Review of BT Network Charge Controls

UKCTA Response to Ofcom Consultation

Submitted in Confidence

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UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at www.ukcta.com.

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1 Introduction

UKCTA members represent the overwhelming majority of the UK's alternative fixed line sector and our members are acutely aware of the importance of both the Wholesale Narrowband Market Review and the resultant Network Charge Control. A successful wholesale market is essential if healthy competition is to flourish in the retail market. For competition to flourish UKCTA members need access to the right wholesale products at the correct price.

When designing a future network charge control Ofcom should take steps to ensure that UK businesses and consumers are not contributing towards costs which have been inefficiently incurred. It would be unacceptable if BT's competitors were forced to contribute towards costs which BT has incurred due to its failure to adapt to changing market conditions or resulted from the mismanagement of its cost base. Any future charge control should take a realistic view of future network costs and not make assumptions which allow an incumbent to automatically over-recover during the charge control period. A well designed price control can create the correct efficiency incentives; however a control that rewards BT with high returns for little or no effort is undesirable and damaging to competition and the wider economy.

In light of the Commission's latest recommendations on the transition to next generation interconnect rates and BT's less ambitious plans for 21CN in the voice interconnection area we would urge Ofcom to make significant modifications to the proposed charge control methodology, in order to prevent UK consumers being squeezed by higher retail prices.

In the sections that follow we will focus on the structure and methodology of the proposed charge control and outline some of the key principles around charge control monitoring and compliance which we believe Ofcom must adhere during the future control period. We also set out what we believe Ofcom must do now to achieve the best outcome for UK consumers and businesses.

2 BT Efficiency

Ofcom's current proposals for a charge control place no credible regulatory pressure on BT to increase its efficiency. UKCTA believe Ofcom has seriously underestimated the scale of the efficiency savings available to BT at this moment in time. We are sceptical of the finding in the NERA report on efficiency and do not believe that the report (which was commissioned in late 2007 and used in both the Leased Line Charge Control and the Openreach Financial Framework Review) is the most appropriate way to ascertain BT's efficiency for voice services in the UK.

There is considerable anecdotal evidence to suggest that BT's current voice operations in the UK are far from efficient, both in terms of staffing and network usage. With little effort BT can take actions to significantly improve the efficiency of its operation and under Ofcom's proposals BT would get to retain almost 100% of this benefit. We would urge Ofcom to increase considerably the efficiency percentages assumed in the model to better reflect the opertunities available.

3 Proposed Charge Control Methodology

The current methodology proposed by Ofcom results in interconnect charges (at the far end of the range put forward by Ofcom) increasing by almost 50%. Ofcom have justified the proposed massive increases by: (i) the fact that fixed network traffic volumes have decreased in the past few years, as a result of the reducing usage of dial-up Internet and fixed-mobile substitution, and (ii) the cost-accounting method(s) proposed to be used. The combination of these two elements results in a strong increase of modelled unit costs. Ofcom's current proposal is massively generous to BT and leaves the UK in an uncompetitive position, being possibly the only member state where fixed telecommunication costs are rising.

Ofcom proposes to assume (for modelling purposes), continued investment in the legacy TDM technology, with any benefits from the planned migration to the next generation network accruing to BT. In reality, of course, BT has been developing its 21CN for five years, and has changed its plans several times. In last couple of weeks BT's plans have changed again, resulting in 21CN for voice being almost abandoned, with the emphasis being on evolution rather than revolution. BT's plans for new technology deployment now resemble that of many European incumbents and as such we don't believe Ofcom should be taking a different approach in the UK.

UKCTA believe Ofcom is making serious methodological errors, and are giving the wrong economic signals, which will have wide-ranging consequences for the competitiveness of the UK economy.

Ofcom's proposals are based on a modelling approach which takes a snapshot of BT's costs today (which in our view are inflated as a result of BT's inefficiencies), projected into the future. The approach involves removing costs associated with BT's next generation network investment but also inflating costs to reflect the fact that Ofcom believes that BT's current TDM costs are not reflective of a sustainable network. These base costs are then projected forward, resulting in a hypothetical future network. The scenario that Ofcom has modelled, which estimates the costs of continuing to invest in and run a sustainable voice network using yesterday's technology, will clearly never arise, given BT's long-standing commitment to replace TDM kit with new technology, which it has justified to its shareholders and policy-makers on efficiency grounds.

We believe Ofcom's current Network Charge Control proposals don't add up. BT's assets are mostly fully depreciated and BT's plan is now to sweat those assets even further. Costs have been falling for over a decade as efficiency savings are realised and any drop in volumes has been both gradual and forecast, allowing BT sufficient time to trim costs and capacity. As new technology becomes available BT will deliver a step reduction in its cost base, so why are Ofcom proposing to implement a regime where prices could rise by as much as 50% over four years?

The reality is that Ofcom's proposals will allow BT to generate far more revenue than required to run the network, resulting in a large cash surplus. This will result in a loss of competitiveness in the alternative operator sector, as variable interconnection costs (origination + termination) could increase by as much as 50%. This will negatively affect the progress towards effectively competitive markets. Given the cost advantages of next generation technology, it is most likely that this period of interconnection charge increases will subsequently be followed by significant reductions in wholesale call termination charges (and presumably also call origination charges, if still relevant). Such fluctuations are bound to send the wrong signals to other network investors leading to the prospect of inefficient investment.

4 Compatibility of Ofcom's proposals with latest EU Recommendations

Ofcom's proposals seem very difficult to reconcile with the European Commission's Recommendation of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU. The Commission also provides clarity on its views in its Article 7 statement[1] of the 20th of May 2009; when it responds to the draft decision from the Austrian regulator on PSTN interconnect rates. The Commission has opposed the draft decision and the Hybrid Cost Model used to derive the rates and is now requiring the Austrian regulator to follow the EC Recommendation of the 7th of May 2009. In its Recommendation of the 7th of May the Commission makes clear that a LRIC methodology based on the latest efficient technology assumptions should be used.

The approach adopted by Ofcom also seems to conflict with the position adopted by the European Commission in several areas relating to the determination of fixed termination rates for alternative operators, where rates have been set on the basis of a bottom up LRIC model of a hypothetical efficient operator, regardless of actual volumes, costs and scale.

[1] SG-Greffe (2009) D/2881: Case AT/2009/0909: Dispute settlement related to call origination, transit and call termination on public telephone networks provided at a fixed location - Comments pursuant to Article 7(3) of Directive 2002/21/EC

5 Charge control monitoring and compliance

Where regulated pricing is prescribed by Ofcom, compliance with charge controls and cost orientation obligations must be proactively enforced by the regulator and Ofcom should not wait for CPs to raise disputes. BT must have a clear incentive to comply in 'real time' with its obligations. Any evidence of non compliance by BT must be punished to act as a future deterrent. UKCTA would welcome more developed proposals from Ofcom on the principles which would govern the consequences when compliance rules have been breached.

We also believe Ofcom should re-convene its work on the Charge Control Compliance Standard at the earliest opportunity. UKCTA would welcome an update on the timetable for this project.

BT accounts and Regulated Financial Statements must be transparent, accurate and produced to a sufficiently granular level of detail that allows monitoring of BT behaviour and compliance with its charging obligations. We note the work underway in Ofcom to address BT's future regulatory accounting obligations going forward and UKCTA look forward to working with Ofcom to ensure that BT has a robust regulatory accounting regime going forward to prevent any further restatement concerns arising.

Where charge controls are prescribed, these should apply for the duration of the control period (i.e. there should be no grace periods at the start or end) and BT should not be allowed to 'catch up' without penalty if it has not complied with controls or cost orientation obligations at the back end of the preceding charge control.

Based on Ofcom's proposed trajectory of interconnect charges Ofcom need to be alert to the possibility of a future margin squeeze. Ofcom is currently investigating a

Margin Squeeze complaint under the Competition Act in relation to BT's Wholesale Calls product (the investigation has been running since August 2008), however if interconnect pricing starts to rise and BT's Wholesale call prices aren't adjusted then there is even greater potential of margin squeeze in the Wholesale Calls market.

6 Recommendations: Getting the correct outcome for UK Consumers

Ofcom should redesign the charge control based on an efficient network model, building in the appropriate efficiency incentives for BT, while restricting the scope for over recovery. We believe interconnection costs should be based on the assumed costs of an efficient provider with any discretionary additional expenditure stripped out. Ofcom states that it is not possible at this stage to predict the cost and timing of the move to 21CN (in light of BT's most recent announcement we are not sure this is still the case). However NGN technology does provide the most appropriate cost base for setting forward looking charges and would allow the UK to satisfy the Commission's guidance.

If it is really not possible to set forward-looking charges, then the alternative should be to use the best prediction of TDM costs which would be made on the basis of continuing to sweat that asset. Ofcom should conduct a review of the cash requirements of the BT's voice network over the next four years. With falling volumes we anticipate the cash demands of the voice network will be very low and surplus kit can be redeployed, therefore avoiding the need to purchase new kit. Any new kit purchased will be much lower cost than old TDM equipment therefore we believe despite falling volumes, interconnect charges should actually fall over the next control period.

Virgin Media will be submitting their own detailed comments relating to the proposed network charge control. The views expressed by UKCTA in this response may not necessarily reflect those of Virgin Media.