OFCOM CONSULTATION
A NEW PRICING FRAMEWORK FOR OPENREACH

Will Page, Chief Economist, MCPS PRS Alliance[1]

About the MCPS PRS Alliance

The MCPS-PRS Alliance - MCPS and PRS work together in an operational alliance, the MCPS-PRS Alliance. Together, they are one of the world's most efficient combined rights collecting operations. MCPS-PRS has succeeded in its goal to offer its members more money, more often and at less cost, whilst ensuring its customers are provided with the most efficient means by which they can use music: www.mcps-prs-alliance.co.uk

Responses to Selected Questions

Question 2.1: What do you consider to be the appropriate goals for a new Pricing Framework?

Whilst a submission from an economist at the MCPS PRS Alliance to this public consultation on *'A New Pricing Framework for Open Reach'* will be unexpected, it should nevertheless not be ignored. The first (of two) question I have chosen to answer allows us to consider why, and the second question allows you (the Regulator, or Internet Service Provider) to understand how. That is, what should the goal actually be – or in Government economic terms what's the *rationale* for having a goal, and given that rational, what is the *objective*. A static analysis would suggest the goal is to price copper, a dynamic analysis would recognise that the value chain has changed and that, changes the goal posts.

To begin with, let's acknowledge that the unexpected popularity of the BBC i-Player presents a *'temporary'* crisis to the Internet Service Providers in today's ultra-competitive market place. Namely, how does one prevent churn, the loss of subscription-based customers, when the cost of keeping them satisfied has become unsustainable? Pricing the online distribution of BBC content should be a relatively straightforward exercise, as it represents a demand-side shock that requires a supply-side response. However, assuming this adjustment process (will be) is 'temporary' demands a caveat; the music industry has now seen the online distribution of its content be under-priced for over a decade.

[1] This material has been prepared by Will Page, in his personal capacity and does not constitute the view of the Management or the Boards of MCPS, PRS or any associated company. He can be contacted at will.page@mcps-prs-alliance.co.uk

Back in 1998, the embryonic Napster service entered into talks with the major record labels which would have allowed it to be 'priced into' the online supply chain. Whilst those talks failed to produce a workable 'deal', what they do now offer – to all present and prospective participants in the online supply chain – is an important retrospective on why the same mistakes should not be repeated. Why? Because, ten years gone, music's online supply chain remains broken. Today, recorded music's revenues can be characterised by an accelerating decline in the old physical format, and a still-fledgling online format which struggles to establish itself due to the leakage from the black market.

The evolutionary lesson that needs to be learned from music is that if you are not 'priced into' the online supply chain, from conception to delivery, it is very difficult for the market participants to ever reach equilibrium. Hence, one would be forgiven for the sense of déjà vu when observing the current pressures which the BBC i-Player has placed upon the internet service providers. Whilst the communication breakdown between the BBC and ISPs is played out in public, a moral hazard will inevitably arise; where the ISP has no incentive to proactively prevent a black market in the distribution of Dr Who and the like, whilst they have every incentive to impose a BBC pay-as-you-go i-Player tax.

Whilst the very notion of imposing an i-Player 'tax' has the potential to call into question the whole BBC structure, ('why should I pay again, given the licence fee'), the real issue is that someone, somewhere in the supply chain will need to pick up the bill for content distribution. It is conceivable, therefore, to envisage the debate moving towards the question of: what does a licence fee – or any other customer proposition on the internet – capture: is it content and distribution, or just one but not the other. It's a question that helps put the current inefficiencies into context: as there is lots of value in both content and connectivity currently locked up due to mini turf-wars within the networks' participants.

From the unique perspective of an economist who works for a natural monopoly, offering a view on a functional monopoly through a public consultation, it would appear that the current 'ostrich' mentality that many of the players have so far exhibited reflects a finite game. This is because we are leaving behind years of a stable, horizontal structured, termination-based telephony supply chain, and now moving-at-pace towards a vertically assembled supply chain which has to also price-in data, as well as intellectual property. Yet given the asymmetric interests of all the different players, it's plausible to view the BBC i-Player as the tip of the iceberg, with the imminent Kangaroo project likely to test the hull of the network further.

One reason why this 'shift' in both markets and mindset is about to come to the fore is this pricing review, which Open Reach is conducting with the UK regulator, OfCom. The

radical thinking behind the creation of Open Reach in 2005 was *"equivalent access"* to all market players: put simply to provide a copper pipe to the house for any Internet Service Provider for a fixed price of £80pa. Whilst this fostered competition for the final mile, the price has remained unchanged since its inception. Of course, a lot has happened since – not just to the price of the 'commodity' and its infrastructure, but also the 'utility' which it provides all participants in the network.

Thus, one *goal* of this price-setting exercise could be to 'kill two birds with one stone': that is, price both the copper and content to fix the broken supply chain. More technically, the objective could be to move away from balancing the raw demand for electrons (bits & bytes) with the underlying cost of supply, but instead to equitably reward the whole supply chain for the bits, including creators, aggregators and distributors. Should that objective prove unworkable, then perhaps there are ways in which incentives could be introduced, to penalise the free-riding currently taking place which is preventing that equitable reward from currently being allocated.

When AT&T's Ed Whitacre famously remarked to Google that if they, and their like, expect to 'use these pipes [for] free', they must be "nuts", he highlighted an increasingly confusing blame game that will only get worse. So, what the network needs now is cross-industry initiatives that help to minimise the cost of distribution. Incentives, be they regulator-enforced or market determined penalties for free-riding, might help reduce the amount of free riding taking place. Once the supply chain works out who picks up the benefits and who ends up carrying the costs, not only is the regulator better placed to regulate, but Open Reach will be better placed to plan for Next Generation Access.

Question 6.9: In the context of the current markets for WLR and LLU what do you consider to be the key challenges for ensuring allocative, productive and dynamic efficiency in the context of the revision of charges?

Firstly, it is worth quoting the key text from the OfCom consultation document to clarify definitions: *'Dynamic efficiency' means that firms have the correct incentives to invest (e.g. in new infrastructure) and to innovate (e.g. to generate new products). Greater reliability and other quality improvements, and the creation of new products and services, are critically-linked to investment and innovation. However, regulation typically involves trade-offs between the three. Importantly these considerations must be borne in mind in the review of unit costs and cost attribution methods – which should drive efficient behaviours'*. This helps us take a step back and think through (i) what are the challenges and (ii) for whom should they be challenging.

Moreover, consider how these definitions of efficiency apply when the entity that is being regulated is not just unique in its functional properties but is one of the regulators own creations – namely Openreach. What that does to the rules (such as efficiency) and *then* what does that then do to the rule book (of a regulation) becomes not a taboo subject, rather a legitimate debate. Again, from the rather unique perspective of another monopoly, the following comments will add value to the process. Add to that, my role in the Broadband Stakeholders Group, where many of these comments were initially raised, and enthusiastically received, and hopefully that will remove the risk of music's voice not being heard by those who exploit their content without fair compensation.

The first of the taboo subjects which this approach raises is that of the options available to maintain or increase efficiency of a network, where two tools can, are and always will be applied – but never fully explained, (at least to those who work in music and copyright) namely: traffic shaping and price discrimination. Traffic shaping, in particular, is something that seems to be celebrated in private yet denied in public – and often protected under an increasingly *in*credible concept of net neutrality. Similarly, price discrimination falls into the same category, yet OfCom recognise that if both tools were to be more transparent and accountable, then the consumer would be better placed to make an informed choice. Good regulation, from our perspective, also means no more incredible excuses from the ISPs who claim nothing can be done about P2P.

The second of these taboo subjects is scarcity, and could the network which Openreach provides access to be treated as a common good? To recap on the history of this concept, it is worth quoting from a recent article in The Economist[2]: *In 1968 Garrett Hardin, a professor of biology, published an article in the journal Science that was to have a profound impact on the social sciences, including economics. In it, he explained "The Tragedy of the Commons". "Picture a pasture open to all," he wrote. A herdsman grazing his animals on the land will have an incentive "to add another animal to his herd. And another; and another…But this is the conclusion reached by each and every rational herdsman sharing a commons. Therein is the tragedy." Each herdsman captures all the benefit from an extra animal but the cost of overgrazing is borne by all.*

Does an argument, which for the best part of a decade has been based around *net neutrality* concepts and *dumb pipe* reasoning, create incentives which then produce a common good? Could it be the case that those who abuse the net's apparent neutrality most get most? And if that was the case, how should a regulator consider that in the static context of (i) *'Allocative efficiency'* which is achieved when prices are close to cost and (ii) *'Productive efficiency'* which means that the costs of production are minimised. No

[2] Available www.economist.com/finance/displaystory.cfm?story_id=11848182

where, in these simplistic OfCom definitions are the externalities (which characterise a 'commons') captured or explored, hence it's worth turning to the 'dynamic efficiency' concept and taking a broader perspective

Yet when you reconcile 'dynamic efficiency' to the consultation's remit, (the 'current markets'), you are presented with a regulatory anomaly: are you happy with the current markets, and are you happy with where the current markets are currently going? A functional monopoly might work today, but is it best placed to work tomorrow, and if not, presumably the market should (then) take over? If so, then, how does one balance the need for a 'dumb' access provider of a copper pipe with incentives to take 'innovative' investment decisions? As mentioned earlier, how does one approach fibre, if their role is to provide equivalent access to the market. You can't have it both ways, hence something has to give.

That 'give' could be captured in the *dynamic efficiency* definition and the trade off that occurs within it, and not across other 'allocative' and 'productive' concepts. If one believes that there are non-core functions which Openreach is best placed to undertake, then how do these non-dumb activities, which bring with them future benefits, trade off against the need for dumb equivalent access, which will demonstrate present costs, as a result. Moving from a static analysis (what's the price of copper) to dynamic scenario planning (who's best placed to invest for the future) are not mutually exclusive. A monopoly is only a monopoly for where it is relevant, and relevance is no constant, hence the need to think dynamically – not dumb.

Given that OfCom is actively touting the Openreach model in other EU states, it would be plausible to suggest that the 'goals' of the framework and 'dynamic efficiencies' which need to be ensured favour broader definitions which are broader than the current blame game on who should invest in Fibre, and more complex than the deriving the right price for copper. Dynamic inefficiencies that have so far arisen from the current regulatory framework, as regards to its neglect to externalities such as copyright and content, can be characterised in two steps: firstly it has incentivised a habitual culture of free-riding upon someone else's network (or copyright) and disicentivising the rational investment in better networks (or more creativity). **The future wealth of the United Kingdom is not derived solely from the efficient use of communication infrastructure, but also in providing a dynamic environment for the creative industries.**

Will Page
Chief Economist, MCPS-PRS Alliance
Submitted in his personal capacity: 17:00 Tuesday 5th August 2008