



Telecommunications Statement

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Nearly two years ago, as Ofcom was established, it was 20 years on from the privatisation of British Telecommunications as a vertically-integrated monopoly and the first introduction of competition. Ofcom, and previously Oftel, had also been a leading regulator in Europe in helping to design and then implement the new regulatory framework for telecoms, and we had conducted most of our initial market reviews at that time. It seemed the right time to step back from the detail and to conduct a strategic review of the UK's telecommunications market.

Today, we are close enough to the conclusion of that review to set out our key conclusions and proposals and give stakeholders a timetable for a series of related announcements which will provide industry with certainty about major inputs to the price and delivery of key wholesale products to stimulate competition; and on the conclusions of our review of the Universal Service Obligation.

It is worth recapitulating briefly the ground this Review has covered. We established at the outset the key questions for the Review to address: what, from the consumers' perspective is a well-functioning market- in other words, what should good look like? Where can effective and sustainable competition be established? Where can regulation be rolled back? How to incentivise efficient and timely investment in next generation networks? And the question of structural or operational separation of BT and full functional equivalence.

The core problem is in the fixed line market. 20 years of pro-competition regulation has led to some improvements for consumers. But years of intrusive regulation have not created the conditions for the sustainable competition necessary for long-term consumer benefit and which, in other countries, has spurred investment in next generation core and access networks.

Ofcom's overall approach, therefore, both in the individual decisions that we have taken over the past year and in the Strategic Review, has been to create a regulatory framework which seeks to encourage and incentivise sustainable, scale, infrastructure competition at the deepest extent possible.

However, some assets in the network are either economically impossible or highly economically inefficient to try to replicate: the so-called enduring bottlenecks- mainly, though not exclusively, in the access part of the network. Without open and truly equivalent access to such assets, sustainable infrastructure based competition would be too risky and too easily frustrated.

In our Phase 2 Report, we therefore posed three Options. Firstly to step back from all ex ante regulation. This found no takers. Secondly to make a reference forthwith to the Competition Commission under the Enterprise Act since, notwithstanding our sectoral competition powers, there were aspects inherent to the market structure that would continue, unaddressed, to provide the incentives for anti-competitive behaviour to an unacceptable extent. By its nature such a Competition Commission investigation would take time - many months at least - to complete; and its outcome would be inherently unpredictable.

The third option was to seek to secure from BT 'real equality of access' – which had two dimensions:

- requiring BT's own downstream operations use the same products, processes, and prices as those used by their retail rivals – equivalence of input in the jargon;

- and alongside that, operational separation within BT that would ensure that those responsible for overseeing BT's bottleneck assets had real incentives to wish to serve other operators in practice and on the ground with the same zeal, efficiency and enthusiasm as they served the remainder of BT's downstream activities.

Though a small minority in the industry favoured an immediate reference under the Enterprise Act, most agreed that we should first pursue our preferred option of real equality of access. But almost all of BT's wholesale customers pointed out the importance of any arrangements being enforceable.

In February, BT offered some voluntary changes to its own business and organisational structure which, it argued, would address Ofcom and industry concerns.

- A new Access Services Division within BT which would provide unbundled local loops to wholesale customers, and would be a functionally separate division of BT, with its own CEO, and its own incentives and reporting structure;
- A new Equality of Access Board which would have responsibility for ensuring that BT fulfilled the commitments that it would make towards Equality of Access.
- 'equivalence of input' in relation to new products, and indicated that it was willing to move towards input equivalence of legacy products including WLR, LLU and broadband leased lines, starting in 2006 and completing by 2010.

We said at the time that this BT proposal was a significant step forward, but the true worth of BT's offer could only be demonstrated by carefully working through the detail. Since February 2005, working with BT and with other key industry players, we have sought to address issues and concerns with BT's initial proposals.

The Proposed Undertakings

The summary of undertakings which BT has proposed to offer in lieu of a reference by Ofcom under the Enterprise Act will, we believe, address outstanding concerns. And the Ofcom Board has accepted that in principle. The undertakings will be published in full on 30 June. But today I want to give an indication of what the undertakings will cover, and how they address the concerns we have identified.

Firstly, enforceability. The undertakings will be legally binding and enforceable – more on this later.

Secondly, scope of ASD. This new entity will include some 30,000 BT staff and nearly all its access infrastructure and facilities, including the copper local loop, local exchanges, and associated ducts and other civil infrastructure. Critically, it will deliver a comprehensive suite of the access products on which wholesale customers rely including:

- All forms of Wholesale Line Rental (WLR);
- local loop unbundling (LLU) products incorporating both full and shared;
- fibre access products including Wholesale Ethernet Service (WES) and Partial Private Circuit access products;
- Ethernet and SDH backhaul products and sub-loops specific wholesale backhaul services which are critical to effective competition including Ethernet backhaul.

Thirdly, incentives and culture within ASD. The ASD will be organised as a separate business unit with its own management structure and substantial operational independence. The management board of ASD will have a clear remit to deliver Equality of Access and will publish an annual plan including a remit, mission statement and performance targets. BT

has agreed that the ASD headquarters management team staff will be moved to a separate physical location to other BT staff, and BT will develop separate operating and trading systems used by ASD from those used by other parts of BT. Remuneration will be based solely on ASD's performance. BT will develop a revised long term incentive plan (LTIP) for use within the Access Services Division from 2006, which will sever the link between the triggering of an award and the performance of BT Group plc's shares.

Finally, BT has also agreed that the ASD should have its own distinctive brand which reflects its operationally separate status from other BT business units. This is work in progress.

The fourth issue we raised was the timing of equivalence of input for legacy products. BT commits to deliver equivalence of input for the following products to the following timescales:

- LLU – ready for service June 2006
- WLR on the PSTN – ready for service mid 2007, migration complete June 2010
- WLR on ISDN2 - ready for service September 2007, migration complete end-March 2009
- WLR on ISDN30 – ready for service December 2007, migration complete December 2009
- IPStream – ready for service end-December 2005, migration complete end-December 2006
- Wholesale Ethernet Service (WES), and Backhaul Ethernet Service (BES) – ready for service September 2006, migration complete March 2007.

BT has separately committed to using its best endeavours to have WLR equivalence of input ready for service by the end of 2006, with a financial rebate to operators of 25p per month per line for any month beyond December 2006. The same financial rebate applies in the event that the June 2006 ready for service date for LLU is not met.

For other wholesale products where BT has Significant Market Power, BT should make those which it makes available to third parties and those which it uses for its own purposes sufficiently comparable to allow competition to take place – so called 'equivalence of outcome'. Three important products in this category are Partial Private Circuits, Carrier Pre-selection and ATM interconnection. BT's undertakings give commitments to resolve outstanding issues in relation to each of these products to achieve 'equivalence of outcome'.

Fifthly, changes in governance and compliance outside of the ASD. BT's undertakings address the question of the relationship between BT Wholesale and BT Retail, providing greater clarity on the organisational separation of governance of these business units.

BT will separate out those product management teams in BT wholesale which provide SMP services from non- SMP services. Similar remuneration and incentive changes as those within ASD will apply to the teams responsible for product management of SMP products.

The Equality of Access Board's remit will cover compliance with the undertakings across the whole waterfront of SMP products. It will have five members, three of whom will be independent, and a BT non-executive board director who will chair the EAB – providing a direct link in terms of accountability to the BT Group Board. It will have independence, resources, powers and teeth.

Finally, BT's undertakings will set out some clear principles on which BT will base its future design, procurement and roll-out decisions for the 21st Century Network. These include:

- BT to ensure that the 21CN design supports competition, by allowing other operators unbundled access to key bottlenecks
- BT to design the 21CN in a way which will support Equivalence of Input.
- BT's charges to reflect a network that is efficiently designed for the above purposes
- BT to launch retail products only when equivalent wholesale products are available.

These principles are underpinned by a commitment by BT to work in a transparent and multi-lateral process with other operators and service providers to manage the transition to NGNs, and to participate in a new adjudication process for disputes that may arise.

Accepting undertakings in lieu of an Enterprise Act will mean that the commitments BT makes are meaningful, enforceable and binding. If the undertakings were breached, Ofcom would be able to seek enforcement in court against BT. BT's Board would be responsible for ensuring that BT complied with the court's decision. Third parties affected by a breach could also seek damages via the court to recover losses incurred as a result of any breach of the undertakings.

These proposed undertakings sit alongside Ofcom's other powers. The Competition Act will continue to apply to all BT's activities and Ofcom will use its powers under that Act vigorously in the event of cases of anti-competitive abuse.

The EU Regulatory Framework will continue to provide the legal and policy basis of our regulatory approach, and provides the process and structure for our regular programme of forward-looking regulatory activity. We see the undertakings and the operation of the EU Framework as complementary. As now, the process of identifying such remedies and the relevant markets to which they apply will be conducted according to the rules laid out in the Framework.

Related Regulatory Policy Initiatives

In parallel with the Review, Ofcom has been developing a series of regulatory policy initiatives which, in their impact on the competitive market, will complement the BT undertakings which will be published in full on 30 June. These come under four headings:

- Policy developments which support the undertakings
- New charge controls for access products considered to be enduring economic bottlenecks
- Measures to promote the development of downstream competition.
- Deregulation initiatives

On 30 June, Ofcom will publish guidelines for how we will interpret undue discrimination conditions of operators with SMP. These will replace the previous version in the Access Guidelines published almost three years ago. They will bring the UK's approach in line with current European best practice.

On the same day we will also publish a full statement on the outcome of our consultation on next generation networks, which will of course reflect the commitments on this subject that BT is making in the undertakings but will also address additional issues such as industry consultation processes going forward.

Secondly, under the EU framework, charge controls: Ofcom is currently consulting on its approach to assessing BT's regulated cost of capital, with a final statement to be published

later this summer, and, also later this summer, we will publish our final conclusions on the cost of BT's copper network.

The cost of the copper access network and the cost of capital calculation are key inputs to the price of WLR and fully unbundled LLU. Whilst we cannot give firm figures today, we welcome BT's separate announcement earlier today of a further, voluntary, reduction in its full-LLU price from £105 to £80 a year. That is consistent with the outcome we currently expect from the regulatory consultations on the costs of capital and of copper. The UK will now have full LLU prices which are very much at the better end of the range of European competitiveness

In WLR, we welcome BT's separate announcement of a reduction of 50 pence in the wholesale price. There will be a full consultation on the WLR charge later this summer, reflecting a firm position on cost of capital and cost of copper, two key inputs. We would expect this to lead, early next year to a further modest reduction in the wholesale WLR price.

Today, BT have announced a commitment to stability of IPStream prices for up to two years to provide greater certainty and clarity of pricing during the key build up phase on LLU. There has been significant progress on LLU but LLU operators are understandably concerned by the threat of unpredictable margin erosion by BT which would foreclose fair competition. BT's commitment will remove one of the key obstacles to the development of LLU. On 30 June Ofcom will publish a short statement on broadband regulation. This will outline Ofcom's plans for reviewing the Wholesale Broadband Access Market which will provide the regulatory framework for LLU operators after the end of BT's pricing commitment.

Fourthly, deregulation: Ofcom has already inherited a commitment previously made by Oftel that, when a truly 'fit for purpose' Wholesale Line Rental product was made available by BT, the regulator would transition existing retail price controls for residential calls and access to a less onerous 'safeguard' regime and in due course review whether controls could be removed altogether on the expiry of the existing price control. We can confirm that we will take this commitment forward, subject to completion of relevant market reviews and consultation exercises. We expect that BT will in the near future declare that WLR is a fit for purpose product; if Ofcom endorse this, following its formal review, it will give BT scope, early next year to change its retail line rental prices within the RPI safeguard regime. For consumers this will be in the context of active competition from a range of providers for both lines and calls.

In large business markets, Ofcom said in 2004 that we would relax the rules on product bundling provided BT's competitors were able to 'replicate' BT's service offerings. This concept of ability to replicate is closely linked to the concept of 'equivalence', and on the basis of BT's commitments as set out in the undertakings, Ofcom will look again in July at the scope for relaxation of downstream remedies on bundling where such 'equivalence' provides the ability for rivals to replicate BT's own retail offerings.

Ofcom will be consulting in July on the application of remedies in leased lines markets, in the light of BT's commitments on equivalence – and we will look again at the question of whether some geographies and routes are already getting a competitive deal – we are open minded about this.

In all these areas, Ofcom will proceed in a careful, evidence-based way and in accordance with the procedural requirements of the EU regulatory framework before making any such deregulatory decisions and will expect to see real progress in delivering 'equivalence' before any regulatory withdrawal is contemplated.

These proposed undertakings, along with our other regulatory proposals, will constitute a major step forward. But we recognise that at least twelve months of sustained hard work is required to implement the undertakings and for BT to deliver on them.

Ofcom intends to produce regular reports between now and mid-2006, with a first report in October, and subsequent reports in January, March and June 2006. These will be in addition to the separate reporting envisaged by BT to be carried out by the Equality of Access Board. We will expect to report on progress by BT in:

- Introducing its new structure and governance arrangements
- Meeting with service provider customers and working to resolve outstanding issues in relation to existing products
- Resolution of outstanding process problems with the existing WLR product
- Introducing EoI for the products already mentioned, including progress toward interim milestones
- Working with industry to develop a common understanding of the process for introducing next generation networks.

We will also be seeking the close involvement of service providers and alternative operators in this monitoring process.

What benefits can consumers expect to see from this?

The proposed undertakings together with the related regulatory policy initiatives will for the first time allow nationwide competitive provision, end to end, for the residential and small business consumer in calls and services old and new. The emergence of a new wave of innovation in broadband, with operators competing not only to drive down price and increase take-up of current generation broadband services, but increasingly developing and deploying exciting new broadband services such as voice over IP (VoIP), IPTV video-on-demand and, advanced on-line gaming – and compelling content in which the UK is a world-leading creator.

For operators, there is the not inconsiderable issue of winning then holding the loyalty of those consumers. Much of that will depend on the general consumer confidence in the fixed line market to be ready to switch between different providers.

Regrettably, there have been activities on the fringes of the fixed line market which do not help engender that confidence: fraud in the case of rogue internet diallers; bad practice in the case of mis-selling or slamming; or simply poor customer service.

It has been particularly hard and frustrating, for those network operators who control only part of the value chain, to see their efforts frustrated by rogue service providers. But now, for the first time, there is scope for a range of operators alongside BT who will share BT's interest in ensuring a good consumer experience end to end along the process. We hope that they will show the same commitment and drive to ensure that the consumer is able to choose from a range of providers in whom they have confidence. And that if a consumer chooses BT it is on the basis of BT's price, choice and quality in a fairly competitive market not as simply a known haven in an uncertain world.

That, frankly, is what good should look like for competitors, for BT itself and above all for the consumer.

As regulator, we will also continue to explore whether, as the market opens up with new offers and opportunities for customers, clearer consumer information is needed and if so where and how this could be provided.

Extra protection is needed for some vulnerable groups. In the Review we examined the need for an evolution of universal service obligations, looking both at scope (the services to which obligations should supply), and funding (what is the most appropriate method of subsidising USO).

Our conclusions are that there is no need to review funding yet, but that it could be an issue as competition bites further – one to keep under review. On scope, on 24 May the European Commission published a communication on the scope of universal service obligations which appears to reach very similar conclusions to those of Ofcom: no case for extension to mobile; an arguable case for extension to broadband when the market has matured – but unlikely to be an issue this decade.

In parallel, Ofcom has been reviewing how the delivery existing universal service obligations in relation to voice services – which include requirements to offer special tariffs for low-income users, to maintain certain public payphones, and to maintain uniform pricing for services regardless of geography, could be improved. A statement on this will be published on 30 June.

To sum up, this outcome should deliver some much-needed regulatory certainty for BT.

It recognises that there are some legitimate benefits to BT of remaining vertically integrated. These benefits remain within BT.

We also believe that BT will benefit from a progressive loosening of the current complex and intrusive mesh of regulation as competition becomes increasingly effective. In particular, the deliver of real equality of access in relation to its legacy monopoly access infrastructure will leave BT with much greater freedom to now pursue new opportunities in growth markets such as broadband content, high end corporate systems integration, and fixed/mobile integration.

Telecommunications is an important market in its own right – worth some £35bn in total, but it is also a key input for the rest of the economy. This new settlement has the scope to improve the competitive conditions of the telecoms market and thus could have significant wider benefits.

The UK was the first country in Europe, and one of the first countries in the world, to identify and unleash the benefits of liberalising telecoms markets. But that early lead has not been maintained – the UK's performance in recent years compared with other countries has been adequate at best. Addressing regulatory concerns cannot alone restore the UK to a leadership position, but Ofcom does consider that with these proposals the UK is back in the forefront in developing radical telecommunication policy and we hope and expect the industry to respond to this.