TELEFÓNICA O2 UK LIMITED'S RESPONSE TO OFCOM'S CONSULTATION: MOBILE CALL TERMINATION: CONSULTATION ON PROPOSED GUIDANCE ON DISPUTE RESOLUTION

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A. Executive summary

1. Telefónica O2 UK Ltd ("O2") is grateful for the opportunity to comment on Ofcom's proposed guidance on dispute resolution in the context of mobile termination rates[1].

2. O2 welcomes Ofcom's recognition that the variety of technological means of providing mobile services, and the business models underpinning them, means that a simple "reciprocity" approach to setting mobile termination rates would not be appropriate in all circumstances. We also agree that providers that do not incur "radio access" costs, should not benefit from reciprocal termination rates and that, instead, fixed termination rates are, in principle, a more suitable benchmark. As Ofcom notes, if providers with significantly lower costs were able to benefit from reciprocal mobile termination rates, they would be able to plough the additional margin into the retail market, thereby distorting competition.

3. However, Ofcom appears to have overlooked a problem in developing its guidance. Fixed termination rates are set on the basis of BT's cost of terminating fixed calls. Ofcom has used a "fully allocated cost" approach to determine this. This is analogous to LRIC+ and, importantly, provides for the recovery of some fixed and common costs. Conversely, Ofcom is proposing to set mobile termination rates in accordance with the pure LRIC principle, which does not provide for the recovery of any fixed and common costs.

4. Accordingly, if Ofcom's guidance were adopted, those mobile providers that did not incur radio access costs would still benefit from a revenue advantage over those operators that incur radio access costs. This is because their termination charges would be pegged to a cost standard that allowed recovery of fixed and common costs, whereas providers that incur radio access costs would not be able to recover any fixed and common costs through mobile termination rates.

5. In summary, O2 supports Ofcom's objective that the regulation of mobile termination rates should not distort competition in the mobile retail market. However, O2 does not agree that Ofcom's proposed guidance would achieve that aim, if Ofcom persists with its pure LRIC proposals in respect of mobile termination rates. Indeed, it would have the opposite effect, since it would "bake in" an unfair cost advantage in favour of mobile providers that do not incur radio access costs. This would distort competition, contrary to Ofcom's principal (relevant) statutory duty, which is to further the interests of consumers, where appropriate by promoting competition[2].

6. In O2's view, this is further justification for the retention of LRIC+ as the cost methodology for setting mobile termination rates. Under this approach, both mobile and fixed termination charges would allow providers to recover some fixed and common costs. The fixed termination rate could then be used as a cost benchmark for mobile providers that do not incur radio access costs, without distorting competition in the mobile retail market.

[1] Mobile call termination: Consultation on proposed guidance on dispute resolution, Ofcom, 7 January 2011. See: http://stakeholders.ofcom.org.uk/binaries/consultations/mct-fair-reasonable/summary/mct-fair-reasonable.pdf
[2] Section 3(1)(b) of the Communications Act 2003 refers

A Telefónica company

B. The problem with reciprocity

7. O2 agrees with the analysis of central problem that this consultation document seeks to grapple with. As Ofcom discusses[3], there are now a number of ways of providing mobile services, from both a technological and commercial perspective. As time goes on, it is reasonable to suppose that mobile providers will continue to use these and, perhaps, other means of providing mobile services, each with different cost profiles.

8. We agree with Ofcom that those mobile communication providers that do not operate a radio access network have a significantly lower cost base. A policy of imposing reciprocal mobile termination rates in these circumstances would permit such providers to recover more than the cost of terminating a call. This unearnt margin could be used to subsidise activities in the mobile retail market (through the "waterbed" effect) and, in this way, distort competition in that market.

9. As Ofcom notes, its principal duty is to promote the interests of consumers, where appropriate by promoting competition[4]. In O2's view, therefore, Ofcom could not adopt a policy of settling interconnect disputes on the basis of reciprocity because the existence of substantially different cost bases would result in the distortion of competition, contrary to its principal general duty.

C. Fixed termination rates allow recovery of common and fixed costs

10. Ofcom proposes that the fixed termination rate is an appropriate benchmark for the termination charge of a mobile communication provider that does not incur the costs of operating a radio access network[5]. O2 agrees, in principle, that this would be a suitable benchmark, because the cost involved in terminating a call on a fixed network is similar to those incurred in terminating a mobile call, absent radio access costs.

11. However, Ofcom does not appear to have considered that, in practice, its approach to the formulation of fixed termination rates has been different to its proposed cost methodology for mobile termination rates. In O2's view, this means that fixed termination rates would not be a suitable cost benchmark for mobile providers that do not incur radio access costs if Ofcom proceeds to peg mobile termination rates to pure LRIC.

12. The termination rates of fixed providers are, in practice, set on a reciprocal basis to those of BT. BT's termination rates are subject to a charge control which has been set on the basis of a fully allocated cost methodology[6]. This is analogous to LRIC+ and, importantly for the purpose of this consultation, provides for the recovery of some fixed and common costs.

[3] See paragraphs 2.11 and 2.12 of the consultation document
[4] Section 3(1)(b) of the Communications Act 2003 refers
[5] Or terminates at least three quarters of calls without incurring such costs
[6] See: http://stakeholders.ofcom.org.uk/binaries/consultations/review_bt_ncc/statement/nccstatement.pdf

D. Distortion of competition

13. O2 has already made representations to Ofcom that to allow the recovery of fixed and common costs through fixed termination rates, but not mobile termination rates, would amount to the favouring of providers of fixed services, and that this would be a breach of the fourth Community requirement and section 4(6)(a) of the Communications Act 2003[7].

14. We remain of that view. But the proposed use of fixed termination rates as a benchmark for mobile providers that do not incur radio access costs adds another dimension to the issue. If Ofcom sets mobile charge controls based on the pure LRIC of mobile termination, then O2, Vodafone, Everything Everywhere and H3G will not be able to recover *any* fixed and common costs through termination charges. Under the proposed guidance, other mobile providers that incur radio access costs will be in the same position. However, those mobile providers that do not incur such costs will have their termination charges pegged to the fixed termination rate, which *does* allow the recovery of fixed and common costs.

15. Further, those providers that are permitted to recover some common and fixed costs through termination charges would be able to plough the additional revenues to subsidise their activities in the mobile retail market, in the way described by Ofcom at paragraphs 2.35 and 2.36 of the consultation document. This would be likely to *distort* competition in that market which, as Ofcom concedes in the consultation document, would amount to a breach of its principal statutory duty to further the interests of consumers, where appropriate by *promoting* competition.

16. In summary, O2 agrees with Ofcom that a policy of reciprocity in mobile termination rates is likely to result in a distortion of competition in the mobile retail market. However, in O2's view, Ofcom's proposed guidance would not be a suitable remedy, if Ofcom imposes pure LRIC based charge controls on O2, Vodafone, Everything Everywhere and H3G.

E. Inconsistency with the Commission's recommendation

17. Recital 3 of the Commission's recommendation on termination rates[8] states that:

> *"Significant divergences in the regulatory treatment of fixed and mobile termination rates create fundamental competitive distortions."*

18. In O2's view, to peg one set of mobile providers' termination rates to a cost standard that provides for the recovery of fixed and common costs, whilst preventing the remainder from recovering any fixed and common costs through similar charges, would amount to a "significant divergence in regulatory treatment", likely to "create fundamental competitive distortions". Consequently, we believe that Ofcom's proposed approach would be inconsistent with the Commission's recommendation.

[7] See: http://stakeholders.ofcom.org.uk/binaries/consultations/wmctr/responses/O2.pdf
[8] COMMISSION RECOMMENDATION of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU
See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF

F. O2's preferred approach

19. Ofcom is aware of O2's position on the broader issue of the way in which mobile termination rates should be regulated and, in particular, about the inadequacy of Ofcom's reasoning in proposing pure LRIC based charge controls. The current consultation document highlights another flaw with this approach. Under its current proposals, some mobile providers would be able to recover fixed and common costs through termination fees, while others would not.

20. Further, there would not seem to be much room for manoeuvre. As Ofcom points out, it is required to resolve disputes within four months. This does not allow Ofcom to carry out a detailed cost analysis. Consequently, Ofcom would need to place proportionately greater weight on a suitable cost benchmark. O2 agrees with Ofcom that, if a mobile provider does not incur radio access costs, the fixed termination rate appears to be a suitable benchmark, in principle. More to the point, O2 is not aware of any other cost benchmark that might be used, in the alternative. But in practice, for the reasons stated above, relying on such a benchmark whilst setting MTRs on the basis of pure LRIC would not be compatible with Ofcom's statutory duties.

21. In O2's view, therefore, another argument in favour of the LRIC+ approach to setting mobile termination rates is that it would allow the use of fixed termination rates to be used as a cost benchmark for mobile providers that do not incur radio access costs. This is because both fixed and mobile termination rates would allow providers to recover fixed and common costs, and there would therefore be no concern of distorting competition if fixed termination rates were used as a benchmark in the way Ofcom describes in the consultation document.