

# Cable & Wireless response to Ofcom's consultation on the mobile call termination market review

22<sup>nd</sup> November 2006



**CABLE & WIRELESS**

## Executive Summary

Cable & Wireless welcomes the opportunity to comment on Ofcom's market review. The timing of this market review is particularly relevant due to the increase in call termination using 3G networks that the current SMP obligations do not cover. Ofcom's proposal to bring 3G termination within the scope of SMP obligations is vital.

The cost of calling mobile phones is too high. Evidence in the market shows it, and Ofcom's own cost modelling confirms it. This results in an inefficient transfer of funds from the fixed telephone industry to the mobile industry and, if left unchecked, will result in a lack of investment and innovation in fixed markets to the detriment of consumers in the long term.

As it currently stands, Ofcom's proposal will fail to adequately address this issue. The level of the resultant charges, throughout the period of the charge control, will result in an over-recovery compared with efficiently incurred costs. Furthermore, if a four year price control is to be applied it will first be necessary to significantly reduce the uncertainty associated with some of the key assumptions used. Cable & Wireless have made suggestions to address these issues.

The key issues in the setting of the charge controls can be summarised as follows:

- 3G termination provides no additional functionality or quality over that of 2G for call termination, therefore any costs that drive 3G to be more expensive in the long run than 2G are not efficiently incurred and should not be taken into account in setting target charges;
- The level of uncertainty associated with some of the assumptions, notably 3G licence costs and volume forecasts, is currently too great for a four year price control to be appropriate. The expected margins of error set out by Ofcom show that it is possible the mobile operators could over-recover by around £1.5bn in the final year of this charge control if the assumptions prove to be wrong;
- Throughout the interpretation of the cost analysis, Ofcom has used conservative assumptions and therefore, by its own admission, the result charges are above its best view of the cost of mobile call termination;
- The concept of the network externality charge is no longer relevant and should be excluded from the cost stack from now on;
- A price control for an established operator should be designed to allow the recovery of efficiently incurred costs over the period of the charge control, whereas the proposed glide path will allow over-recovery of between £200m and £250m for each 2G/3G operator in relation to even the conservative figures used in Ofcom's proposal.

We also make important suggestions in relation to the market definition and the implementation of the prohibition of undue discrimination. The relevant market consists of all mobile call termination, not just that sold to other Communications Providers and the SMP obligations placed upon the operators must prevent discrimination in favour of their own downstream businesses.

## Table of Contents

1	Introduction	3
1.1	Current charges are too high	3
1.2	The 3G issue	5
1.3	The impact of high termination rates	6
2	Market Definition and SMP Assessment	7
2.1	Market Definition	7
2.2	SMP Assessment	7
3	Cost Modelling	9
3.1	Spectrum	9
3.2	Network externality and non network costs	11
3.3	The use of conservative assumptions	12
4	Charge control and other remedies	14
4.1	Charge controls for 2G/3G operators	14
4.2	H3G glide path	15
4.3	No undue discrimination	15
5	Answers to Ofcom's Questions	16

## 1 Introduction

In this introduction we set the scene for the key issues for this market review. We set out the evidence as to why we believe the current termination rates are too high and why we believe that 2G costs set a very important benchmark for the efficient costs of using 3G. We also provide some brief comments on the impact of high termination rates, although we note that these have been discussed at length in previous consultations on this issue and many of the problems remain the same today.

In section 2 we consider the definition of the market and SMP assessment. Then in section 3 we discuss some of the most important issues around the cost modelling undertaken in support of this market review. We make some significant suggestions that will help align the regulated price of call termination to the efficiently incurred costs of providing it and ways to reduce the uncertainty in Ofcom's proposal. In section 4 we cover the SMP obligations and finally, in section 5 we answer Ofcom's questions for which more detail can be found throughout the body of this response.

### 1.1 Current charges are too high

Cable & Wireless believe that wholesale charges for calls to mobile handsets are too high. The reasons for our opinion are twofold; firstly, they are high in relation to retail prices for mobile services, and secondly, Ofcom's own cost modelling shows that they are.

#### ***Wholesale prices are high in relation to retail prices***

The current termination rates were effectively set in 2004 based upon the view of cost at that time. Since then retail prices for mobile services have fallen. Ofcom's Communications Market research shows that for a typical basket of retail mobile services prices fell by over 10% between 2004 and 2005. It also shows that the average price of an on-net call fell by over 15% to 4.2ppm. We do not think these reductions were extra-ordinary. Competition in the mobile market is driving ever increasing bundles of minutes and we expect the price decline trend to have continued over the past year; and we expect it to continue into the future.

In comparison the regulated target charge for wholesale mobile call termination has stayed constant in nominal terms, effectively falling only by inflation over the past 2.5 years. Ofcom's current proposal to reach 5.3ppm (in 2006/7 terms) by 2010/11 would see average rates over the four 2G/3G operators stay roughly constant in nominal terms. In other words, assuming current inflation rates, wholesale rates are falling by about 2.5% per year in real terms. It is not possible to know how retail rates will change over the whole six and a half year period but on the basis of the last two years it is clear that they will fall by much greater than 2.5% per year.

This difference in the relative reduction on prices cannot be explained by the fact that Ofcom, and the Competition Commission, got the figure wrong in 2004 and the rates set then were too low. Since that time Ofcom has twice reviewed the costs, once to roll over the charge control for the current financial year and

again here, and each time they have found the costs to be lower, not higher than those calculated in 2004.

In previous consultations on this subject Ofcom has considered the possibility of tying wholesale termination rates with retail prices in some way. In theory such a solution is attractive, however, Cable & Wireless agrees with Ofcom that in practice it would be extremely difficult to implement robustly. Even so, there is merit in looking at retail rates. In a competitive market, such as the retail mobile market, the price of the bundle of services to the most valuable customers should tend towards cost plus an appropriate margin of profit.

A quick look at the price plans for the mobile operators shows that high usage customers (those that use over 1000 minutes per month) would pay between 3 and 4 ppm (before VAT) if they used all the minutes in the plan. Such prices do not relate directly to mobile termination, as they must also cover many other expenses. The cost of the handset, the retail customer care and billing, the marketing costs and the cost of other services such as SMS that are included in the plan are not relevant to wholesale termination. Some operators will even throw in a free broadband line. An alternative way to reduce the effect of these factors is to look at the incremental cost of increasing the number of minutes within a mobile price plan. Using this method it is easy to find plans where the incremental cost is less than 3ppm and for some it works out to be less than 1.5ppm.

It is also necessary to take into account that, on average, over half the calls will use two, not one, of the expensive wireless legs as the calls will both originate and terminate on mobile handsets. Offset against this is the likelihood that customers will not use all their inclusive minutes in their bundle and there will often be additional 'out of plan' charges to boost profits. Taking all of this into account it is hard to conclude that retail prices are set using a similar view of costs to that used in setting wholesale charges.

### ***Ofcoms own cost modelling shows they are too high***

The cost modelling undertaken by Ofcom also shows that mobile termination rates are too high. Figure A13.9 shows Ofcoms latest view of 2G costs, which for this year are approximately 4ppm. Even when the inefficiencies resulting from the migration to 3G are taken into account, the cost is only about 4.5ppm. These figures compare with a current regulated target for 900/1800 2G operators of 5.63ppm.

In practice the situation is probably even worse. Ofcom is very clear that it has used conservative assumptions in arriving at its proposed charges for the next four years. Ofcom confirms that it thinks that the volumes used are conservative, the 3G licence fee assumptions are conservative and the figures chosen are those relating to the highest cost operators rather than the average. These conservative assumptions may mean that the current charges are even further above cost than the figures show and certainly mean that the proposed target charges are much more likely to be too high than too low.

In summary, the cost modelling undertaken by Ofcom supports the fact that the current charges are too high and, on the basis of Ofcom's proposal, it can be expected that they will remain that way throughout the charge control period.

## 1.2 The 3G issue

The current SMP obligations placed upon the four 2G/3G mobile operators relate only to the termination of calls on their 2G networks. All of these operators now operate 3G networks as well and they have seen the lack of obligations on 3G as an opportunity to increase the price of call termination. The 2G/3G operators have all issued pricing notifications that blend a proportion of 2G usage at rates that meet their regulatory obligations and a proportion of 3G usage at unregulated rates. For all operators, the implicit 3G charges that underlie the proposed rates are significantly above the conservative view of 3G costs calculated for this market review. This clearly illustrates the need for control on all mobile call termination and Cable & Wireless welcome Ofcom's proposal to bring 3G within the scope of the charge control.

Cable & Wireless, however, does not believe that the charges for 3G should be any higher than those for 2G. In essence this is because we do not believe that 3G provides any greater functionality or quality over that of 2G for mobile call termination. In a competitive market it would not be possible to charge more for what is essentially the same product and it should not be so in a monopoly either.

It is worth noting that all current 3G mobile handsets also have the capability to operate using 2G. The mobile operators have chosen to deploy them in a way that they default to 3G where available, but it is not essential. Call termination would work just as well if handsets defaulted to 2G for receiving incoming calls. The fact that mobile operators have chosen to deploy their networks in this way suggests that, over all, they believe that it is more efficient to use 3G. So why should charges for termination using 3G be more than those using 2G?

We believe that 3G is not just more efficient over all but also it is more efficient purely for the purposes of call termination and we note that Ofcom's analysis supports this view. However, even if it were less efficient for call termination it would still not be appropriate to pass this additional cost on for call termination for as long as 2G networks continue to exist. In a competitive market, it would only be possible to pass these higher charges on to those customers who also want the services that rely on 3G and who value them accordingly. If the additional costs were passed on in the form of higher termination rates it would result in the purchasers of mobile termination subsidising the efficient charges of the other services that rely on 3G.

Once again it is worth considering retail prices. In this competitive market, voice cannot command a price premium when supplied using 3G, instead some operators provide increased incentives for customers that take a 3G handset rather than a 2G. Whilst this does not necessarily mean that the mobile operators see 3G as being cheaper than 2G it does indicate that, in a competitive market, customers are not willing to pay a premium for 3G voice. Ofcom's preferred solution to the problem of SMP in call termination was to find a way of creating effective competition in mobile termination and that would have allowed the market to dictate prices; just as in current retail markets 3G would not command a premium. We do not see any reason why Ofcom should set regulated rates in any other way to that which their preferred solution, a competitive market, would have done.

### 1.3 The impact of high termination rates

The impact of high termination rates is now well known and Ofcom has covered them in section 7 of the consultation document. In general we agree with Ofcom's assessment of the issues. The issues are very closely related.

Of particular concern is the inefficient structure of prices. Ofcom comments that if the waterbed effect were complete then mobile operator profits would be invariant to the level of termination charges and they would be unconcerned about the level of such charges. We do not agree with this due to the other issues that Ofcom has considered. Even if profits were unaffected by high termination rates they would have the effect of encouraging the use of mobile over fixed lines for making calls to mobile handsets. This is because the mobile operators are insensitive to high charges between each other as the increased inpayments offset the increased outpayments. In the long term this situation will encourage greater usage of mobile phones, in general reducing the competitive threat from fixed telephony.

The impact of this can be seen already. Ofcom's Communications Market research shows that about 10% of calls made from fixed lines terminate on mobile handsets whereas 55% of calls from mobile terminate on mobile. There is an argument that some retail rates for fixed to mobile calls are high in relation to wholesale termination rates and this may partially explain the discrepancy. However, it is easy to find retail mobile price plans where the incremental cost of increasing the number of minutes in the bundle is less than 3ppm. The fixed operators know that they cannot compete with these rates when the termination charges alone are 6ppm. The price sensitive user is always likely to use their mobile to call other mobiles however close to their cost the fixed operators choose to price their service.

The situation brings about two detrimental effects. Firstly, it encourages inefficient utilisation of expensive and potentially scarce resources. If the cost of mobile telephony really is as expensive as the cost modelling suggests, then it is inefficient to encourage the use of two mobile segments when only one is needed. It will also speed up the utilisation of the 3G spectrum that Ofcom argues is a scarce resource. Secondly, the resultant decline in fixed services will discourage investment by the fixed network operators, most notably in next generation networks. Over time this will constrain innovation and consumer choice in the fixed markets.

A further impact of high termination rates is that they encourage undesirable methods of bypass. The use of GSM gateways remains a grey area but there is evidence that their use is increasing once again. If the cost of mobile telephony is anything close to that suggested by the cost modelling, their use is clearly an inefficient method for terminating calls. There are also mobile operators own bypass solutions such as leased line access. Although there are genuine uses for such solutions they also have the potential to encourage discriminatory behaviour. Left unchecked, this will result in a decline in fixed services that in turn will lead to a lack of investment and reduced innovation and customer choice in fixed markets.

## **2 Market Definition and SMP Assessment**

### **2.1 Market Definition**

In general, we agree with Ofcom's analysis that underpins the definition of the market. However, we note that the final definition of the market has changed from that used in 2004. The proposed definition of the market includes only calls provided to other Communications Providers which would appear to exclude on-net and some other calls.

We have not been able to find any explanation as to why the definition has changed or why the market only includes calls sold to other Communications Providers. The termination of calls is not different depending upon where the call originates. For example, a call from a retail business requires exactly the same termination if it is sent directly to the MNO to that required if it is sent via a third party Communications Provider. Furthermore, such a definition would imply that there is another market, call termination sold to anyone apart from another Communications Provider, and calls to any particular handset could fall into either market.

In fixed markets the established definition defines the markets for call termination to include all calls to the subscribers of fixed geographic services. The definition is not only logical but essential in the case of vertically integrated operators to enable to effective control of any potential discrimination between internal and external supply.

The market definition should be worded in a way that covers all call termination. If Ofcom feels that such a definition is not appropriate then it should consult in detail on the reason why it feels a change is required and the justification for a different approach in mobile rather than fixed markets.

### **2.2 SMP Assessment**

Cable & Wireless agree with Ofcom's SMP assessment. Each operator has 100% market share in the relevant market and without some technology intervention or a move away from the calling party pays system, SMP will normally exist. The constraint placed upon fixed operators, such as BT and ourselves by ex-ante regulation prevents them from being able to exert countervailing buyer power that can constrain rates to an efficient level.

In its analysis of this issue Ofcom refers to the attempts by some operators to resist the price increases recently proposed by some of the 2G/3G operators by their 3G blended rates. This action does not provide any meaningful evidence with respect to countervailing buyer power due to the following reasons that are covered by Ofcom:

- An SMP finding already exists covering all forms of termination, including 3G, even though the obligations do not cover 3G. The fact that this SMP finding exists will impact the parties expectation of how Ofcom would view any dispute;
- The existing regulation of 2G call termination has set the benchmark for call termination rates. This benchmark forms a crucial input into any

negotiation for similar services as their value can be judged in relation to the value of 2G call termination;

- There will have been an expectation that the issue of 3G blending is limited to a defined period of time, and hence value, due to the existence of Ofcom's proposals to bring 3G termination within the scope of the next charge control;
- Decisions taken by any of the parties could be influenced by the potential to send signals on this issue of countervailing buyer power.

Ofcom's conclusions on countervailing buyer power are correct. The situation now is no different to that of a few years ago when regulation was necessary to reduce termination rates to the current levels.

## 3 Cost Modelling

### 3.1 Spectrum

#### *Ofcom's proposal*

The issue of 3G spectrum costs is one of the most important issues in this consultation. The five mobile operators paid very significant sums for their licences and it appears that the allocation of these costs makes up the single largest element of the proposed charges. However, the allocation of spectrum costs in the manner set out in this consultation is inconsistent with the situation that would be expected in a competitive market and it does not align with Ofcom's objective to send appropriate price signals to consumers. The fundamental point is, as Ofcom states, that mobile operators should be able to recover their efficiently incurred costs.

Ofcom's analysis of this issue gives consideration to the total value of the 3G licences. It is certainly not clear that the amount that the 3G operators paid for their licences represents an accurate valuation of the total spectrum today. The evidence actually points to the fact that the mobile operators may have paid too much and indeed that was the view of many commentators at the time of the auctions. Comparisons with other countries show that UK licence fees were in excess of 3 times more per head of population than most other European countries and the premium with respect to many non-European countries was even greater.

Ofcom has looked at the current balance sheet valuations of the licences of the UK operators and found that only one has so far impaired their valuation. However, consideration of these valuations is not relevant. Those valuations may be influenced by the regulatory treatment of spectrum costs and therefore a clear incentive exists to wait until regulation is set before re-valuing the licences. Alternatively, operators may still believe in the value of advanced 3G data services that we assume drove their original valuations.

It must also be remembered that the 3G auctions took place at a time when many poor business decisions were taken in both the fixed and mobile industries. The extent of the write-off made by telecoms firms since 2000 demonstrates that in competitive markets the cost of poor decisions cannot be recovered from customers. Whilst we make no judgement on whether the 3G licence fees paid were good or bad decisions what is absolutely clear is that if operators were "attributing" 20 to 25% of the value of the licence on the basis of the potential call termination revenues then that would have been an extremely bad decision. Such costs could not be recovered in competitive markets and should not be recovered in monopoly markets.

Ofcom's proposal considers several alternative ways to allocate the licence fee to mobile termination based upon radio traffic and total traffic volumes. This is one approach although we note that in mobile markets, probably more than in any other telecoms markets, SMS has proved that value is not proportionate to bandwidth. Fundamentally, however, such an approach relies on an appropriate valuation of the spectrum as a whole and it is clear both that such a valuation is impossible to achieve and that it is not the appropriate way to address this issue.

### ***Cable & Wireless' proposal***

It is not the total cost or value of the licences that should be considered, with a portion then being attributed to call termination, but rather what value a business would rationally put on the spectrum to be used for voice call termination. As a starting point it is worth considering the assumptions that the mobile operators would have made at the time of the 3G auctions. The guidance given at the time was that valuations should be made on the basis of expected prices for 3G services. When considering the amount of value to attach to the portion of the spectrum that would be used for voice call termination no operator would have expected prices for 3G termination to be greater than 2G termination. Whatever their expectations of those prices were at the time is irrelevant as those estimates are their genuine business risk, a risk that the existing operators at least were in the best position of anyone to assess. The prices that are relevant are the 2G prices that would exist over the next four years, absent 3G. These are the efficient charges based upon the 2G only scenario.

If a mobile operator were looking to use 3G technology to displace 2G technology for call termination it would only do so if it either allowed extra functionality or was lower cost. It therefore follows that the maximum efficient price for using 3G technology for voice call termination (which has no added functionality) is the 2G call termination price. The efficient valuation of spectrum used for call termination could not be greater than overall efficiency gain made by the use of 3G for the purposes of call termination.

In a competitive market the valuation of spectrum for call termination would lie somewhere in the range between zero and the total efficiency gain provided by 3G technology for the purposes of call termination. Ofcom's decision should be to determine where within this range they should set this valuation. Crucially, the margin for error in this is significantly less than the extreme uncertainty involved in any attempt to value the licence as a whole and allocate it across all services.

In fixed telecoms markets it is normal to share the efficiency gains made on regulated products between the operator and consumers. This is achieved through the setting of consecutive charge controls, the operator keeps the gain during the control and then the whole of the gain achieved is passed on to consumers within the next target. Therefore there is a clear precedent for sharing this gain and we believe that to provide 50% to the mobile operators and 50% to consumers would be an appropriate solution.

The approach that we have outlined above would be far more consistent with Ofcom's stated objectives than that currently proposed. These objectives are:

- a) providing appropriate price signals to the consumer
- b) the impact on MNOs cost recovery
- c) the impact on MNOs incentives to use spectrum efficiently

As we have already argued the current proposal shows wholesale mobile termination rates falling far more slowly than retail rates. However, the disparity that already exists today sends very wrong signals to consumers in as much as it encourages them to use their mobile phone for all calls to other mobile phones, using twice the expensive radio spectrum that is necessary. Ofcom's

proposal would make this situation worse. In contrast, our proposal will result in lower rates, valuing spectrum as it would be valued in a competitive market, sending more appropriate signals to consumers.

In terms of cost recovery our suggested approach allows mobile operators to recover those costs for spectrum that were efficiently incurred for the purposes of call termination. To allow spectrum costs to push 3G costs above those of 2G termination would be to allow the recovery of inefficiently incurred costs.

Ofcom state that it is not the primary objective of this regulation to ensure that the incentives exist for MNOs to use spectrum efficiently. We note that, whatever the level, a single target charge covering 2G and 3G will not provide incentives for the operators to speed up or slow down 3G take-up other than for their own genuine efficiency gains.

There is a final objective, not explicitly stated in relation to spectrum but covered elsewhere, to encourage innovation. The value of 3G licence fees was justified on the basis of innovative new services that could not be provided over 2G. The greater the portion of the licence fees that the operators are allowed to recover in monopoly call termination, the less incentive there is for them to develop innovative new services to recover the fees. If anything, a high allocation of spectrum to call termination could act as a barrier to innovation.

In summary, the method of allocation of spectrum costs detailed in the consultation is impractical because of the uncertainty involved in the licence valuation and, as currently proposed, would lead to a recovery of inefficiently incurred costs that would not be recoverable in a competitive market. The solution proposed by Cable & Wireless would provide a solution that is consistent with a competitive market, has a much smaller margin for error and is better aligned with Ofcom's stated objectives.

### **3.2 Network externality and non network costs**

Cable & Wireless does not believe that the concept of network externality remains valid for mobile call termination. In the UK we now have roughly one active mobile subscription for ever person who lives here. Furthermore, the excess recovery enabled by the inclusion of the network externality charge is not effectively targeted at marginal customers.

In the past, the biggest issue in attracting the so-called 'marginal customers' has been the cost of persuading them to subscribe to mobile services and the subsidy required for their mobile handset. This is a significant expense that would not have been recoverable from low usage customers. Today, the big issue is the number of old handsets that are no longer in use. The availability of pay-as-you-go and sim card only services combined with an excess of handsets, means that there is no longer a requirement for the mobile operators to pay for the handsets of marginal users whose usage will not cover that cost. Encouraging the re-use of existing handsets can also help reduce the increasing burden of the disposal of electronic waste.

It could be argued that the pay-as-you-go and sim card only services are only available because of the subsidy from call termination. However, the retail

market is competitive, and the mobile operators would not offer such services if they were not viable. There is no mechanism in place that will ensure that the externality charge does what it is intended to do. Indeed it is far more likely that it will be used to subsidise the price to the most attractive customers, those that spend the most money, than the marginal ones.

The network externality charge is no longer valid, and, even if it was, it is ineffective as it currently stands. It should not form part of the setting of mobile termination charges.

### **3.3 The use of conservative assumptions**

Throughout the consultation document Ofcom highlights the significant degree of uncertainty associated with some of the assumptions, particularly traffic volumes and spectrum costs. We agree with Ofcom that this is a significant issue and we make suggestions for ways in which this level of uncertainty can be reduced. However, we do not agree with the approach taken that makes use of conservative assumptions in order to minimise the chance that the mobile operators will under-recover their costs. The implication of this approach is that they will be most likely to over recover costs.

The impact assessment of this issue in section 9 highlights the detrimental effect of under-recovery. As a result of the waterbed effect, retail prices would rise leading to a possible reduction in volumes, which in turn could lead to reduced investment and innovation. The point may have some merit, although it is not clear that lower volumes would lead to reduced investment and innovation; alternatively they may lead to increases, as there would be a need to attempt to stimulate growth. However, what is clear is that if lower volumes of mobile traffic were to slow investment then it is also the case that lower volumes of fixed traffic would slow investment by fixed operators. It has already been noted that a disproportionate number of calls to mobiles come from other mobile phones; anything that makes the cost of a mobile to mobile call even cheaper (albeit artificially so) than a fixed to mobile call can only exacerbate this situation. The fixed industry is currently undergoing its own investment programs, notably in next generation networks, and the very same issues apply in the other direction if over recovery in call termination occurs.

The impact analysis should consider the efficient structure of prices, as they will drive the efficient levels of investment by operators. In the UK, the calling party pays for calls made to mobile handsets under well-established principles. However, in some countries the receiving party pays for both incoming and outgoing calls. In essence, there is a value in the ability to be called when not at a fixed location just as there is a value in the ability to call someone when they are in such a location. The calling party pays system suggests that the most value lies in the ability to call whereas the receiving party pays system suggests the most value is in the ability to be called. In practice the value is likely to be shared between the two.

If that were the case the efficient level of investment in mobile services would be achieved in a situation where the cost of termination is shared between the calling and the called parties. If the called party gains some value from being called then that should be reflected in the balance of prices: the called party

would be willing to bear a part of the cost of termination, which, given the waterbed effect, would mean that it would be efficient for customers' retail prices to be set at a consequently higher level. This would be the efficient set of prices and hence it would result in the optimal level of investment and innovation.

We are not suggesting that Ofcom set this particular set of charges in direct recognition of this issue although it may have merit for future charge controls. It is, however, relevant for Ofcom's impact analysis on the risks of setting the charges too high or too low. The risk of constraining efficient investment is actually likely to be greater where termination rates lead to over-recovery of costs rather than where they lead to under recovery. The use of conservative assumptions by Ofcom is, therefore, inappropriate.

It is necessary to correct this but that alone will not overcome the issue of uncertainty of certain assumptions. We have estimated the impact of the use of incorrect assumptions here. For the four 2G/3G operators, the mid point in the low unit cost range is 3.8ppm that compares to the currently proposed target charge of 5.3ppm. It is expected that each operator will have around 15m subscribers by 2010/11 and the higher forecasts show about 140 incoming minutes per sub per month. So under this scenario, in 2010/11, each operator would over recover on call termination 1.5ppm over a volume of 25bn minutes. This is £375m each, or £1.5bn over all four. The over recovery on call termination would be a figure that dwarfs the most optimistic view of the entire profits from any fixed operator except BT. Uncertainty of this magnitude, with these potential detrimental impacts, is unacceptable.

Ofcom must take steps to reduce this level of uncertainty. That could be achieved by reducing the length of the charge control period. Alternatively, Ofcom could make provisions to review the volume assumptions used annually, while keeping other less problematic assumptions constant.

## **4 Charge control and other remedies**

### **4.1 Charge controls for 2G/3G operators**

In general, Cable & Wireless supports the use of charge controls over a period of up to four years as a method of controlling charges for regulated services. Such controls help provide valuable stability and provide incentives for efficiency improvements that, over time, are then shared between the regulated operator and consumers. In this case there are two areas that need to be addressed before it is appropriate to make use of a charge control such as that proposed. First, the level of uncertainty in the efficient charges must be significantly reduced and second the charge control must aim to provide the recovery of efficient charges over the period of the control.

We have already provided some suggestions that will reduce the level of uncertainty in the future costs. In spectrum allocation our approach is more representative of a competitive market and less sensitive to the assumptions used. In respect of volume forecasts it is difficult to see a clear solution but we believe the annual review of forecasts used in setting the charge control would still provide some of the benefits of such a control, while overcoming this major area of uncertainty.

The other issue relates to the level of cost recovery that would be allowed using the charge control proposed. It is clear from Ofcom's cost modelling that the current 2G regulated prices are already above efficiently incurred costs. The 2G/3G operators are well established operators and any charge control should be designed to allow the recovery of efficiently incurred costs over the period of the charge control and not just by the end. The important fact is that the reductions in costs that have occurred since 2004 are due to changes in the cost modelling and assumptions used and they are not genuine efficiency gains that have resulted from efficiency improvement initiatives taken by the operators themselves.

We have estimated the over-recovery that would occur using the proposed glide path approach and assuming the medium view of volumes used by Ofcom. In order to undertake the analysis we have looked at the underlying cost benchmark trend in Fig A13.9 which shows that currently the efficient charge is less than the 5.3ppm it is expected to be at the end. We estimate that, over the period of the charge control, each of the four operators would over recover between £200m and £250m compared with a charge control that accurately tracked the costs. These are very material sums and it is not appropriate for a charge control to allow such significant over recovery.

There are two potential solutions. A glide path could be set so that any over-recovery at the start is offset by under recovery towards the end of the control period. We would not favour such an approach, as it is likely that it would result in a follow on charge control that would increase charges and hence we would lose the stability benefits that we desire. Alternatively, there should be a one off adjustment for charges to expected cost in 2007/8 and then the charges should be adjusted to track costs between then and the end of the control period. Such an approach would ensure that only efficiently incurred costs were recovered and we favour this method.

## 4.2 H3G glide path

The situation with the H3G glide path is slightly different. H3G is still a relatively new operator and there is an argument for allowing some over recovery of efficient cost for a limited period in order to allow the new operator to establish itself. In the long term the consumer benefit from increased retail competition may offset the short-term detrimental effects of higher termination rates.

However, the current H3G termination rates are, as Ofcom observes, very significantly above cost. This current situation is not desirable because it is unlikely to lead to the new operator establishing itself in a stable manner. In particular, the existence of the 'We Pay' revenue share gives a strong indication that H3G termination charges are inefficiently high and that growth on this basis is unlikely to be sustainable. Therefore we conclude that it is essential that Ofcom implement a one off adjustment to H3G rate for 2007/8 to act as a starting point for the glide path.

The appropriate level for such a one off adjustment is difficult to judge. As we have argued previously, the allocation of spectrum costs should be revisited and the use of conservative assumptions is not appropriate and so, in our view, the efficient charge for 2007/8 is significantly less than the 6.8ppm indicated by Ofcom. In our view a starting charge of 8.5ppm would be at least double the efficient charge and this is too much. Therefore, of the options set out by Ofcom we would support only the third.

## 4.3 No undue discrimination

We argued earlier in our response that the use of leased line access and other methods to bypass mobile termination rates have the potential to be discriminatory. In the impact analysis presented by Ofcom in section 7 it discusses the risk of anticompetitive behaviour due to the supply of the same input to the operators' retail business as is supplied to its fixed and mobile competitors.

We agree with Ofcom that the greater the gap between wholesale price and cost, the greater the risk that certain types of behaviour, e.g. discrimination, would have anti-competitive effects in retail markets. There is strong evidence that there is currently a significant gap between wholesale price and cost and the insights we have provided into retail prices suggests that, without very significant reductions to the current proposed rates, that this gap will continue throughout the charge control period.

The prohibition of undue discrimination is important. However, while there is any doubt that mobile termination rates are above efficiently incurred costs, and there is significant doubt, it is vital that this prohibition covers internal and external supply of mobile termination. This is the only way that such an obligation can prevent the anti-competitive behaviour that Ofcom and Cable & Wireless have identified. Of course, such an obligation does not lessen the need for the charge controls to be set at the efficient levels in the first place.

## 5 Answers to Ofcom's Questions

### ***Question 1: Do you agree with Ofcom's market definitions?***

No, the definition of the market must include all forms of mobile termination and not just that supplied to other Communications Providers. If that is corrected, Cable & Wireless would agree with Ofcom's definition. Please see section 2 of our response for more details.

### ***Question 2: Do you agree that each of the five MNOs has SMP in the market for wholesale mobile voice call termination provided by it to other Communications Providers in the UK?***

Yes, please see section 2 of this response

### ***Question 3: Do you agree that it is appropriate to impose the following SMP conditions on each of the five MNOs;***

- ***A charge control on mobile to mobile MCT to apply until 31 March 2011.***
- ***A charge control on fixed to mobile MCT to apply until 31 March 2011***
- ***A prohibition of undue discrimination***
- ***An obligation to meet reasonable requests for MCT on fair and reasonable terms***
- ***An obligation to publish access contracts***
- ***An obligation to publish charges and notify call volumes***

The proposed SMP conditions are appropriate, but only once several important issues are addressed. Firstly, if a four year price control is to be appropriate then the level of uncertainty must be significantly reduced. Secondly, the prohibition of undue discrimination must cover all users of call termination, including own supply.

### ***Question 4: Do you agree that the appropriate level of the target average charge to apply to mobile to mobile MCT and fixed to mobile MCT in 2010/11 in respect of H3G is 6ppm (2006/7 prices), and in respect of the 2G/3G MNOs is 5.3ppm (2006/7 prices)?***

No, the current charges are too high and these target charges are also too high. Our reasons for believing that costs are too high are explained in the body of this response but can be summarised as follows:

- 3G termination provides no additional functionality or quality over that of 2G for call termination, therefore, any costs that drive 3G to be more expensive in the long run than 2G are not efficiently incurred and should not be taken into account in setting target charges;
- Throughout the interpretation of the cost analysis, Ofcom has used conservative assumptions and therefore, by its own admission, the result charges are above its best view of the cost of mobile call termination;
- The concept of the network externality charge is no longer relevant and should be excluded from the cost stack from now on;

**Question 5: Which of the following glide path options should be used to define H3G's target average charge in each of the first three years of the charge control period;**

- **Option 1 - A smooth glide path with charges reducing at a constant percentage rate in each of the four years from today's average charges to the target determined for 2010/11.**
- **Option 2 - A one-off partial cut to 8.5ppm (2006/7 prices) for the first year followed by a smooth glide path to ensure that the maximum average charge aligns with the target determined for the final year of the charge control.**
- **Option 3 - A cost based glide path with charges reducing immediately to align with the 3G-only operator cost benchmark for 2007/8, and then set equal to the forecast cost path thereafter, such that in 2010/11 the maximum average charge aligns with the target determined for that year**

Cable & Wireless believe that H3G's termination rates are currently significantly above cost, leading to distortions in the marketplace, and that an immediate adjustment is essential. The situation with H3G is slightly different to that of the other operators in as much as they are still very much in startup phase. If Ofcom is to encourage efficient and sustainable competition in the long term it will sometimes be necessary to allow startup operators time to establish themselves. However, a cut to 8.5ppm would still result in a rate that we believe is over double the efficient charge for call termination and this is insufficient as a one off cut. Therefore, based upon these three options C&W believes that Ofcom should adopt option 3.

**Question 6: Do you agree that the 2G/3G MNOs should be required to reduce their charges in line with a smooth glide path of constant percentage rate in each year of the charge control such that average charges in the fourth year (2010/11) align with the target determined for that year?**

No, we do not agree with the proposed implementation of the glide path. In general we support the stability and efficiency incentives provided by a four year price control but such a control should be set to allow recovery of efficiently incurred costs over the period of the control. If the glide path allows for over-recovery at the start it should force under recover at the end to offset. However, we are concerned that in this case to do that could cause instability in future charges beyond this control period and therefore we believe that charges should be set to closely follow the path of efficiently incurred costs over time.