Review of BT network charge controls

Response to Ofcom consultation

1. Introduction

COLT welcomes this review of the Network Charge Control (NCC) imposed on BT as a result of its Significant Market Power (SMP) in certain narrowband wholesale markets. In our responses to the relevant market reviews we have commented on the appropriateness of the findings of SMP and of where Ofcom has found no SMP.

COLT provides services to business customers who demand high quality, reliable services and keen prices. Many of the companies we serve are battling hard to survive the recession and they are able to relocate if operational costs in the UK become too high. We are therefore extremely concerned that, through this charge control, Ofcom will allow BT to raise costs of wholesale call termination and origination by up to 50% above inflation over a four year period for reasons which, as we explain later, are economically spurious. Given the narrow margins of firms in the market, it is inevitable that these wholesale price rises will be reflected in retail prices at a time when the economy can least afford such increases.

It also seems perverse that Ofcom is proposing to allow such large price increases for BT at a time when BT, and the industry as a whole, is investing in more efficient technology (next generation networks) that should result in lower costs and so lower prices for end customers.

Ofcom's argument for allowing BT a positive value of X is spurious. The approach to modelling and the values of X (4.16 - 4.21) suggests that because volumes have declined faster than was expected under the current charge control, BT will be allowed a positive of X to "catch up" with the FAC. This seems to indicate that the fixed cost of the network can be divided by the number of minutes resulting in a price per minute. If the volume falls, the unit price rises to compensate. This results in a perverse incentive for BT not to rescale its network to meet falling demand for narrowband services, but to wait for regulation to allow it to raise its prices.

In a competitive market facing declining volumes, each firm would have to reduce its costs so that it could continue to meet the price expectations of consumers and remain profitable. Indeed, BT's competitors such as COLT would have to reduce costs in the face of falling demand, not raise prices. Only in a monopoly market could a firm facing falling demand compensate by raising prices. Ofcom's proposal seems therefore to be re-introducing the worst aspects of a monopolist's ability to behave independently of its customers. This proposal fails the Article 88(1) test of promoting efficiency. In fact we would go further and say that the proposal promotes inefficiency.

Rather than allowing BT to raise prices above the rate of inflation to compensate for falling demand, Ofcom should place the same incentives on BT to rescale resources to meet market conditions as would be found in a competitive market. We will return to this point in our answer to question 4.12.

When imposing the NCC we believe that it is important that Ofcom follow a number of key principles set out below:

i) Consider the impact of the charge control on all customers, not just residential consumers. Many businesses rely on electronic communications to promote their goods and services to their customer and for trading. The cost of telecoms is therefore an important input for these companies. Ofcom should explicitly consider the effect of their proposals on the firms that serve these customers and on the customers themselves. We note that the Communications Management Association (CMA) is so concerned about Ofcoms general focus on the needs of residential customers that it has called for a change to the Communications Act to give Ofcom a legal duty to consider the needs of business, not just citizens[1].

ii) In complying with its Section 88 obligations, Ofcom needs to consider the effect of the NCC on all operators in the market and their customers. In particular, Ofcom needs to consider the effect on business users of electronic communications services. To be specific, all CPs have to interconnect with BT, regardless of whether or not they technically have SMP in the market. BT is therefore able to make decisions which affect the whole market, as it is doing with 21CN. COLT, in common with other CPs may or may not have chosen to make parallel investments to a core NGN dependent on their own assessment of customer demand and/or costs savings. However, because BT is making its investment in 21CN, COLT has no option but to make parallel investments regardless of whether they are efficient or not. Section 88 requires Ofcom to promote efficiency. In meeting this requirement, Ofcom needs to consider the efficiency of all players in the market, not just BT.

iii) BT has made its decision to invest in 21CN to make both dynamic and productive efficiency gains, that is to offer new services not available on the PSTN network and to reduce its cost of supplying existing services. At various points in the consultation document, Ofcom refers to the costs of running 21CN (see for example 4.17, 4.64 onwards). As a matter of principle, BT should not be able to recover any additional costs of running existing services on a new platform. Any investment made by BT should be to deliver cost savings. If it turns out that it costs BT more to deliver, say, call origination or termination on 21CN than it does on the current PSTN network, BT should not be rewarded for this investment. We believe that this approach is being adopted by Ofcom under the banner of technology neutrality.

iv) When Ofcom is in a position to model the costs of the 21CN separately, it is important that BT is not able to exploit cost models of different networks to behave strategically. Ofcom must ensure that BT is unable to act strategically by loading costs onto the PSTN and reducing them on the 21CN artificially to speed up the transition, or vice versa, loading costs on the 21CN to slow down transition. We believe that the hypothetical ongoing network model and a technologically neutral approach should prevent such behaviour, especially as Ofcom says that it does not have enough information to develop a cost model of the 21CN.

It is essential that BT's accounts provide adequate information for COLT and other stakeholders to be able to monitor BT's behaviour. COLT has previously raised concerns with Ofcom about the quality of BT's regulatory accounts (see for example our response to the Leased Lines Charge Control (LLCC) consultation, March 2009). In particular the RGL paper which accompanied the UKCTA response demonstrates where BT's accounts are not fit for purpose for monitoring leased line costs. We expect that a similar analysis of BT's narrowband accounts would highlight similar issues.

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[1] CMA Press Release: 24th February 2009

2. Response to Questions

Question 4.1*: Do you agree with Ofcom's proposal to set a four year NCC from 1 October 2009 – 30 September 2013?*

We have carefully considered Ofcom's proposal for a four year term for the NCC and make the following observations.

First, as fixed and mobile markets converge further, we believe that there is a strong argument for bringing the charge controls into synchronisation, in particular for call termination. Whilst we accept Ofcom's statement in 4.32 that the benefits of synchronisation do not outweigh other considerations *at the moment*, we believe that that will change probably over the course of this NCC. We would therefore like to see Ofcom putting forward a "roadmap" for synchronisation of fixed and mobile charge controls.

Secondly, in 4.33 - 4.35 Ofcom discusses the (lack of) visibility of 21CN costs. In line with the principles we set out in the introduction, it is critical that once these costs are visible, BT is not rewarded if 21CN turns out to be more expensive than the PSTN to deliver existing narrowband services. BT would not be rewarded for such inefficiencies in a competitive market and so should not be so rewarded in a regulated market. Our concerns with regard to this aspect are heightened following recent announcements from BT regarding the delays in 21CN voice services and the continued use of the PSTN for the foreseeable future.

Finally, in 4.42, Ofcom holds out the prospect of an early review of the NCC if there is a "material change" in the wholesale market. COLT had expected the narrowband market to be subject to significant change over the next four years from both the introduction of 21CN and the likely increase in the use of IP telephony. We are less clear about impacts following BT's changes to their 21CN plans for voice. However we are pleased to see that Ofcom has not closed its mind to a mid term review which we believe will be necessary.

With the above provisos, we agree with the four year NCC.

Question 4.2*: Do you agree with Ofcom's proposal to use a hypothetical ongoing network model to establish the technology neutral cost base for the next NCCs?*

Technology neutrality is one of the critical issues of this NCC as BT switches over from the PSTN to 21CN. As we said in our introduction, it is important that the NCC does not inefficiently incentivise BT to speed up or slow down the switch over from the PSTN to the 21CN by allowing BT to game prices on each network. It is important therefore that Ofcom concentrates on the service supplied by the network rather than the technology of the network. We therefore agree that it is essential that the next NCC is technology neutral. Ofcom's hypothetical ongoing network appears to meet this objective.

In 4.47 Ofcom states that it is "impossible to build a model that reliably reflects the relationships between volumes and costs on the 21CN". Let us suppose, hypothetically, that the relationship is greater on the 21CN than on the PSTN resulting in a higher unit cost per minute of terminated traffic. It would be entirely wrong if BT was able to recover that increased cost through a higher regulated termination charge. If the cost of the 21CN is greater than the PSTN then BT should not have made that investment and should not be able to recover any inefficiencies of that investment from firms, and ultimately customers, who have little choice but to buy from the SMP operator.

We therefore agree with the statement made by Ofcom in 4.53 that it proposes to use a technology neutral model which is not dependent on the platform BT uses to deliver wholesale narrowband voice services.

Earlier in the consultation document (4.16 - 4.19) Ofcom mentions the "potential inefficiencies which may arise as a result of the parallel running of the PSTN and 21CN". This has become particularly important since Openreach announced its "21CN Strategic Priorities 2009/10" on 7th April 2009 (after the publication of the fixed narrowband wholesale service market review). In the Strategy Review section of the briefing note, Openreach states: "We still plan to proceed with the planned migration to 21CN voice services across the country from 2010, *but it will be at a slower pace and smaller scale than previously envisaged."* (Our emphasis) Later in the same document, Openreach says in relation to NGN Call Conveyance that development of an NGN interconnection product will continue "but with a slower pace of migration, timings may well be impacted". Finally, Openreach says that "We have decided not to proceed with plans to introduce WBCC/WVC" (Wholesale Broadband Connect Converged and Wholesale Voice Connect). All these statements imply that parallel running of the PSTN and the 21CN will continue for longer than originally anticipated, and therefore that the "potential inefficiencies" will also continue for longer.

COLT views any costs of parallel running as part of BT's capital investment in the 21CN which will presumably be repaid through lower operating costs of the 21CN. BT will presumably want to eliminate such costs as soon as practical through a steady switch over to the 21CN. In a competitive market it would not need any external incentive (other than competition) and we do not believe it should receive any incentive from Ofcom. It is essential therefore that the charge control does not in any way reward BT for running the two networks in parallel even over a longer period than originally expected.

Question 4.3*: Do you agree with Ofcom's proposed methodology for the hypothetical ongoing model, including the use of adjusted base year costs from the previous NCC model to create a stable network from which to model costs?*

We agree with the general principle that BT financial statements for 2007/08 do not make a good starting point for the reasons Ofcom states in 4.57. In particular we agree that the costs of investing in 21CN would need to be excluded.

Question 4.4*: Do you agree with Ofcom's proposed approach to efficiency as regards BT's 21CN in proposing these charge controls?*

We broadly agree with Ofcom's approach to efficiency as regards BT's 21CN. In particular we agree with the statement in 4.62 that in the long term the expected costs of 21CN will be below the costs of the PSTN. Indeed there would be no point in BT making the investment in the 21CN if they cannot deliver the current set of services at a lower cost.

As we mention in our introduction, the costs of parallel running of the 21CN and the PSTN which Ofcom regard as an "inefficiency" are to our mind part of the capital costs of investing in the 21CN and should not be regarded as running costs which needs to be recovered.

Our primary concern with Ofcom's argument in this section of the consultation document is with the incentives for the rate of switch over from the PSTN to the 21CN. Ofcom phrases this discussion purely in the context of benefits for end users (e.g. 4.63) without consideration for the wholesale customers of BT who will be delivering those benefits to end users. Again referring to our introductory comments, we argue that Ofcom should take account of the efficiency of all players in the market and not just BT. Through its NCC, Ofcom could incentivise BT to switch off the PSTN too early for all its wholesale customer to be ready to offer services. Alternatively those wholesale customers might find it necessary to bring forward their own investment plans to meet BT's deadline in a way which is inefficient for them. Ofcom's focus therefore on BT and end-users is too narrow and needs to be widened to consider the interests of intermediate customers of BT.

***Question 4.5**: Do you agree with Ofcom's proposal to use a FAC CCA methodology to establish the cost base for the next NCC?*

COLT supports the continuing use of FAC CCA for the reasons set out by Ofcom in 4.85.

***Question 4.6:** Do you agree that product management, policy and planning and interconnection circuits should be subject to separate controls?*

We agree with this proposal.

***Question 4.7:** Do you agree that there is no need to introduce sub-caps on rental charges in the ISB basket?*

Provided that line rental continues to account for around 80% of the ISB basket, we agree that there is no need to introduce a sub-cap on rental charges. However, Ofcom needs to be vigilant to ensure that the proportion of the ISB basket accounted for by rental charges does not change significantly from 80% such that a sub-cap may be needed.

***Question 4.8:** Do you agree that Ofcom is not in the position to regulate BT's 21CN wholesale voice services at this point?*

We agree with this and, as we have stated before, we consider it important that Ofcom takes a technology neutral approach to the NCC. If Ofcom were in a position to regulate 21CN based wholesale voices services at this point and found that the costs of providing such services was greater than on the PSTN, BT should not be allowed to recover those extra costs arising from an inefficient investment.

***Question 4.9:** Do you agree with our proposed efficiency adjustment range of 1 – 3% annually?*

Ofcom defines two types of efficiency adjustments: "catch-up" and "frontier shift" (4.118). The latter is defined as annual cost reductions with constant volumes driven by overall sector productivity improvement. Ofcom concludes that the likely frontier shift will be more modest in 2009 – 2013 than it was during the 1999 – 2004 period.

This conclusion is difficult to understand. The switch from a TDM based network to an IP "next generation network" capable of running multiple services on one network <u>is</u> a "frontier shift". This efficiency gain is sector wide as all firms are investing in NGN and comes from running multiple services on the same network, with services separated at the access layer, rather than running different networks for different services.

When BT first announced its investment in the 21CN it said that it was expecting efficiency savings in the region of one billion pounds per annum. As other companies are also investing in NGN (Thus was the first company to do so) all companies should be making equivalent levels of efficiency savings.

We therefore consider Ofcom's proposed efficiency adjustment of 1- 3% too modest and would want to see a more substantial adjustment. As a rough calculation, Ofcom could calculate the efficiency adjustment as the proportion of network running costs accounted for by BT's expected one billion pound per annum savings.

Question 4.10: *Do you agree with Ofcom's proposal that BT be required to provide all data necessary to monitor compliance with the NCC within three months of the end of each NCC year?*

We agree with this proposal.

Question 4.11: *Do you agree with Ofcom that NCC charges should be set using RPI as the measure of inflation for indexation, prior year revenue weights to calculate charge changes, and with provision for carry over?*

We agree with continued use of RPI, the use of prior year revenue weights and the provision for carry over.

Question 4.12: *Do you agree with Ofcom that NCC charges should be aligned with modelled FAC at the end of the NCC period using a RPI+X glide path?*

We do not accept that BT should be allowed a positive X to catch up with lower volumes than were forecast in the last NCC. As we stated in the introduction, this provides BT with the perverse incentive not to rescale its network to meet current market conditions. An incentive to rescale would most definitely be present in a competitive market where firms would not be able to increase prices to compensate for lower demand. Competitive carriers, such as COLT, are not in a position to raise prices in the face of falling demand but have to become more efficient instead.

As an analogy, suppose that a firm of lawyers was experiencing a drop in demand such that fewer hours were being paid for by clients. As law is a competitive market, we cannot imagine the firm responding by raising its hourly rate when its competitors were not raising theirs. Rather, the firm would have to reduce costs by reducing capacity.

COLT operates in 13 European countries and so has a clear view of how regulation in one country compares with that across the EU. The UK currently has the lowest interconnection rates in Europe which help to contribute to the UK's international competitiveness as a destination for international businesses. Ofcom's proposal for a positive X would raise interconnection rates by up to 50% over four years. We believe that this could have a very negative effect on the UK's competitiveness and would therefore be damaging to the UK economy as a whole at a time of economic recession.

We cannot understand why Ofcom is not imposing the same discipline on BT as would be found in a competitive market. We therefore completely reject both of Ofcom's proposed approaches which we consider to be economically indefensible and as encouraging BT to maintain an inefficiently large network.

Our proposal would therefore be for a simple RPI-0% charge control allowing BT no opportunity to raise prices by more than inflation. This would give them the incentive to re-scale their network to meet demand and to move cut over to the 21CN to get efficiency benefits. We believe that this approach would meet the Section 88(1) objectives.

- It would promote efficiency by giving BT incentives to switch over to the 21CN and to reduce the capacity of their current network to meet demand;
- It would promote sustainable competition by ensuring that efficiency gains are passed on to wholesale customers; and
- It would confer the greatest possible benefit on end users through stable prices and the switch over to the 21CN with the new services it can offer.

In the event that Ofcom decide to adopt either Approach A or B we agree with Ofcom's preferred option of Approach A as it would not result in a large one-off price rise for wholesale customers which will have to be passed on to consumers.

Question 4.13: *Do you agree with Ofcom that, in the event that starting charges for the next NCC are below DLRIC floors, the NCC should allow increases in the first year of the NCC to align charges to DLRIC floors?*

For the reasons given in our answer to 4.12, we do not agree with Ofcom on this proposal. Allowing this one-off increase would effectively reward BT for not adjusting their network size to meet demand and so would reward BT for inefficiency.