been widespread support for the *Terminate the Rate* campaign in favour of much lower mobile termination rates. Indeed the *Terminate the Rate* campaign has won the support of:

- 66 organisations representing the interests of customers disadvantaged by the current regime including the *Federation of Small Businesses*, *Age Concern*, *Carers UK* , *MacMillan Cancer Support* and others;
- 154,000 individuals who signed the *Terminate the Rate* petition; and
- 262 MPs who signed an Early Day Motion calling for lower mobile termination rates.

By contrast, BT is not aware of any single body or person outside of the incumbent mobile network operators who favours the continuation of the status quo.

The *Terminate the Rate* campaign struck a chord with people because of widespread and serious concern about the cost of calling mobile phones. This concern is felt particularly by the hard pressed; by people with fixed and limited incomes like carers and students; by public bodies struggling to balance their books and maintain valuable services; and by small businesses fighting to survive tough economic times and continue to keep people in work. Ofcom's proposals offer hope. If the proposals are implemented (and implemented over a shorter time period that currently planned) then we will see:

- sharp reductions in the cost of calling a mobile phone;
- new unlimited calling plans from BT (and probably the other fixed network operators too) that include calls to mobiles as well as calls to fixed phones, and that are attractively and affordably priced - well below the level at which such plans have been offered from time to time by mobile network operators;
- peace of mind and less 'bill-shock', especially for the hard-pressed;
- an increase in the number and length of calls to mobile phones, again especially by the hard-pressed - by people who need to contact their carers while they are taking a break, or by small businesses and public bodies who need to speak to people while they are away from homes and offices; and
- the start of a new wave of innovation as the barrier of high termination rates is removed, to facilitate services and pricing plans that bring together fixed and mobile calling.

In short, this move will really get people talking again.

And the reductions in wholesale charges must reach customers as soon as possible. As Ofcom's calculations show, mobile termination rates are appreciably above cost, and the balance between operator and customer is significantly out of kilter. We urge Ofcom to maintain its rate of progress in the market review and ensure that the lower rates will take effect on 1 April 2011, at the start of the next control period, as planned. Any delay would only penalise long-suffering consumers and businesses.

We look forward to seeing Ofcom's bold and admirable proposals reflected as decisions in the Final Statement and, from next April, to the start of a new era of fairer competition, enhanced choice, noticeably lower prices, and improved innovation for all citizens and consumers.

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1: Ofcom's Market Review

1.1 Market definition

There seems to be little disagreement that Ofcom's established market definition is correct. Under the "calling-party-pays" system, there is no substitute for terminating a voice call on the network of the subscriber's chosen provider so the relevant economic market is that for all calls that terminate on the individual network(s) in the UK. The refinements that Ofcom has made to the definition – that is, to anchor the control to mobile numbers rather than networks and to couple this with the ability to control the termination rate – appear successfully to remove specific technologies from the equation and enable Ofcom to regulate the specific economic activity in question. There cannot be any question that the definition fully complies with the intention of the European Commission in listing wholesale mobile voice call termination markets as susceptible to *ex ante* regulation in its Recommendation.

1.2 Market power

Ofcom's fine-tuning of the market definition renders the assessment of significant market power (SMP) all the more stark. All those with the unique ability to set the termination rate for calls terminating on their mobile numbers have monopoly power. Barriers to entry in the termination market remain extremely high, regardless of the technology that might be employed, because the mobile number range-holder determines the termination rate. As Ofcom points out, this power is enduring and results directly from the calling-party-pays system, which is highly unlikely to change over the course of the coming control period. Finally, we concur with Ofcom's assessment of BT's own level of countervailing buyer-power which, if it exists at all given BT's connectivity obligations, is insufficient to negate the market power of mobile communication providers (MCPs).

1.3 The need for regulatory remedies

BT agrees with Ofcom's assessment, in Section 5 of the Consultation, of the potential harm to competition and to consumers from the mobile network operators' (MNOs) exercise of SMP – that is, economic inefficiency, excessive prices and distortion of consumer choice, and we have expanded on our reasons for this view in later sections of this response.

1.4 Radical reforms

We are pleased that Ofcom has discounted four of the six options it had put forward in last year's Preliminary Consultation[1]. As BT had described in its response[2], the consumer's

[1] Wholesale Mobile Voice Call Termination: Preliminary Consultation on Future Regulation, 20 May 2009 http://www.ofcom.org.uk/consult/condocs/mobilecallterm/mobile_call_term.pdf

more immediate need is for the much lower mobile termination rates that the proposed remedy will deliver. Once rates reach these much lower levels, the opportunity will arise to consider a move to a different system of regulation. We note that in their responses last year[3], all the incumbent operators also discarded these options (at least for the short term, though for varying reasons) and came down in favour of the status quo.

[2] Wholesale mobile voice call termination: BT's response to Ofcom's preliminary consultation, 29 July 2009 http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Consultativeresponses/Ofcom/2009/Wholesalemobilevoicecalltermination/index.htm

[3] See http://www.ofcom.org.uk/consult/condocs/mobilecallterm/responses/

2: Proposed Remedy

Given that mobile network operators have SMP in call termination and that they have in the past, as Ofcom reports in Section 4 of the Consultation, sought to exploit their monopoly power, mobile termination rates have to be controlled.

Ofcom describes in Section 7 of the Consultation its criteria for deciding whether in the next control period to maintain the status quo (which Ofcom refers to as the "LRIC plus" approach) or to follow the European Commission's Recommendation (referred to as "pure LRIC").

BT supports Ofcom's decision to regulate mobile call termination in a way that is consistent with the European Commission's Recommendation. But Ofcom reports the choice as being "finely balanced" and swung ultimately by the need to harmonise regulation in the UK with the rest of the European Union. We disagree. The key feature of the status quo is that mobile termination rates have been set to recover not just the incremental costs of completing calls but also a share of mobile network access costs whereas fixed termination rates have only ever been set to recover the incremental costs of completing calls. This asymmetry has had two consequences:

- competition between fixed and mobile networks has been distorted; and
- prices for calling mobile phones, especially from fixed phones, have been too high, discouraging use.

The asymmetry between the regulation of fixed and mobile platforms favours one type of service over another and is therefore inconsistent with market convergence and the common regulatory framework.[4]

2.1 Symmetrical regulation for converging markets

Against this background, there would need to be very strong reasons for such asymmetrical regulation. Ofcom has not presented these in the Consultation and BT does not consider that they exist. We note that:

- Ofcom does not consider either of the cost methodologies to be superior in terms of allocative efficiency within the mobile market;
- it would clearly be wrong to make any allowance in mobile termination rates for call externalities to mobile users and not make the same adjustment in fixed termination rates;

[4] Article 8 of the Framework Directive requires National Regulatory Authorities to take the utmost account of the desirability of making regulation technologically neutral; "that is to say, that it neither imposes nor discriminates in favour of the use of a particular type of technology" (Recital 18).

- the profit impact on the MNOs is not of a scale likely to raise issues as to their ability to fund their investments and invest in future services[5], and so there is no reason why "dynamic efficiency" will be harmed;
- there are strong grounds to believe the changes will benefit low income and vulnerable groups, when the likely impact on fixed customers is considered, as Ofcom's analysis of the distributional impacts on consumers makes clear, as well as users as a whole.

The EC Recommendation is the best guarantee of symmetrical regulation.[6] This will mean that there is fair competition at the retail level with no supplier, or group of suppliers, using economic rents earned on voice termination to distort the retail market for access and outgoing calls.

In paragraph A12.92, Ofcom noted BT's concern that high wholesale mobile termination rates distort competition between fixed and mobile operators. Ofcom also recognised, in paragraph A12.93, that there is a strong "competitive interaction" between fixed and mobile services. However, Ofcom's description of the problem still seems to us to underplay a very significant issue. Key features relevant in this context are:

- fixed and mobile phones are available to everybody in the UK and people make choices as to whether to give a fixed or a mobile number to the people who want to call them and whether to use a fixed or a mobile phone to make a call;
- BT's market research shows that 56% of mobile phone calls are made while the callers are within their homes and offices and hence within easy reach of a fixed phone;
- in the last five years, fixed geographical calls have decreased by 25% despite price reductions of nearly 10% in nominal terms; substitute services , most notably mobile-originated calls, are clearly reducing the demand for fixed-line originated voice calls;
- Ofcom has noted that, "*In 2008 the proportion of voice calls originating on mobile networks increased by 3.9 percentage points to 44.5% ...".* The same pattern was evident in the five-year period to December 2008, with mobile gaining market share at

[5] It is also worth noting that the merger between T-Mobile and Orange in the UK has brought about a significant consolidation of the market (increasing the HHI to over 3000) and this is widely expected to lead to "market repair" and improved margins for the industry as a whole.

[6] BT notes that in paragraph A12.94, Ofcom says that, "Adopting either a LRIC+ or pure LRIC standard for *both* fixed and mobile call termination would provide consistency and any differences in costs would be entirely driven by the underlying traffic sensitive costs of the different technologies". However, the very wide disparities between fixed and mobile rates (and the huge difference in the allowance for common costs) indicates that consistency has, in fact, not been achieved under the so-called 'LRIC plus' standard.

the expense of fixed operators. If current trends continue, mobile-originated voice call volumes should overtake those from fixed lines in 2010;"[7]

- Ofcom's 2009 Consumer Experience report showed the proportion of mobile-only households has increased from 7% in 2003 to 14% in 2009. Among some age groups, the proportion approaches 30%;[8]

- there is increasing price convergence between fixed and mobile services. According to Ofcom's Communications Market Report 2009, the premium to call from a mobile fell from 8.5ppm in 2004 to just 3ppm by 2008; for those subscribers who use a very high proportion of their inclusive mobile minutes, the choice between the cost of mobile-originated and fixed-originated calls can now be finely balanced, when the fixed-line rental charge is included in the calculation.[9]

That fixed and mobile networks do compete with each other is beyond dispute even if they are not deemed to be in the same market for the purposes of imposing *ex-ante* regulatory obligations on fixed operators. This means that it is particularly important that regulation does not favour one type of network over another.

This is especially true of the two-way termination markets where each provider has absolute control of its own market, yet where the service is one on which the supplier and the receiver are both dependent, regardless of any market boundaries. The European Commission summarises this competition problem in Recital 3 of its Recommendation[10]:

*"Significant divergences in the regulatory treatment of fixed and mobile termination rates create **fundamental competitive distortions**. Termination markets represent a situation of two-way access where both interconnecting operators are presumed to benefit from the arrangement but, as these operators are also in competition with each other for subscribers, termination rates can have **important strategic and competitive implications**."[emphases added]*

The European Commission's Explanatory Note[11] that accompanies its Recommendation reinforces this point in a number of places:

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[7] Page 224 of Ofcom's Communications Market Report 2008 (http://www.ofcom.org.uk/research/cm/cmr09/)

[8] See Page 24 at http://www.ofcom.org.uk/research/tce/ce09/

[9] See Page 245 at http://www.ofcom.org.uk/research/cm/cmr09/

[10] Commission Recommendation 2009/396/EC of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU: *Principles for the calculation of wholesale network termination rates in mobile networks*. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF

[11] Commission Staff Working Document accompanying Commission Recommendation 2009/396/EC of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU: *Explanatory Note*, Sec (2009) 600, page 31. http://ec.europa.eu/information_society/policy/ecomm/doc/implementation_enforcement/eu_consultation_procedures/explanatory_note.pdf

"Furthermore, with the evolution of fixed–mobile hybrid services and a move towards convergence, a different regulatory treatment of fixed and mobile termination rates raises a **possible inconsistency issue**. The regulatory model underlying the FTR regulation assumes that operators will recover the cost of the local loop via retail subscription charges, and that these costs are not included in the FTR paid by other operators, including mobile operators. This is not the case in mobile networks where the access network costs are largely recovered via the termination rate. This needs to be considered in order **to ensure that competitive distortions do not arise** and that allocative-efficiency concerns … are addressed. (paragraph 2.1) [emphases added]

"In an environment of **increasing convergence** between fixed and mobile networks and with a view to promoting sustainable competition and investment within and across all telecoms markets, it is important that regulation is, as far as is practicable, technology neutral and ensures that there is no **distortion or restriction of competition** and that efficient investment and innovation is encouraged." (paragraph 4.1) [emphases added]

2.2 Current asymmetries are material

A simple calculation shows how currently fixed customers contribute very much more to mobile networks' common costs than mobile customers do to fixed networks' common costs.

In Figure 17 in the Consultation (page 150), Ofcom shows mobile termination rates at about 6ppm in 2008/9 and the LRIC cost at about 1ppm. On every call to a mobile network therefore, a fixed customer is contributing approximately 5ppm towards the common costs (that is, the indirect costs) of the terminating mobile network. Against this, in 2008/9 fixed termination rates were about 0.3ppm[12] which means that, on a per minute basis, contributions to common costs were at least seventeen times as great in one direction to another.[13]

Even in the first year of the proposed price cap the problem will be material, with a 2ppm contribution above direct costs going from fixed customers to mobile networks. This works out at a transfer of nearly £250m[14] in 2011/12 alone. Based simply on the amounts involved, BT therefore disagrees with Ofcom's assertion that, _"we are not aware of any empirical evidence as to the potential materiality and impact of differences in termination rates between mobile and fixed network investment over time."_[15] Given the amounts

[12] Based on 0.3ppm for Single Tandem Call Termination.

[13] This multiple has been calculated on the basis that there are no incremental costs to fixed termination, so the contribution is 0.3ppm. Given that there are such costs, the contribution will be lower than 0.3ppm and hence the disparity would be even greater. We note that Ofcom says in paragraph 2.14 that wholesale fixed termination rates are "currently no more than 0.25 pence per minute", this being the published BT daytime rate.

[14] Based on 12.5 billion minutes per annum.

[15] See paragraph A12.98 of the Consultation.

involved, we do not think there can be any question of the materiality of the advantage one type of network has been deriving over the other.

A disparity of this magnitude would certainly require a convincing justification, but this is nowhere provided in the Consultation[16].

BT therefore supports Ofcom's implementation of the Recommendation because it will provide fair competition between fixed and mobile suppliers, something the European Commission consistently promotes as an important objective:

"A common approach to call termination markets based on efficient costing principles should help foster a stable and effective regulatory environment for future investments and contribute to a more level playing field and enhanced competition between different operators and networks (e.g. fixed and mobile networks)." [17]

2.3 Mobile access costs should be excluded under any costing methodology

As the European Commission has recognised, the prime cause of the asymmetry between the treatment of fixed and mobile termination rates is that mobile termination rates have been set to recover network access costs whereas fixed rates have not. This key distinction is somewhat obscured by referring to the two methodologies as "pure LRIC" and "LRIC plus" – it is possible that access costs could be excluded from the calculation of termination rates and that those costs that are included could nonetheless still include an appropriate share of other common costs. So even if Ofcom were to decide that those costs that were to be recovered through mobile termination rates should include an allowance for some common costs, mobile access costs should still be completely excluded from the calculation of mobile termination rates. Only in this way can Ofcom hope to establish symmetry.

When discussing the issue of asymmetry in Annex 12, Ofcom points out that access network costs are largely "subscriber driven" for fixed networks. BT interprets this to mean that access costs are largely specific to individual subscribers. In contrast, mobile access costs are said not to be specific to individual mobile subscribers.

BT appreciates this distinction, but the important point not drawn out is that mobile access costs are incremental (direct) costs across the set of <u>all mobile</u> customers. It is wrong to imply that, because they are not specific to individual mobile customers, this provides a justification for treating them as costs which are common across mobile *and fixed*

[16] We are not suggesting here that there has been any oversight on Ofcom's part - the difference between fixed and mobile termination rates is an anomaly and not one unique to the UK. Rather, we applaud the EC and Ofcom for now taking action to solve the problem.

[17] Paragraph 3.4 (page 15) in the Commission's Staff Working Document accompanying Commission Recommendation 2009/396/EC of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU: *Implications for Industry, Competition and Consumers*, Sec (2009) 599 http://ec.europa.eu/governance/impact/ia_carried_out/docs/ia_2009/sec_2009_0599_en.pdf

customers. That is, mobile access costs are not legitimately shared across fixed customers, any more than fixed access costs are deemed as being common to mobile customers.

It is therefore mistaken to classify mobile access costs as "common costs" and then apportion them, in part, to fixed customers. Mobile access costs may not be individual subscriber-driven in the way that fixed access costs are, but that does not mean to say that they are "common" to fixed customers.

If regulation is to be consistent and not distort competition, then either (i) fixed customers should contribute to mobile access costs when they call mobile phones, and mobile customers should contribute to fixed access costs when they call fixed phones; or (ii) fixed and mobile network operators should each cover their own access costs in their retail prices. The first option would be both complicated and inconsistent with the Commission's Recommendation. The obvious conclusion is that fixed operators should cover all their access costs in their retail prices (as they do) and that mobile operators should do likewise. Neither should then contribute to the access costs of the other in payments made for call termination. [18]

BT considers this to be a minimum requirement in order that regulation does not impede competition in a converged world and to ensure that the UK is meeting the requirement in the common regulatory framework that national regulatory authorities regulate in a way which is technologically neutral.

2.4 On-net and off-net rates

Mobile network operators are able to offer low prices for on-net calls. This is particularly so for larger business contracts which have a high proportion of on-net calls[19] and for which retail prices can be well below the regulated charge for terminating a call; this occurs even though an on-net call makes twice as much use of network facilities as a terminating call, providing a strong indicator that termination rates are currently greatly in excess of the true cost of completing calls. This has made it difficult for fixed operators to compete for calls to mobile phones and has made it harder for a new entrant like 3 to gain scale.

This is particularly distortive in a converging world in which mobile operators are making significant inroads into the fixed market. Mobile operators can sell fixed-mobile traffic (terminated on their networks) to their large corporate customers at rates that a fixed

[18] The fact that, "[t]here is no equivalent of the fixed line rental in mobile networks" then becomes irrelevant as it is simply up to the mobile networks how they structure their retail charges between fixed and variable elements. This means that there would be no significance – at least for the regulation of termination services – if there were to be no rental charges in the mobile sector (we believe that the mobile equivalent of the fixed line rental does exist in fact, but that this is bundled with usage and presented as a contractual charge).

[19] This is because employees call each other under the same contract and on the same network.

operator cannot match because of the high termination charges which fixed operators incur for terminating the very same calls.

This will remain a problem as long as there is a material difference between the regulated price for termination and the true resource cost of delivering a call. Given that Ofcom does not propose to prohibit this form of discrimination, it is imperative that regulated prices and resource costs are brought into line. This is another important reason why Ofcom is right to favour the adoption of the Commission's approach.

2.5 Impact on consumers

It hardly needs to be said that because mobile termination rates have been set so far above the true incremental cost of completing a call, the demand for calls to mobile phones has been suppressed below the level that would have been economically efficient. This is particularly true of calls to mobile from fixed phones.

This was recognised by the Commission which concluded Recital 3 of its Recommendation by highlighting one of the prime consumer outcomes of high termination rates:

"High termination rates tend to lead to high retail prices for originating calls and correspondingly lower usage rates, thus decreasing consumer welfare."

There is a particular problem that high termination rates make it difficult to offer customers fixed price unmetered packages – in part because such packages would have to carry a high price tag and in part because the risk to the operator if usage exceeds forecast levels is too great. Again the European Commission recognised this in its Explanatory Note[20]:

"Furthermore, it may be claimed that high termination rates charged on a per-minute price basis create pressure on operators to adopt per-minute retail tariffs, thereby limiting the possible emergence of more innovative offers such as those based on flat-rate tariff structures which could in turn ***promote greater retail consumption****." [emphasis added]*

The Commission went on to highlight the consumer and economic benefits of such packages:

"Moreover, consumers tend to respond to flat-rate plans by making extensive use of the service in question. As communications services are typically characterised by significant upfront costs and low marginal costs, such flat-rate plans can be efficient for both the consumer and the provider and promote a higher utilisation of the service." [21]

[20] *Ibid* paragraph 4.1 (see footnote 11).

[21] Paragraph 4.3.5 in the Staff Working Document (see footnote 17).

2.6 Conclusion

Ofcom asserts in a number of places in the Consultation that the choice of methodology is "finely balanced". By this Ofcom presumably means that no single set of economic, legal or regulatory arguments, nor the differences in distributional impacts, indubitably favours either remaining with the status quo or moving to the recommended approach. It seems to be the European Commission's Recommendation which is the deciding factor for Ofcom's choice between the two.

Ofcom is right to place significant weight on the EC's Recommendation, but Ofcom need not regard the EC's Recommendation as divorced from the other arguments (which might be the inference to take from the summary in paragraph 1.10) because those assessments all point to the superiority of the recommended approach.

As we have described earlier in this response, high mobile termination rates have suppressed demand for calls to mobile and distorted competition between fixed and mobile networks (and made it more difficult for a new entrant like 3 to establish itself in the UK market). As the Commission says "*the further termination rates move away from incremental cost, the greater the competitive distortion*".[22] With fixed termination rates already around 0.25ppm, and likely to be even lower under the next control, it is clear that a mobile termination rate at 0.5ppm (or less) is precisely what is needed in order to end the competitive distortion.

This correction should arguably have been made before now, but the imperative of the EC Recommendation, and the increasing demand for next generation services and convergent offerings, now make the case unequivocally.

[22] Paragraph 4.1 in the Explanatory Note (see footnote 11).

3: Probable Counter-Arguments

We expect that the incumbent mobile network operators will object fiercely and at length to Ofcom's proposals. They have benefited greatly and for a number of years from the current regime and are not likely to welcome change.

Exceptionally therefore, we thought it might help Ofcom were we to anticipate and respond to a number of the arguments that we expect they will raise, given the arguments that have been put in other contexts. We take a look at:

- Ramsey Pricing
- The waterbed effect
- The impact on mobile penetration and usage
- The social impact
- Pass-through
- The investment impact

3.1 Ramsey Pricing

The incumbent mobile network operators might well call for "Ramsey Pricing", that is to say, for mobile termination rates to be set above cost on the grounds that the demand for call termination is price inelastic.

Ofcom's Preliminary Consultation included a short consideration of Ramsey pricing principles, stating that its current methodology was not based on such principles. Should this question be raised again in the current round of consultation, we would point out that:

- Ramsey Pricing is much talked about in academic and consulting circles but rarely, if ever, implemented;
- when the incumbent mobile network operators talk about "Ramsey Pricing" what they really mean is that they want to be able to exploit their monopoly power in the pricing of call termination, but the whole point of the price control is to prevent such an exploitation of monopoly power;
- discussions of price inelasticity and Ramsey Pricing rarely acknowledge the reality of competition between fixed and mobile networks and the impact of different approaches to the setting of fixed and mobile rates on that competition;
- finally, as we need hardly point out, Ramsey Pricing is not compatible with the EC Recommendation.

3.2 The waterbed effect

It is often asserted that the mobile sector operates under a so-called "waterbed effect", whereby any forcing of lower prices in one part of the market will cause a corresponding rise in prices in another part, and similarly that any excess profits in one area will be competed away in another. The argument goes on to suggest that this means that the burden of a reduction in mobile termination rates will be borne by consumers in the form of higher rates for handsets or outgoing mobile calls.

We have four observations here.

First, the reason the incumbent MNOs make so much of a fuss about the "waterbed effect" is because they would much rather earn their revenues and profits from other companies' customers than from their own. This is perfectly understandable, and every business would like to do the same but it does not make it right.

Secondly, if the "waterbed effect" is complete then the mobile market will adjust to the new regime with MNOs earning a competitively determined return on capital. If the "waterbed effect" is not complete then the MNOs will lose margin but this is margin that has been generated through a monopoly over call termination.

Thirdly, the incumbent MNOs' waterbed arguments look only at the impacts within the mobile sector and ignore the fact that the current excessive termination rates involve a transfer of margin from fixed to mobile operators and this has damaged fixed customers' interests and distorted competition[23].

Finally, the incumbent MNOs' waterbed arguments generally ignore the fact that under the current regime there has been a significant transfer of resources from the maverick competitor, 3, to the incumbent operators, again damaging competition.

The European Commission has looked at the "waterbed effect" and noted that the academic literature finds that the waterbed effect is lower in higher-penetration markets. It noted that:

"…given the higher usage and significantly lower RPM observed in certain countries where termination rates are much lower than in the EU, there would appear to be scope for further reductions in termination rates without this impacting negatively on end-user prices as the waterbed effect would suggest. In fact, the evidence [presented in graphs showing the relationship between MTRs and usage in various countries] *would suggest the contrary,*

[23] This is true also of most academic work, including the article by Genakos and Valletti which found a substantial (but incomplete) waterbed effect, and which has been cited by the MNOs in their responses when the Commission consulted on its Recommendation.

*i.e. that **retail prices may be expected to decrease and usage to increase in the presence of lower termination rates**." [24] [emphasis added]*

3.3 The impact on mobile penetration and usage

It is possible that the incumbent MNOs will argue that the effect of reducing mobile termination rates will be prices in the mobile origination market rising to such a level that mobile penetration and usage are significantly reduced.

BT agrees with Ofcom that, for economic efficiency, the key question is which methodology will lead to better relative prices.[25] It follows that the basic question posed in relation to a proposed shift from the status quo to the implementation of the EC Recommendation, is whether it is likely to be better for mobile retail prices to be higher and wholesale termination rates lower. This turns on the response of customers to the changed relative prices.

We agree with Ofcom that the changed relative prices are likely to mean lower call charges and higher fixed fees. We appreciate that the *risk* of higher fixed fees is that some consumers *may* decide to exit the mobile market and, if enough customers made such a decision, then it is conceivable that this negative consequence might outweigh any positive benefit from customers making more calls. In the absence of firm evidence on actual demand elasticities for usage (likely to increase) and take-up (likely to decline), BT believes that consideration of this question ought to centre on the likely impact of take-up. It is only if there is a plausible basis to believe that there might be a significant drop in mobile take-up, that considerations of allocative efficiency can support the continuation of the status quo methodology for setting mobile termination rates.

Ofcom provides a lengthy consideration of this issue in the Consultation Document[26]. We agree that any impact is likely to be "muted". In addition to the reasons suggested by Ofcom,[27] we consider that there are four other reasons why any effect is likely to be small.

First, customers who might be inclined to exit the mobile market will tend to be lower users who will not have high volumes of incoming minutes. Whilst a reduction of 1.2ppm (pence per minute) in the termination rate will decrease the profitability of such customers, other things being equal, it must be questioned how much difference this will make. Based on incoming calls of 20 minutes a week, this is equivalent to about £12.50 a

[24] Paragraph 4.3.4 in the Staff Working Document (see footnote 17)

[25] See paragraph A12.38 of the Consultation.

[26] Mainly contained in paragraphs A13.62 to A13.110.

[27] Ofcom suggests that (i) the level of multiple subscriptions may reduce but not overall ownership (paragraph A13.76); (ii) prices may not increase by the full reduction in MTRs (A13.80); (iii) price increases may be tailored not to impact on marginal customers (A13.82); and (iv) consumers might not act in the way they say they will under survey conditions (A13.86).

year[28] which, even if this revenue reduction is fully recovered through higher retail prices, would not seem likely to result in a mass market exit.[29] To put this in perspective, £12.50 is equivalent to 9% of a standard annual fixed line rental charge. For low users, the amounts involved simply do not suggest price impact ought to be a large factor.

Secondly, we note that there does not seem to be evidence that "generous" termination rates are needed to create and maintain high mobile market penetration.

The incumbent mobile operators have in past cited the example of the USA (where the called party pays to receive calls – though in practice these are part of a bundle of calls) as demonstrating that high terminating income is needed to maintain high levels of penetration. This argument was considered by the Commission which had this to say[30]:

*"It is suggested that mobile penetration in Europe might fall closer to US levels if termination rates are regulated on a pure LRIC basis. However, given current levels of market penetration in the EU, incentives to create network effects, and the fact that the regulated termination rates would continue to cover the incremental cost of this service, it is not clear why operators would not be capable of internalising any such access externalities going forward or why mobile penetration levels would fall as a result. … The incentive for operators to create communities of interest suggests mobile network operators would seek to retain their pre-paid customers, even if their termination rates were regulated on a pure LRIC basis. Thus, it may be expected that **mobile network operators would seek to retain their pre-paid customers on their networks even if they were no longer subsidised by above-cost termination rates paid by customers of other networks**."[31] [emphasis added]*

In fact, the Commission went on to observe that market trends in the US indicated that penetration levels were rising[32] and that some analysts quoted by the Federal Communication Commission had attributed this to the attractiveness of service models such as pre-pay.

The attractiveness of pre-pay in the US market appears to have continued, with the Wall Street Journal able to bear that out in an article on 14 May 2010:

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[28] 20 minutes times 52 weeks times 1.2ppm = £12.50. Assuming volumes of incoming and outgoing calls are symmetrical, this is equivalent to usage of 40 minutes a week of calling just between fixed and mobile phones which seems unusually high for a customer who does not place a high value on having a mobile phone.

[29] To the extent the mobile call termination reduction is passed through as a retail price increase, we also note that for the customer we would expect some of this to be offset by decreases in the number of outgoing calls, making mobile ownership more attractive.

[30] These had been cited as a reason for not departing from the status quo methodology for setting mobile termination rates in a paper prepared by Frontier Economics for the incumbent MNOs.

[31] Paragraph 4.3.6 (page 39) in the Staff Working Document (see footnote 17).

[32] At the time of publication of the Recommendation, May 2009.

"The big U.S. wireless carriers [are] risking profits for growth [by] moving more aggressively into the low end of the cellphone market, selling services to consumers without requiring them to sign contracts." It went on to note that *"one out of every five Americans with a cellphone had a prepaid plan at the end of 2009, compared with 15% in 2007 … in some markets, up to 30% of subscribers are on prepaid plans … carriers, while pushing smartphones and data services, also feel pressed to follow users"*.

So it seems clear that it is not only simplistic, but also wrong, to claim that low mobile termination rates will result in damage to the pre-pay sector. The United States, along with India[33], provide current examples of where this is plainly not the case.

Thirdly, it must also be recognised that *even if* there is a decline in penetration of mobile service, the customers exiting the market will be those who place only a low value of service. They are marginal in the sense of perceiving their private value of mobile service (under current prices) as only being just above the charges levied. The loss of such customers does not therefore have a high cost on the basis of lost allocative efficiency, simply because the customers assumed to be leaving the market do not value the service highly.

Finally, we observe that the incumbent MNOs have made similar predictions in the past and the predictions of doom have never been realised. We drew attention to these "cry wolf" claims in our response to Ofcom's Preliminary Consultation last year[34]; for example when the mobile termination control was previously tightened, the MNOs predicted rising subscription, call origination and pre-pay handset prices and falling penetration with 25% of existing customers abandoning their mobile phones; but in the event call volumes continued to rise at the same rate as before the MTR reduction, penetration continued to increase, and the price of a basket of mobile services fell by over 25% between 2002 and 2006; by 2008, half the money spent on telecoms was being spent on mobile services, with penetration levels exceeding 120% and most people were on pre-pay.

The likelihood is that when mobile termination rates are reduced to fair and appropriate levels:

- the mobile network operators will adjust quickly and look to cut other costs (becoming more efficient) before they increase consumer prices;

[33] The EC noted in paragraph 4.3.6 of its Staff Working Document (footnote 78 on page 40) that "In 2003, India introduced a CPNP regime but implemented unusually low fixed and mobile termination rates of just 0.0007 USD per minute. The number of subscribers went from some 13 million at the beginning of 2003 to more than 100 million subscribers by the middle of 2006. Furthermore, this dramatic surge was not at the expense of usage which nearly doubled over the same period." (see footnote 17).

[34] See pages 8-9 in BT's 29 July response to the Preliminary Consultation of 20 May 2009 at http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Consultativeresponses/Ofcom/2009/Wholesalemobilevoicecalltermination/index.htm

- even if the mobile network operators decide to reduce their handset subsidies for relatively light users, this need not lead to a fall in penetration as the market for second-hand handsets is already growing quickly and small, attractive handsets with adequate call functionality are now being produced in large volumes at low cost for developing markets (and as the Commission pointed out, most subsidies are given to encourage switching between networks not to encourage the first adoption of mobile phones[35]).

The European Commission gave careful consideration to what was likely to happen to the pre-pay sector when mobile termination rates fell as the result of the adoption of its Recommendation. It found that there is no strong negative correlation between the size of the pre-paid segment and ARPU, albeit that it was true that a low-usage customer is more likely to subscribe to a pre-paid than to a post-paid scheme. In commenting on the argument that that termination revenues (above the level of cost) are important because a portion of low-usage pre-paid customers may not be profitable in the absence of high MTRs (and therefore that it may be necessary to cut handset subsidies and/or introduce certain additional requirements), the Commission said:

"The above line of argument implies that operators whose customer base consists largely of low-usage pre-paid subscribers are subsidised by other networks, including fixed networks, and finally by the subscribers of those networks. Given that this may result in higher prices for certain end-users and raise possible allocative-efficiency concerns, setting MTRs above the level of efficient costs in order to serve very low-usage customers does not seem to be justified due to the various market distortions it is likely to engender."

The Commission then went on to examine (and reject) the case for a network externality, and to address the argument that low termination rates would result in a portion of marginal or low-spending customers (presumably largely those on pre-pay) leaving the networks. In judging that the risks to consumer welfare were not significant, it concluded that:

"The recommended approach is consistent with the interests of all European consumer groups, including low-spending or marginal consumers, and will continue to preserve operators' incentives to retain these customers on their networks."[36]

[35] As the Commission noted, "where such subsidies continue to be applied they may increasingly be used to fund switchers from competing mobile networks or to upgrade customers to 3G networks, rather than to attract marginal subscribers as such. … As neither of these activities is directly aimed at retaining marginal subscribers for voice services, this would not appear to provide sufficient justification for recovering these subsidies via the regulated voice call termination charge." – paragraph 4.3.6 in the Staff Working Document (see footnote 17).

[36] Paragraph 4.3.7 in the Staff Working Document (see footnote 17).

Finally we understand that 3 has previously said that it will match the offers currently available in the pre-pay sector even after mobile termination rates have been reduced. 3 would still want pre-pay customers even if the incumbent MNOs did not.

3.4 The social impact

The incumbent MNOs might raise concerns about social inclusion. Here we note that the Competition Commission has already concluded that a Network Externality Surcharge was not a cost-effective means of supporting levels of mobile ownership[37]. It must also follow that generous mobile termination rates would also not be a cost effective means of promoting such an objective.

We also note that there has been no regulatory consultation - let alone decision - to the effect that regulatory intervention in the mobile market is warranted on grounds of furthering inclusion.

Further, to the extent that any such considerations might exist, there is no necessary overlap with regulation of MTRs anyway.[38] BT therefore suggests that Ofcom should divorce these issues (to the extent that they do arise) and consider the need for any social intervention separately from that of regulating MTRs at a cost-based price.

Finally we offer the observation that BT already offers low priced fixed services tailored to the needs of socially disadvantaged customers (with no support from other fixed or mobile operators).

3.5 Pass-through

It is possible that the incumbent MNOs will object that fixed network operators will not pass the benefit of falling mobile termination rates on to their customers. In response we make three comments:

First, BT is committed to passing on the benefit of any reduction in mobile termination rates to its customers; in particular we look forward to rates falling quickly to a level where we can offer unlimited calling packages including calls to mobile phones at prices very much lower than those few packages that are so far available in the market.

[37] See Section 4 in the Competition Commission Determination of 16 January 2009: Reference under section 193 of the Communications Act 2003: Hutchison 3G UK Limited v Office of Communications (Case 1083/3/3/07), British Telecommunications plc v Office of Communications (Case 1085/3/3/07) "Mobile phone wholesale voice termination charges" http://www.competition-commission.org.uk/appeals/communications_act/mobile_phones_determination.pdf

[38] The only apparent overlap arises from the presumption that the right intervention is to allow high MTRs to encourage penetration but as noted in the text, the effectiveness of such a remedy has already been rejected by the Competition Commission.

Secondly, when BT was deemed to have market power in the fixed market (that is, prior to last year's fixed retail narrowband market review), BT was able to demonstrate to Ofcom that it had in fact passed on the benefit of the mobile termination reductions to its customers;

Finally, the "waterbed effect" can be expected to be even more powerful in the fixed than in the mobile sector of the market given that there is strong competition, full number portability, all competitors can use the bottleneck parts of BT's network on equivalent terms, and given the absence of barriers to entry and expansion[39]. This is in contrast to the mobile sector where there are significant barriers to entry and expansion and a declining number of competitors. It can therefore be expected that competition will ensure that customers will benefit from reduced termination rates.

3.6 The impact on investment

The incumbent MNOs may well claim that the adoption of Ofcom's proposals would lead to reduced investment in mobile networks.

But clearly any investment that is predicated on charging excessive termination rates is likely to be economically inefficient and any consideration of the impact on investment has to take into account the impact on investment in fixed networks. It is simply not appropriate for MNOs to be incentivised by the continuation of an asymmetrical regime under which charges fall disproportionately on fixed line services.

This was recognised by the European Commission which pointed to the need to take account of dynamic considerations in relation to the impact on investment. It described the current regulatory approach as a risk to efficient investment, and in particular as a barrier to investment in fixed networks, particularly next generation networks.

*"The large gap between fixed and mobile termination rates engenders **large transfers from fixed to mobile consumers**, rendering fixed-line subscribers the biggest contributors to mobile revenues when phoning mobile numbers. This transfer is said to be contributing to inefficiently low usage of fixed networks in some Member States and could ultimately prove to be a **barrier to important innovations and investments** in the fixed sector such as fibre*

[39] Commenting in paragraph A4.55 on the way MTR reductions find their way into retail offerings, Ofcom acknowledges that "the benefits to consumers arising from a fall in MTRs may flow in the form of reduced charges for other components of the bundle, other than calls to mobiles." Drawing on its 2009 market review of the fixed narrowband retail markets, Ofcom disagrees with those who claim that MTR reductions have not been passed through and states that, "rather than observing that fixed operators have absorbed MTR reductions in the form of higher revenue and profit, the evidence suggests that overall retail prices for fixed services have fallen, even if retail prices for fixed to mobile calls have decreased proportionally less".

roll-out and the delivery of Next Generation Networks (NGNs) which will allow higher bandwidths and more efficient provision of multiple services".[40] _[emphases added]_

The Commission went on to say in paragraph 4.2.1 of its Staff Working Document:

"**Enhanced competition** resulting from the elimination of the competitive distortions associated with above-cost termination rates should provide **investment and competitive opportunities** for a range of different operators in the mobile sector. This should serve to constrain the costs of mobile phone ownership and usage for all end-users … Furthermore, increased competition should in turn encourage operators to offer **innovative bundled and/or convergent services**, providing additional revenue sources and opportunities and thereby reinforcing the **financial stability** of the sector as a whole." [emphases added]

The last time Ofcom reviewed the control of mobile termination rates it was suggested that tight controls in the UK would create disincentives to invest in the mobile sector in the UK relative to other countries. Any such argument ignores the fact that the new rules are to be rolled out across the whole of the European Union.

Nor is it right to ignore the fixed sector. If the Recommendation is implemented elsewhere in the European Union but not in the UK then by the same logic not implementing the Recommendation would make the UK a less attractive market for fixed network investment than other countries.

Finally, it is worth bearing in mind that bald predictions of revenue and/or profit losses need to be tempered with the lower out-payments that mobile operators will have to make as a result of Ofcom's proposals. As the European Commission's model revealed in relation to the assumptions it had made:

"…**the mobile industry as a whole will not suffer** significantly from the more comprehensive and harmonised approach recommended by the Commission. Although mobile termination revenues would decrease more significantly under the recommended approach than under the baseline scenario and there would also be less voice revenues generated during the period considered (i.e. between 2007 and 2012), it is also noted that mobile operators' termination expenses would be considerably lower under the recommended approach. This implies that the overall impact on industry cash flow (and thus on profits, other things being equal) would be much lower than its effect on pure revenue indicators." [41] _[emphasis added]_

BT does not consider that a reduction of 1.2ppm (the difference between continuing with the status quo and implementing the EC's Recommendation) in the termination rate will

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[40] Paragraph 3.2 (page 12) in the Staff Working Document (see footnote 17).

[41] Paragraph 4.2.1 (pages 20-21) of the Staff Working Document (see footnote 17).

undermine competition in the mobile market over the longer term. The amounts involved need to be viewed in perspective. Reductions in mobile call termination payments between MNOs will net out and therefore should not have any impact on the overall profitability of the industry. The reductions in mobile call termination rates paid for by fixed customers can be valued at about £150m each year. This is just **1% of MNOs' annual UK revenues**[42] and the MNOs would themselves say that much of this can be expected to be recouped through the "waterbed effect".

[42] Based on mobile retail revenues of £15.4bn in 2008, according to Figure 4.1 in Ofcom's "The Communications Market 2008" (http://www.ofcom.org.uk/research/cm/cmr09/).

4: Design of the Price Control

4.1 Control period

BT usually agrees that a four-year control is likely to be appropriate as this balances the incentive properties with price controls and the need for stability to be set against erroneous assumptions and mistakes in forecasting efficiency and volume growth.

However, the special circumstances now surrounding the next mobile call termination control suggests that a shorter control is appropriate. In this case, we suggest a three-year control, so that it lasts until 2013/14. There are **five** principal reasons for this:

First, it would mean that the UK will have implemented the European Commission's Recommendation by April 2013, which is much closer to the EC's target deadline. As Ofcom recognises in paragraph 9.18, Ofcom's current proposals for a four-year control will cause the UK to fail to meet the Commission's requirement for termination rates to be set on the basis of the recommended approach by the end of 2012. Recital 21 of the Recommendation says:

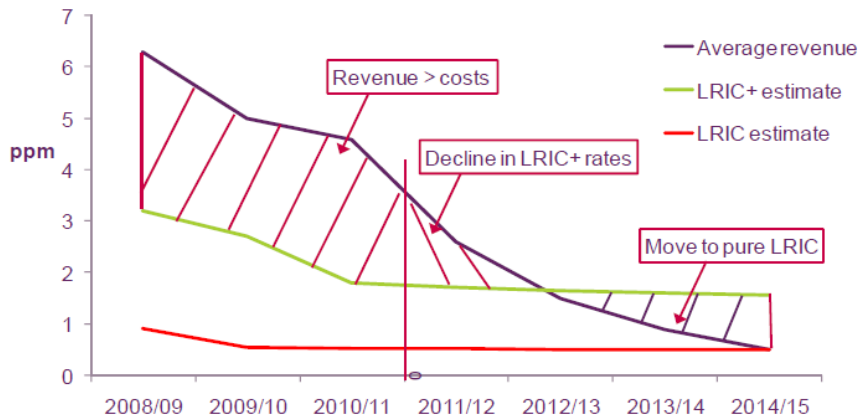
"A period of transition until 31 December 2012 should be considered long enough to allow NRAs to put the cost model in place and for operators to adapt their business plans accordingly while, on the other hand, recognising the pressing need to ensure that consumers derive maximum benefits in terms of efficient cost-based termination rates."

Secondly, it would recognise that the price control as proposed by Ofcom does not regulate mobile termination on the basis of the Commission's Recommendation when viewed over the four-year period of the proposed control as a whole. That is, even if the 2012 deadline is disregarded, a four-year control as proposed fails to satisfy the principle of the Recommendation. This is easily seen in Figure 17 on page 150 of the Consultation, (reproduced below) which shows that, over the four years, the average MTR is approximately equal to what Ofcom describes as "LRIC plus" – the very standard the Recommendation states should no longer be used[43]. It is not until April 2013 that rates are below those which would have been set using the status quo methodology.

Under a three-year control with a constant annual reduction, prices would be approximately 2.15ppm in 2011/12 and then 1ppm in 2012/13 and a charge of about 1ppm is needed in order to see the introduction of genuinely converged fixed and mobile services and tariff packages which can include generous (or even unlimited) "mobile minutes". Thus a three-year control would mean that the new approach would have a bigger impact sooner.

[43] We appreciate that Ofcom's correction to its cost model may entail some marginal changes to the figures, but our general point holds that MTRs will be covering the incremental costs of completing calls and making a substantial contribution to mobile access costs over the period.

Figure 17 - Impact of declining MTRs



Taking the above two points together, a three-year control means that the UK can be much more confident that it has taken "utmost account" of the Recommendation.

Thirdly, a three year control would mean that the timing of regulation of fixed and mobile termination rates would be better aligned as both would end in 2013/14, albeit the fixed price control in September 2013 and the mobile control six months later in March 2014. The closer proximity of the two controls would make it easier for Ofcom to take an explicitly consistent and symmetrical approach to regulation in both sectors[44].

Fourthly, we do not believe Ofcom's concern (expressed in paragraph 9.20), over the possible problems engendered by 18 month or two-year contracts, is legitimate. The fact is that the fundamentals of the European Commission's Recommendation will have been known for at least two years by the time the new control is implemented[45]. It is surely for the operators to have taken note of the Recommendation and not have committed themselves to pricing plans which (Ofcom suggests) might be inappropriate under a new regime. This is particularly the case when the Commission has set out a timetable for the introduction of the new cost methodology.

Even under a three-year control, average termination charges would be over 1.5ppm for the first two years, which is three times what Ofcom estimates to be the "pure" incremental cost of termination. We would also point out that two years from the date of publication of the Ofcom Consultation is April 2012, and therefore only a maximum one year of the new price control will be left on a two year contract agreed on or before publication of the Consultation.

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[44] And as Ofcom itself recognises (in paragraph 9. 16), a three-year control is more likely to align with the requirements of Article 16 of the Framework Directive once this is transposed into UK law by next year.

[45] The Commission's final Recommendation, together with its Explanatory Note and Staff Working Document, were published on 7 May 2009, following a draft for consultation in June 2008.

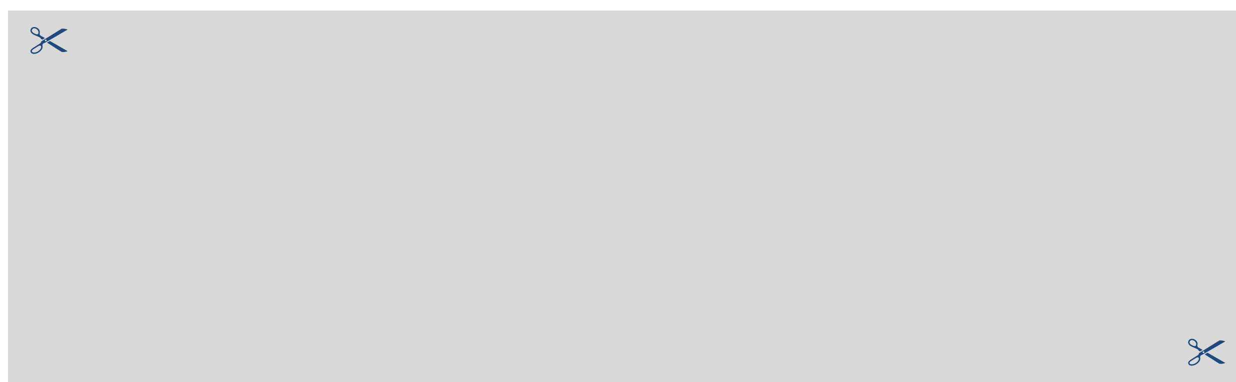
Nor do we agree that the need for upfront capital investment justifies dragging out implementation of the Recommendation. The fact is that the current regime is distortionary and postponing remedial action is likely to be more detrimental on purchasers of call termination than any of the disadvantages that a quicker implementation may impose on the mobile operators.

Finally, such is the disparity under the current regime that even under a three year control the mobile operators will still be net beneficiaries over the period. This is because, in terms of contribution to common costs, fixed customers would be paying about 1.65ppm in 2011/12 and 0.5ppm in 2012/13. This contribution would be worth roughly £270m to the MNOs.[46] Assuming mobile-to-fixed minutes are equal to fixed-to-mobile minutes, the total cost of fixed termination would be around £75m.[47]

In other words, the contribution to the common costs made by fixed customers to the MNOs would exceed the total costs for termination paid by the MNOs to fixed operators by nearly four times. In terms of contribution to indirect costs, therefore, the price controls would still significantly favour the MNOs. (The extent of this advantage would be even higher under a four-year control.)

4.2 Time-of-day flexibility – limitations on 'flip-flopping'

The practice of flip-flopping is a cynical (and, it seems, successful) attempt by most of the mobile network operators to extract additional unearned revenue from all operators and their customers who terminate calls on their networks. The exploitation of this loophole not only causes millions of pounds a year to be unjustifiably transferred from the fixed sector to the mobile sector, there is also a potential for flip-flopping to have unknown detrimental effects on individual consumers, certainly where originating operators reflect the wholesale charges in their retail prices. We have summarised our experience and the financial cost to us from flip-flopping in the confidential paragraph below, and we trust Ofcom will conclude it must indeed be stopped.



[46] Based on annual minutes of 12.5 billion and LRIC of 0.5ppm.

[47] 12.5 billion minutes times 2 [years] times 0.3ppm = £75m.

We are disappointed that Ofcom has decided that, in the interests of regulatory certainty it will not revise the current control, despite the current control being clearly defective in its present form. However, we are encouraged that limitations are to be put in place to prevent the same exploitation happening again (at least to the same degree) under the new control.

Ofcom describes a need to balance two demands: on the one hand, there is clearly a need to prevent MCPs making frequent and significant changes to their rates to take advantage of the basis of the compliance calculation[48] and thereby earn unintended revenue over and above the regulated cap. On the other, there is a need to allow network operators the ability to use wholesale rates to encourage efficient network use. While these might seem to be conflicting demands, they are in fact closely linked. As Ofcom points out in paragraph 9.125, the second objective cannot logically be achieved unless there is relative stability in wholesale prices to enable retailers, and in turn consumers, to change, respectively, their prices and calling patterns.

As there seem only to be these two objectives at play, one way to help address both of them would be to extend the notice period for wholesale price changes from the proposed 28 days to 90 days. This would provide retail-level purchasers of mobile call termination a much better opportunity to change their price structure to support the wholesale-level objective on network usage. Given that a 90-day notification period already operates in the fixed sector, this would also have the additional benefit of bringing the two sectors into line – see also paragraph 5.3 below.

While not a complete solution in itself, the 90-day requirement would help alleviate some of the possible drawbacks with Ofcom's other options, which we describe below. Our concern is that the greater the latitude given to the mobile network operators, the greater the potential jeopardy to compelling retail price packages – one of the main benefits of low MTRs.

Option 1 (the status quo) is clearly not a valid option – a price control should not be implemented in the sure knowledge that it is capable of being abused.

Option 2 (rate-change restrictions) has merit in limiting flip-flopping and a 20% restriction would appear to be reasonable. However, this does not appear to prevent a large quarter-on-quarter change once a year, and, given that there is no restriction on decreasing rates, MCPs could set very high rates at the start of the year and then reduce them dramatically at some point later in the year.

Option 3 (constant time-of-day ratio) imposes a constraint on time-of-day changes, but does not restrict the size of the change quarter-on-quarter, nor does it require the ratio to align with standard industry practice of decreasing through day, evening and weekend.

[48] This is based on the prior year's achievement and seems to be an arrangement neither Ofcom nor the mobile network operators wish to see disturbed.

Again, this would mean there could be large discrepancies quarter-on-quarter in the actual value of each time-of-day price.

Option 4 (flat rate) does not appear to satisfy the operators' need to use termination rates to influence network usage in the interests of efficiency.

This is a complex and esoteric area and, given that neither Ofcom nor many in the industry seem to have realised the existence of the flip-flopping loophole, we are concerned that there may be further opportunities to game any revised system. This would be less of a concern were mobile termination rates already around the 0.5ppm level, but under Ofcom's current proposals, there may yet remain significant incentives to exploit any fresh loophole. Perhaps Ofcom might convene a short industry workshop over the summer to help reach a consensus. Or it might simply ask for an undertaking from the main MCPs not to seek to earn more than the Target Average Charge.

4.3 Ofcom's cost model

We have no comments to offer on Ofcom's modelling at this stage. We are grateful that Ofcom notified stakeholders of a "minor formulaic error" that would result in the Target Average Charge under the previous methodology increasing by 0.2 pence per minute. However, given that Ofcom does not propose to adopt this approach to the calculation of costs, we have simply noted this as a point of reference.

5: The other SMP Conditions

5.1 Requirement to provide network access on reasonable request (SMP Condition M1)

The requirement for those non-network providers which set termination rates to provide network access on "fair and reasonable" terms (Condition M1) is a minimum and appropriate constraint to impose and should be maintained in conjunction with the publication requirement – see 5.3 below. We are pleased to note that Ofcom has provided clear guidance on what it would consider to be "fair and reasonable" in the event of a dispute and we welcome the certainty that this provides. Symmetry in termination rates has been a feature of fixed sector interconnection for many years.

5.2 Requirement not to unduly discriminate (SMP Condition M2)

There is no doubt that mobile network operators have a monopoly position in the voice call termination market and there is a significant risk that they could use their size to hamper the development of competition by imposing both price and non-price conditions on other providers. It is therefore entirely appropriate to continue to impose a requirement not to unduly discriminate on the established network MCPs.

While we understand that Ofcom would not wish regulation to stand in the way of an industry move to a different charging arrangement that would benefit consumers, it would be in Ofcom's power to judge whether any discrimination under a new arrangement was undue or not. That is, this condition need not prevent such moves. In any case, such a change seems unlikely given the history of this market and the proposed level of termination rates.

We believe this control remains a valid remedy in respect of the main operators. For the other, much smaller MCPs, we agree that it would be proportionate for Ofcom to rely on *ex post* powers.

5.3 Requirement to publish charges (SMP Condition M4)

Price transparency is an established method of constraining market power and the publication requirement (Condition M4) is a proportionate mechanism to achieve this. Transparency in mobile call termination charges is absolutely key. As Ofcom acknowledges, there is no material disadvantage for the MCP in having to publish prices, yet there is potential for anti-competitive effects if interconnecting operators are not required to publish prices (the 'blended rates' episode in 2006, which led to the Mobile Call Termination Rate Disputes[49], being one example of the problems that can arise). Publication also enables originating operators to act on the consumer's behalf in

[49] See http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_942/

challenging any disreputable pricing practices (such as flip-flopping) before they take effect, giving the terminating operator an opportunity to reconsider.

However, we note that Ofcom has applied a different notice period in respect of mobile rates from that which was applied in analogous fixed markets last year.

Ofcom's proposals for MCPs to be required to publish their termination rates are set out in paragraphs 7.62-7.68 of the Consultation. These are justified principally on the grounds of transparency and the monitoring of compliance with charge controls and (later in the section) with the no undue discrimination obligation.

Ofcom also proposes that such publication should be subject to 28 days' prior notice, although there is no discussion as to why this particular timescale is considered appropriate.

This seems to be at odds with the approach taken by Ofcom in the conclusion of the Wholesale Narrowband Market Review (WNMR) in September 2009. In that Statement Ofcom rejected BT's view that: (a) 28 days was a sufficient notice period for price changes to its own regulated services; and (b) this would bring fixed call origination and termination into line with mobile termination as regards notification periods, there being no obvious difference in principle. Ofcom's justification for imposing a 90-day advanced publication requirement on BT's fixed-line services was mainly based on the arguments of other Communications Providers that they needed to:

> *"…consider and implement a price change once notified by BT. Not only do CPs need to consider the impact of any changes, they may also need to go through their own internal governance processes if they are changing retail prices. They would also need to update billing systems, reproduce marketing material and notify existing customers. The feedback indicated this was unlikely to be possible within a 28 day period and would place them at a disadvantage, be it either to implement price reductions and therefore compete for customers or reflect price increases and therefore recover the costs of an increased wholesale input charge."*[50]

We do not understand how this argument is any different when applied to mobile call termination. When a mobile operator notifies its intention to change its termination rate, BT and other originators have to go through all of the things detailed above. So if 28 days is considered to be long enough for this to happen when mobile rates change, then it must surely be sufficient for changes to any other wholesale input charges such as fixed call origination and termination.

And, given that they are generally higher than their fixed equivalents, changes to mobile termination rates could represent a greater material impact on other CPs and their associated

[50] Paragraph 11.97 in "Review of the fixed narrowband services wholesale markets: statement on the markets, market power determinations and remedies including further consultation" 15 September 2009 http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/main.pdf

commercial decisions. To subject them to a notification period which is less than a third of that applied to fixed services only serves to highlight the excessive nature of the 90-day requirement on BT's fixed services.

We note that Ofcom committed itself to review the notification periods once this mobile market review had been completed:

> *"In relation to the notification period for mobile call termination, a review of that market is currently in progress. Once the mobile call termination market review has completed, and has decided on the merits of that market what notification periods are required, it will be appropriate for Ofcom to consider whether, for consistency across markets, any changes should be made to fixed call origination and termination notification periods."*[51]

We look forward to those discussions.

[51] *Ibid* paragraph 11.103.

6: Answers to Ofcom's questions

MARKET DEFINITION (Section 3)

Question 3.1: *Do you agree with our views on whether and when new MCPs should form separate markets? Are there any factors we have not considered which should inform this view?*

We agree with Ofcom's proposals to define separate markets in respect of all MCPs that set the charge for call termination. See also Section 1.1 of this response.

Question 3.2: *Are there any other types of providers we should also consider?*

We are not aware of other types of provider in this context.

Question 3.3: *Do you agree with our views on the specific call types that should be included in the market? Are there any factors we have not considered which should inform this view, resulting in call types other than those identified being either included or excluded from the market?*

We agree with Ofcom and welcome the analysis of specific call types in the consultation, and in particular the clarity provided by the table on Page 30. See also Section 1.1.

Question 3.4: *Do you agree with our view of that the geographic market for each of our proposed markets should be the area of the UK within which the MCP provides and can set a charge for mobile voice call termination services?*

We agree.

SMP ASSESSMENT (Section 4)

Question 4.1*: Do you agree with our view? Or are there other developments, not considered elsewhere in this consultation document, for potentially removing the underlying causes of SMP?*

We have nothing to add to our 29 July response to this question from the Preliminary Consultation.

Question 4.2: *Do stakeholders have any comments on the analysis set out in this section?*

See Section 1.2 of this response.

Question 4.3: *Are there any other providers with SMP that we have not identified?*

We are not aware of any.

Question 4.4: *Do stakeholders agree with our proposed SMP assessment for the period until 2014/15?*

We agree.

ISSUES ARISING FROM SMP FINDING (Section 5)

Question 5.1: *Do stakeholders agree with the identified harm to consumers of excessive termination rates in the period 2011 to 2015?*

We agree. See also Section 2.5 of this response.

Question 5.2: *Do stakeholders consider there to be any other forms of relevant consumer harm that we have not identified?*

We have identified various manifestations of consumer harm in the other sections of this response.

CHOICE OF REMEDY (Section 7)

Question 7.1: *Do stakeholders agree with Ofcom's view regarding the need for transparency in MCT charges?*

See Section 5.3 above

Question 7.2: *Do stakeholders agree with our preliminary view on application of a condition requiring network access to be provided on F&R terms?*

We agree. See also Section 5.1 of this response.

Question 7.3: *what are your views on the need for an ex ante undue-discrimination condition for the period of the next review?*

See Section 5.2 above.

Question 7.4: *Do stakeholders believe that there are any circumstances or situations where the UK differs from other EU markets to the extent that would support a departure from following the EC Recommendation?*

We are not aware of any evidence to suggest that the United Kingdom differs in any material way from the rest of Europe in respect of the market set out in the Recommendation and certainly nothing which might justify a departure from the EC Recommendation.

Question 7.5: *do you agree with Ofcom's proposals for its preferred set of remedies for the provision of MCT services?*

We agree. See also Section 2 of this response.

NATURE & DESIGN OF THE CHARGE CONTROL (Section 9)

Question 9.1: *Do you agree that a four-year period for the SMP remedies is appropriate?*

We do not agree. See Section 4.1 above.

Question 9.2: *Do you agree with our proposed modelling approach, as discussed in this section, the supporting annexes and the actual model? If not, please discuss the specific proposals you disagree with.*

See Section 4.3 of this response.

Question 9.3: *What is your view of the harm caused by flip-flopping? Please provide evidence to support your response.*

See Section 4.2 of this response.

Question 9.4: *Do you agree with our preferred option for resolving the issue of flip-flopping – i.e. charge changes restricted to the first day of each quarter and a 20% cap on individual time of day rate increases? If not, why not? Which is your preferred option and why? You may want to include discussion of the following in your response:*

- *the specifics of each option, e.g. the 20% cap in our preferred option,*
- *the effectiveness of the options in addressing the objectives,*
- *the practicalities of the options for you,*
- *any disadvantages/adverse effects of these options for you, and*
- *any other information or views that you feel are relevant to preventing flip-flopping.*

See Section 4.2.

Question 9.5: *Are there other, more proportionate solutions that we should consider?*

We are not aware of any.

Question 9.6: *Is it clear which types of calls are included in, and which types are excluded from, the new charge control and in turn the compliance calculation? If not, which call types do you want clarified?*

It seems clear enough.

Question 9.7: *Is Ofcom taking the right steps to monitor compliance?*

We would advocate continued vigilance by Ofcom, as the exploitation of the flip-flopping loophole would seem to demonstrate is required. The MCPs should be required to provide the proper amount of information required in order for Ofcom to satisfy itself of full compliance. With ever-lower average rate targets, there will be increased incentives to maximise the return.

Question 9.8: *Are MCPs able to provide the information required to demonstrate compliance and for Ofcom to monitor compliance?*

Where BT is an MCP, it will aim to provide all appropriate information to Ofcom.

Question 9.9: *Do you agree with the conclusions of our distributional impact assessment?*

See Section 3.3 in this response.

Question 9.10: *Do you agree with our EIA, that reducing MTRs will have no significant impact on any specific identifiable group? If you disagree with this statement we would welcome any evidence you hold showing why this statement might be incorrect.*

We agree.