THUS plc
1-2 Berkeley Square T 0141 567 1234
99 Berkeley Street
Glasgow G3 7HR www.thus.net

Clive Carter
Strategy & Market Developments
Ofcom
Riverside House
2a Southwark Bridge Road
London
SE1 9HA

By email: clive.carter@ofcom.org.uk

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Dear Clive

Ofcom consultation: Future broadband - Policy approach to next generation access, 26 September 2007

THUS is pleased to respond to the above consultation. Our answers to the questions posed in the consultation are set out below.

Question 1 When do you consider it would be timely and efficient for next generation access investment to take place in the UK?

We understand that BT is likely to change its policy imminently with regard to greenfield developments and start deploying fibre instead of copper, as is happening in Ebbsfleet. However, we doubt there will be sufficient demand to justify widespread deployment of NGA in areas currently served by copper for at least 5 to 10 years, by which time BT and LLU operators may be expected to have generated a return on current ADSL2+ deployments. In the residential market, we are not aware of any economically high value applications which cannot be served reasonably well by ADSL2+. (Although there may be 'demand' for higher bandwidths, this is not yet matched by a willingness to pay a sufficient premium over current generation broadband.) In the business market it is already possible for companies to purchase ethernet services at 1Gbps or more and the costs of such business-oriented access products is likely to continue falling.

Question 2 Do you agree with the principles outlined for regulating next generation access?

Ofcom has outlined three principles for securing timely and efficient investment in NGA infrastructure (contestability, reflecting risk in returns and regulatory certainty), and three principles for promoting competition in services over that infrastructure (contestability, maximising potential for innovation and equivalence[1]). We agree with these general principles.

[1] We note that Ofcom is now referring to the principle of 'equivalence' instead of 'equality of access' used in the Strategic Review, and assume that the terms are being used interchangeably to imply a regime where 'equivalence of inputs' (EoI) is mandated for all relevant upstream products.

We offer the following comments:

- One of the barriers to contestability in infrastructure deployment is the unequal tax treatment of different classes of telecoms operators under the current rating system. We request that Ofcom work with the government to achieve more level playing fields for investment.

- Although there may be competing NGA infrastructure in certain parts of the country, we doubt it will be economic to deploy more than one NGA platform over the majority of the UK. Therefore, although we would support contestability at the platform level, we believe the most important area for Ofcom to focus on is contestability in provision of services. Contestability at the service level would also go a long way to alleviating the concerns over 'net neutrality' which have preoccupied the US.

We agree with Ofcom's caution over public intervention in respect of digital divide concerns. As noted by Ofcom, pre-emptive intervention risks wasting public funds and could distort incentives for commercial deployment. We believe it is more appropriate at this stage for public sector intervention to focus on 'not spots' in current generation deployment.

Question 3 How should Ofcom reflect risk in regulated access terms?

As with first generation broadband, Ofcom faces a dilemma in reconciling the objectives of:

- disincentivising margin squeeze or predatory pricing at the retail level
- disincentivising excessive pricing (monopoly rents) at the wholesale level
- incentivising timely and efficient deployment of NGA infrastructure.

The experience across Europe of first generation broadband rollout has confirmed the risks of retail margin squeeze: Deutsche Telekom was fined €12.6 million in May 2003 for margin squeeze, France Telecom/Wanadoo was fined €10.4 million in July 2003 and a further €45 million in October 2007 and Telefonica was fined €151 million in July 2007. In the early days of UK broadband, BT's retail prices were in some instances lower than the input wholesale products (justified by BT on the basis of hopelessly optimistic expectations of advertising revenue), and Ofcom is still investigating BT's conduct. This experience illustrates that there are strong incentives for incumbents to engage in margin squeeze and that the prospect of ex post competition law enforcement does not appear to be a particularly effective deterrent.

We are concerned that Ofcom may have underestimated the risks of margin squeeze. For example, in the context of allowing the incumbent to set its own access prices, Ofcom states at paragraph 5.28 (emphasis added):

> "There remains a risk with this approach that the bottleneck asset owner would attempt to distort competition by trying to extract monopoly rents from its upstream division and margin squeeze all competitors. It may be incentivised to do this either to maximise its upstream profitability or to foreclose competition downstream. However, <u>its incentives to do so may be relatively weak given that the organisation's goal may be to promote take-up of next generation access services and rapidly increase traffic on the network</u>."

We accept that in the first few years, the incentive to extract monopoly rents will be balanced by the desire to increase take up. But we see no reason why the incentives for margin squeeze should be 'relatively weak'. European incumbents would have faced similar pressures to increase take-up and traffic on their networks for first generation broadband, but this did not prevent margin squeeze. The natural response of any incumbent is to set retail prices as low as possible (to encourage take-up) and then set wholesale prices as high as it can get away with (to maximise retail market share and overall profit).

In concluding the discussion of anchor product regulation, Ofcom states at paragraph 5.37 (emphasis added):

> "In the event of any complaints being raised on access terms, prohibition of margin squeeze would be covered by competition law, and could result in ex post price regulation as a result of complaints as opposed to ex ante price regulation of services. If this is a likely outcome, it may be more suitable to determine prices ex ante in order to provide clarity on the terms of access and to ensure that, before the conclusion of any margin squeeze assessment, no parties can gain a competitive advantage in terms of market share."

As noted above, we believe that margin squeeze *is* a likely outcome, and given the poor track record of ex post competition law in deterring such abuse, we believe Ofcom should be giving serious consideration to some form of ex ante regulation to prevent such abuse (or allow it to be corrected on shorter timescales than is possible using ex post competition laws). Such measures could include an explicit rule constraining the wholesale-retail margin and/or transparency measures such as accounting separation and retail price publication. It may also be worth considering whether alternative incentives can be created to discourage margin squeeze. For example, if Ofcom were to indicate that future regulatory intervention (eg to extend access charge controls) would be triggered if BT's retail market share increased significantly above current levels, that could reduce BT's incentive to margin squeeze.

We agree that anchor product regulation merits further consideration, but believe Ofcom has made an unnecessary logical leap in linking the implementation to first generation broadband. As far as we are aware, previous applications of 'anchor product' regulation have essentially exploited the 'chain of substitution' effect to focus regulatory intervention on a narrow set of 'anchor products' allowing the prices of other access products to be set by the market, subject to the constraint of substitution by the anchor product[2]. The chief merit of this approach is that it simplifies regulation and reduces the regulatory burden, both for regulator and incumbent. Ofcom has extended this concept to propose that the price of the anchor product should be linked explicitly to the price of first generation broadband products, in order to ensure that no customers are made worse off 'relative to the position they would have found themselves in with respect to current generation access networks.'

We agree that protecting consumers from price hikes is a worthwhile aim, but we do not believe that this approach to anchor product regulation will be practical to implement nor will it provide sufficient constraint on the type of abuses discussed above. In particular, we believe that if anchor product regulation is to provide a meaningful constraint, it must apply to the main NGA product

[2] Eg, we understand that anchor product regulation has been used in Ireland in the context of SLA/SLGs. The regulator dictated the terms of the 'basic' level product and allowed the price of products with enhanced SLA/SLGs to be set by the market.

that BT is consuming itself and not to some niche variant whose properties have been degraded to match those of first generation broadband. The dangers of focusing regulation on a product that is not mainstream from BT's perspective are illustrated by the history of DataStream versus IPStream regulation. DataStream was never used in volume by BT and the indirect regulation of IPStream (via chain of substitution from DataStream) proved clumsy and ineffective. The relative service quality of MPF and SMPF also illustrates the increased effectiveness of regulation that is focused on the products that BT actually consumes.

Although there are difficulties in defining an appropriate project-specific cost of capital, we believe that this is the most sustainable basis for price regulation going forward, and it is better for Ofcom to grasp the nettle now.

Finally, we would note that the chain of substitution effect is often weak or ineffective between residential and higher end business products. The option should therefore be retained of defining separate anchor products for residential and business applications.

We would therefore suggest that a more effective approach to regulation could involve:

- a mandated upstream price for one or more anchor products, where
    - anchor products correspond to the products consumed by BT in the greatest volume (the definition may need to be reviewed from time to time);
    - the price of the anchor product is based on a project-specific cost of capital including estimates of risk;
    - separate anchor products are defined for residential and business applications
- pricing freedom for non-anchor access products;
- equivalence of input on all access products;
- transitional safeguard regulations to ensure that consumers who lose access to current generation broadband are able to buy equivalent products based on the NGA platform (similar price and no worse functionality).

Question 4 Do you agree with the need for both passive and active access remedies to promote competition?

Yes, we agree that both active and passive remedies will be required to promote competition. On the basis of current knowledge, it seems fairly clear that passive options (subloop unbundling in the context of FTTC or dark fibre in in the context of FTTC) will only be viable (if at all) in relatively densely populated parts of the UK, so there will always be a need for active access remedies, and these should be the first priority. However, it is likely that passive remedies *will* have a role to play (if only via the latent threat of market entry) and it is important that these options are kept available and free of incumbent-created obstacles.

We would also urge Ofcom to ensure that the definition of active access remedies strikes an appropriate balance between the needs of residential and business service providers. Although businesses are currently relatively well served by products in the leased line market, the widespread deployment of NGA potentially offers a step reduction in the cost of higher speed broadband, with many more business applications becoming affordable. Such applications may well have a greater impact on the UK economy than, for example, increased consumption/choice of entertainment by residential consumers, and should therefore be encouraged. Key features for businesses are likely to include, for example, higher levels of availability and resilience, symmetric upstream and downstream bandwidths and quality of service functionality.

Question 5 Do you consider there to be a role of direct regulatory or public policy intervention to create artificial incentives for earlier investment in next generation access?

We consider it vital that any regulatory or public policy intervention adheres to the principle of trying to create the conditions for efficient and timely investment by the market. Time and again, the market has proved more effective and more efficient than public sector intervention in matching capital investment to customer demand. Any intervention which does not respect the principle of market investment risks undermining existing investment and deterring market players from making future investments. It is also likely to represent an inefficient use of taxpayers' money and therefore be damaging to the UK economy as a whole. Hence, we do not believe there is any role for direct regulatory or public policy intervention to create artificial incentives for earlier investment than would be delivered by a competitive market.

Regulatory or public policy intervention would only be justified where there is clear evidence of market failure (defined in strict economic terms). The obvious example of market failure is where a player has significant market power, and this clearly justifies ex ante regulation by Ofcom to ensure that it does not abuse this SMP.

A second potential example is where there are positive externalities from deployment of NGA which mean that the optimum deployment date from a 'UK plc' perspective would be earlier than the date which would result from normal operation of the market. However, intervention on the basis of positive externalities should not be contemplated without robust evidence and a rigorous economic appraisal of the case. So for example, if the claimed externality relates to reduced public expenditure on transport infrastructure or reduced greenhouse gas emissions, as a result of increased teleworking, there would be a need to demonstrate the incremental impact on these externalities compared to the base case in which penetration of current generation broadband continues apace and investment in NGA occurs on a timetable dictated by the market.

As noted above, social policy objectives may also justify public sector intervention, eg to encourage rollout into rural areas or fill in 'not spots', but such intervention should take place *after* the mainstream deployment, not in anticipation of it.

Yours sincerely

Richard Sweet
Director of Government Affairs