

Clive Carter
Director of Strategy
Ofcom

By email

16 October 2015

Dear Clive

Strategic Review of Digital Communications

Telefonica UK Ltd (“Telefonica”) welcomes the opportunity to comment on Ofcom’s Strategic Review of Digital Communications.

Our response to a subset of the questions raised is set out in the Annex attached to this letter.

Yours sincerely

Lawrence Wardle
Head of Regulatory Affairs

ANNEX

Should competition policy remain at the core of good availability outcomes for most consumers, complemented by targeted intervention as required?

Q1: Do stakeholders agree that promoting effective and sustainable competition remains an appropriate strategy to deliver efficient investment and widespread availability of services for the majority of consumers, whilst noting the need for complementary public policy action for harder to reach areas across the UK?

Telefonica notes Ofcom's comments in relation to investment in mobile, at paragraphs 6.39 – 6.43, and on the relationship between effective competition and timely and efficient investment at paragraphs 6.44 – 6.50.

In Telefonica's view, there is a notable omission in Ofcom's list of factors that determine investment in mobile networks, set out in paragraph 6.39, which is: the extent to which mobile operators can compete for scarce investment within their respective groups of companies. In practice, each UK MNO is part of a wider group of telecommunications companies operating elsewhere in Europe and across the globe. In the case of Telefonica, [X]

[X]

Further, as Ofcom is aware [X]

[X]

In Telefonica's view, Ofcom's starting point, that competition is an important contributor to a range of good outcomes, including investment and innovation¹ is just that: a starting point. Empirical evidence reveals a more nuanced position. Research commissioned by Ofcom² does not provide evidence of a strong correlation between the number of competitors and investment and suggests that highly concentrated markets can result in good consumer outcomes, whilst markets that are not concentrated give rise to poor outcomes (though, interestingly, concentrated markets do not appear to result in poor

¹ See paragraph 6.42

² Competition & investment: An analysis of the drivers of investment and consumer welfare in mobile telecommunications. WIK-Consult, 3 July 2015. See: http://stakeholders.ofcom.org.uk/binaries/consultations/dcr_discussion/annexes/Competition_and_investment_mobile.pdf

consumer outcomes). Consider the first, second and third columns in the following diagram:

Table 14: Country rankings for consumer outcomes, competition, investment and other factors, 2013

	Consumer outcomes	Investment CAPEX/revenue	Competition - HHI	Costs - share of rural population	Demand - GDP per capita	Demand - Smartphone penetration	Demand - mobile video usage
South Korea	1	4	10	4	12	1	1
Australia	2	na	11	2	1	4	4
UK	3	10	2	5	8	3	5
US	4	2	4	6	2	7	2
Japan	5	1	9	1	9	12	3
France	6	9	6	7	7	11	8
Austria	7	7	7	11	4	8	na
Netherlands	8	3	8	3	3	6	na
Ireland	9	na	na	12	5	5	na
Italy	10	5	3	10	10	9	7
Spain	11	8	5	8	11	2	6
Germany	12	6	1	9	6	10	9

Source: WIK-Consult report, page 69

Within that context, Telefonica agrees that the promotion of effective and sustainable competition is an appropriate strategy to deliver efficient investment, but the emphasis is very much on what is sustainable. [X]

As regards the issue of whether efficient investment is capable of delivering widespread availability of services for the majority of consumers (however defined), in Telefonica's view, this is, essentially, an empirical matter. To the extent that availability is not socially optimal (because, for example, there is some sort of externality at play, or wider availability is regarded as politically desirable), then Government has a role to play in reducing the costs of network rollout, and/or by subsidising it (in part or in full), subject to State Aid rules.

What more can be done through public policy to deliver truly widespread availability?

Q3: We are interested in stakeholders' views on the likely future challenges for fixed and mobile service availability. Can a 'good' level of availability for particular services be defined? What options are there for policy makers to do more to extend availability to areas that may otherwise not be commercially viable or take longer to cover?

Telefonica believes that the Government can do more to bring down the cost of rolling out networks and, consequently, promote greater network rollout. The Statement of Commitments, entered into by the Government and the four UK mobile operators, dated 17 December 2014³, included a commitment on behalf of the Government to reform the Electronic Communications Code and consider complementary reform of planning law. For their part, mobile operators agreed to accept amendments to their spectrum licences, to achieve 90% geographic voice coverage throughout the UK by no later than 31 December 2017. The mobile operators duly stuck to their side of the bargain; licences were amended early in 2015. Regrettably, however, we are still waiting for the Government to give effect to either of its promises.

³ See Annex A of Tackling Partial Not-Spots in Mobile Phone Coverage: Government Response to Consultation, DCMS, 12 March 2015. See: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/412618/Government_Response_FINAL_1.pdf

Does convergence and consolidation in our sectors suggest new approaches or tools are required to deliver effective competition?

Question 4: Do different types of convergence and their effect on overall market structure suggest the need for changes in overarching regulatory strategy or specific policies? Are there new competition or wider policy challenges that will emerge as a result? What evidence is available today on such challenges?

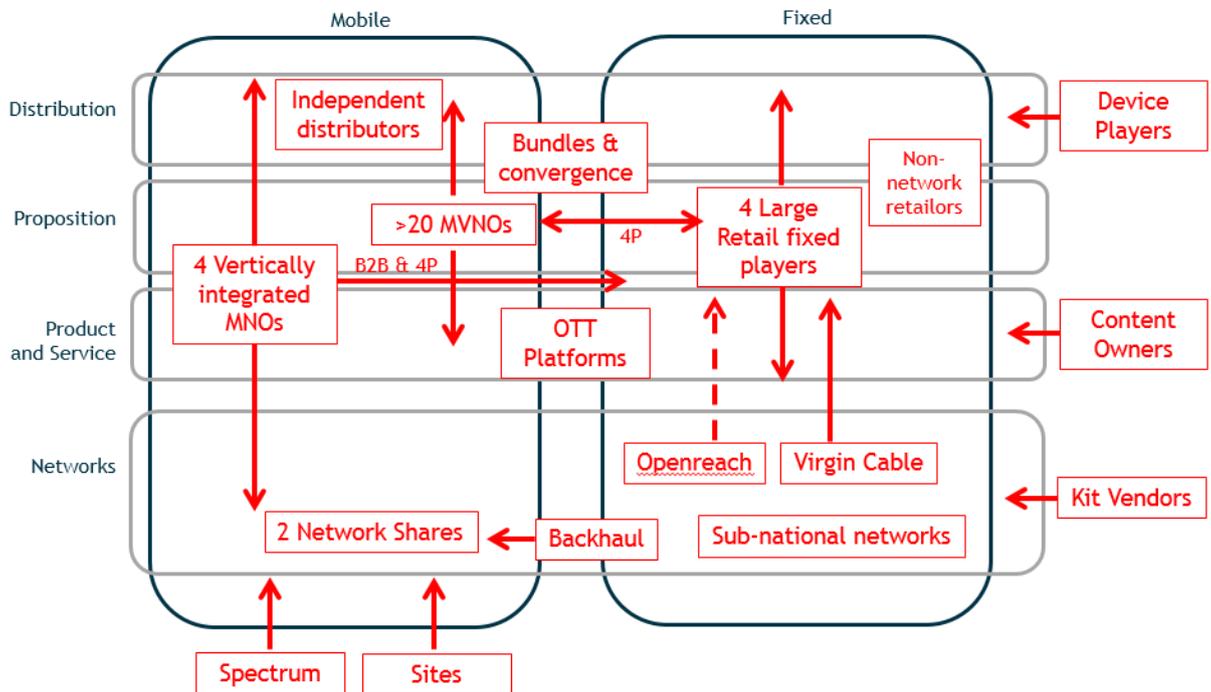
As Ofcom remarks, the telecommunications sector today looks very different to when Ofcom concluded its last strategic review in 2005. No doubt the same will be said again in 10 years.

Broadly, we believe that Ofcom's central objective, to ensure good outcomes for customers and business, should remain central to its strategic approach going forward. Telefonica itself has pursued a strategy of putting customers at the heart of all it does. And on that basis we share Ofcom's central objective to deliver good outcomes for our customers. (Although, this is not to say that sometimes we may differ on our views about the right regulatory approach to particular issues.) Ofcom's Consultation document discusses various aspects of convergence and the possible implications thereof. Overall, Telefonica believes that convergence and changing market structures will introduce significant new competitive dynamics into the marketplace.

We summarise these competitive dynamics below and comment in response to this question⁴.

Value chains are increasingly complex and interconnected. Whilst Ofcom uses three diagrams (Figures 20, 21 and 22) to present three value chains (fixed, mobile and media/ content), in Telefonica's view, the sectors and value chains are more complex and interconnected. We illustrate these diagrammatically as follows:

⁴ At paragraph 8.1, Ofcom explains that: "The purpose of this section is to consider how convergence and changing market structures could alter the competitive dynamics in communications and whether these changes have any implications for how Ofcom approaches regulation. Our intention is to consider its strategic approach to these issues rather than to reach conclusions on the competitiveness of particular markets, or to propose specific remedies."



In principle, we believe a strategy of “targeted regulation” remains valid for such a complex and interconnected sector. Further, we believe that the key is identifying “economic bottlenecks” and determining the appropriate approach to them. It will be important to recognise this complexity and the associated competitive dynamics inherent in the value chain (and how bottlenecks in one area can inhibit innovation, investment and effective competition in another).

Significant converged fixed/mobile/content players (for example BT/EE and Sky) are emerging. This introduces a new [asymmetric] competitive dynamic compared to mobile players such as Telefonica. For example, converged players may be able to subsidise mobile elements of their offerings using non-mobile revenue streams, self-use network assets (core, backhaul and access) for both fixed and mobile services and strong media players (such as Sky) have significant “hero” content assets with strong appeal to customers.

Content is increasingly important for customers and likely to increase in importance for customers when they choose a provider (whether a mobile offering or a multiple bundle). The ability to offer content may become increasingly important.

OTT services and global players (such as Apple and Google) are an increasingly significant competitive factor, both in providing competing services and in exercising control over handset operating systems, home-screens and their integrated cloud platforms and app stores and the customer relationships they drive. New technology such as eSIMs and increasing Wi-Fi penetration, strengthen the opportunities of converged operators and OTT

players. Growth to date in mobile has been supported through open interfaces and standards – ensuring openness where proprietary handset operating systems and platforms are present is likely to be important in providing for interoperability and the ability for consumers to switch providers. Absent interoperability and open standards, customers risk being locked into a specific vendor’s vertical solutions for all their communication services needs.

What does this mean for Ofcom’s strategic approach?

Telefonica believes that delivering good customer outcomes should remain the underlying objective for Ofcom’s strategic approach

Telefonica believes that a regulatory approach of targeted regulation remains relevant for this increasingly dynamic competition (and deregulation where possible). Identifying any “economic bottlenecks” and determining the appropriate response will remain central to Ofcom’s work. Given the competitive dynamics discussed above (arising from converged players) it will be important to ensure bottlenecks in one area cannot be used to distort competition in other areas. This would disincentivise efficient investment and, ultimately, harm consumers.

In the Consultation, Ofcom rightly (in Telefonica’s view) identifies backhaul as increasingly important for mobile along with the regulated access regime. The opportunity for passive access should be considered, in particular dark fibre. But these are not panaceas. Our response to Ofcom’s Business Connectivity Review discusses this in more detail. Appropriate charge controls in respect of active and passive access remedies will also need to be reviewed.

Ofcom notes that there are many different ways for consumers to access content. We believe that content (particularly “hero” content) and the competition from OTT and global players are also increasingly important competitive dynamics for mobile and, as such, regulators will need to consider approaches where economic bottlenecks arise.

Ease of switching and/or unbundling services will be important. The implications (and dynamics) of bundling and the participation of OTT and global players in the value chain will need to be considered. Of particular importance for mobile players will be ensuring that customers can select unbundled services or subsequently “unbundle” or switch out of part of the bundle. There is an asymmetric risk here for mobile operators.

We return to a number of these aspects in our responses to questions 9, 17 and Q24.

Question 5: Do you think that the current regulatory and competition tools are suitable to address competition concerns in concentrated markets with no single firm dominance? If not, what changes do you think should be considered in this regard and why?

Yes. As a matter of principle, Telefonica believes that reliance on general competition law is preferable to sector specific regulation, unless there are good reasons to the contrary. Telefonica is not aware of any such reasons in respect of markets it operates in.

In the UK, Ofcom has access to a wide range of extensive powers to address competition concerns in concentrated markets with no single dominance, by virtue of the Enterprise and Regulatory Reform Act 2013, which amended the Enterprise Act 2002. We have not seen any evidence to suggest that additional sector specific powers are required by Ofcom.

What model of competition should future regulatory strategy focus on: full end to end networks; passive access to support end to end networks; or active wholesale remedies to deliver downstream competition?

Q6: What do you think is the scope for sustainable end-to-end competition in the provision of fixed communications services? Do you think that the potential for competition to vary by geography will change? What might this imply in terms of available regulatory approaches to deliver effective and sustainable competition in future?

Telefonica believes that the optimal position for consumers is to have end-to-end competition based upon multiple competing infrastructures. Today, the UK already exhibits multiple fixed infrastructures in many urban and suburban networks, with at least two and sometimes three broadband networks available. As penetration of higher speed services increases, the risk of deployment of new networks declines and so we are already seeing expansion of high speed network deployment, for example Virgin Media.

There will come an economic limit where the returns for more than one infrastructure owner make deployment unviable. A single access product is required for each regulated player. A range of regulated products including bitstream will be required in areas where BT is the only viable infrastructure.

We believe that a distinction can be drawn between the regulation of FTTH versus FTTC deployments. FTTC leverages the existing copper last mile and so to some degree the costs and risks for the investor are mitigated by reliance upon sunk infrastructure. By contrast, FTTH deployments require a completely new investment even by an incumbent copper network owner.

Where effective duct access is not available, a dark fibre remedy is required. This is the case in the UK, where effective duct access has not been made possible due to the poor quality of BT's ducts and record-keeping of its infrastructure and also due to the regulated PIA product not being credible. As a consequence, dark fibre is required, with a requirement to place some clear incentives on BT to deploy fibre to meet all customer demands not just BT's own and not to strategically game the system or block ducts routes with their own under-utilised cables or fail to recover redundant cables. Dark fibre should be available on a duct route basis in order that mobile operators can connect small cells in close proximity, as opposed to having to purchase whole routes back to the BT exchange.

Q7: Do you think that some form of access regulation is likely to continue to be needed in the future? If so, do you think we should continue to assess the appropriate form on a case by case basis or is it possible to set out a clear strategic preference for a particular approach (for example, a focus on passive remedies)?

Yes. With a focus on passive access where FTTH and to simplify any bitstream access remedies to reduce the burden of regulation. Dark fibre is required as already stated above.

Q8: Do you agree that full end-to-end infrastructure competition in mobile, where viable, is the best means to secure good consumer outcomes? Would alternatives to our current strategy improve these outcomes, and if so, how?

Yes. Focus should be on the quality of competition between operators, not the number of operators per se. There is a need to consider both static competitive effects and dynamic benefits of investments. The UK is one of the highest traffic and highest population density countries in Europe. The market is much more capacity sensitive than it has been in the past and in comparison to other European markets. In the future, the ability to compete (and hence the intensity of competition) will be significantly reduced if operators are capacity constrained.

Convergence between fixed/mobile and content value changes mean that the level of competition is likely to be impacted by bottlenecks in adjacent markets. It is therefore important to take a more holistic cross-market view rather than a narrow focus on pure mobile sectors. It is also important to recognise innovative competition from alternative technologies like Google Loon and new LEO satellite solutions.

Are there new or unresolved competition issues in digital communications services?

Q9: In future, might new mobile competition issues arise that could affect consumer outcomes? If so, what are these concerns, and what might give rise to them?

We are concerned that consumers could be adversely affected by the dominance of global digital players through both platform and devices. For example, the imposition of proprietary standards are capable of: creating barriers to entry and innovation; potentially reducing the viability of connectivity and infrastructure players, where there is effective competition at the moment; and creating barriers to switching. This should be a matter of concern for Ofcom. As we set out in our response to question 24, below, we strongly urge Ofcom to take a broader look at the position of such global digital players and how their commercial strategies could affect consumer outcomes.

Q10: Does the bundling of a range of digital communications services, including some which may demonstrate enduring competition problems individually, present new competition challenges? If so, how might these issues be resolved through regulation, and does Ofcom have the necessary tools available?

Telefonica believes that the application of a margin squeeze test for multi-product firms will prove increasingly difficult as regulated and unregulated products are bundled into the customer offer.

Bundling exposes traditionally separated value chains to bottlenecks in adjacent ones, impacting competition and incentives to invest. Concentration of content rights ownership is a concern in the UK. The impact of bundling on switching is also open to abuse and some minimum protections may be appropriate.

Should Ofcom do more to further support empowerment at each stage of the consumer's decision making process?

Q17: What do stakeholders think are the greatest risks to continuing effective consumer engagement and empowerment?

As noted above, of particular importance for mobile players will be ensuring that customers can access, assess and act in relation to mobile services when “bundled” and where OTT services and global players (such as Apple and Google) are an increasingly significant competitive dynamic.

Accordingly, we believe Ofcom is right to consider whether consumers may face a number of increasing challenges in exercising effective choice, through:

- Greater product, pricing and bundle complexity may reduce consumers' ability to assess the choices and make informed decisions
- Increased complexity in service offerings may unduly discourage switching.
- Proprietary interfaces between devices and platforms which lock customers into a single supplier for all their communications services

As discussed below, it is important for Ofcom to ensure that it monitors the right indicators such that it can make robust, evidence based decisions.

Q18: What indicators should Ofcom monitor in order to get an early warning of demand-side issues?

Good customer outcomes should remain as the underlying objective for Ofcom's strategic approach – and as Ofcom notes, it already publishes a range of measures to inform its work.

We believe it would be sensible for Ofcom to undertake a review to ensure that it has the right indicators to fulfil its duties going forward (including whether existing indicators remain relevant). It is important that there is clarity in respect of duties and remit – as well as ensuring it assesses the effectiveness of regulatory interventions.

We note that Ofcom suggest that rather than focus on single indicators, it may be sensible to consider using a broader range of indicators to assess “the whole”. We believe this approach is worth exploring further. In principle, it can provide overall context and a broader assessment of overall outcomes (for example, risk of “unintended consequences”). It can also assist in determining if interventions are necessary and proportionate and help guard against detailed “micro-management” responses.

Q19: What options might be considered to address concerns about consumer empowerment at each stage of the decision-making process (access, assess, act)? What more might be required in terms of

information provision, switching and measures to help consumers assess the information available to them? What role may Ofcom have to play compared to other stakeholders (including industry)?

Ofcom asks whether it should do more to further support empowerment at each stage of the consumer's decision-making process. For example, greater use of "nudge" based remedies. To the extent that intervention is necessary, intervention via "nudge" based approaches may well have merits – particularly where they provide Ofcom with the means for intervening in the least intrusive manner.

Ofcom discusses some potential options for consideration: for example, enhancing the roles of "intermediaries" and user generated content recommendations, devising common comparators, mandating simpler and more comparable retail propositions and setting up the communications equivalent of the "Money Advice Service".

Telefonica is not convinced that such interventions are the answer to helping consumers assess choices. They bring with them their own dynamics and incentives (for example, the business models of intermediaries/user generated content sites drives certain behaviours, whilst intervention to require "basic" services/common comparators have their disadvantages in dynamic and innovative markets.

In our experience, provider initiatives, driven by customer insight, are the most impactful for customers. For example, Telefonica's O2 Refresh tariff.

What more should Ofcom do to support better quality of service for consumers, in either competitive or less competitive markets?

Q20: Are there examples in competitive or uncompetitive sections of the market where providers are not currently delivering adequate quality of services to consumers? What might be causing such outcomes?

As noted above, the mobile operators agreed to accept licence amendments which required them to improve geographical coverage for voice and text. This will be done at the same time that 4G networks are being rolled out in the UK at record speed. In return, the Government agreed to reform the Electronic Communications Code and consider complementary reform of planning law. However, the industry is still waiting for the promised reform. Telefonica believes that reform would enable mobile operators to build out their networks more effectively and efficiently and that service levels would improve as a consequence

Q21: What further options, if any, should Ofcom consider to secure better quality of service in the digital communications sectors?

Telefonica would welcome Ofcom's assistance in pressing Government for reform of the Electronic Communications Code and planning law.

Are there opportunities for deregulation or simplification that will bring broader benefits whilst avoiding new risks to consumer harm?

Q22: Might there be future opportunities to narrow the focus of ex ante economic regulation whilst still protecting consumers against poorer outcomes?

Telefonica favours a regular, systematic review of ex ante regulation to determine whether it remains necessary, or whether it should be reformed or removed.

Q24: What are the potential competition and consumer protection implications of the rise of OTT services? Might the adoption of such services enable future deregulation without raising the risk of consumer harm?

Ofcom's discussion of the implications of OTT services is set out in paragraphs 14.26 – 14.48. Telefonica agrees with much of Ofcom's analysis (e.g. the likelihood that OTT services will increasingly act as a competitive constraint on services provided by mobile operators). However Telefonica believes that Ofcom does not appear to have considered the full repercussions of the impact of OTT services, which are likely to be profound. In particular:

Bottlenecks. Ofcom notes that bottlenecks may emerge as a result of the growth of OTT services, because of vertical integration, the possibility that app stores might act as gateways, and the difficulties of switching between platforms⁵. However, Ofcom says that its review will not consider such issues on the basis they are subject of European Commission antitrust cases and in-depth investigations.

Such an approach appears to Telefonica to erroneous. The purpose of Ofcom's review is to "make sure digital communications markets continue to work for consumers, citizens and businesses. It considers future policy challenges across fixed, mobile and content sectors..."⁶ Telefonica simply does not understand how this purpose can be achieved if important implications of OTT services, particularly those vertically integrated to specific device ecosystems – like the possibility of new bottlenecks, the lack of interoperability and the inability to switch easily between platforms - are to be expressly excluded from the review.

If Ofcom is to deny itself the opportunity to understand better these developments, how will it be able to make well-reasoned decisions about how best to deploy its limited resources? For example, how could Ofcom arrive at an informed view about different barriers to switching that mobile consumers face, if it doesn't consider the structure of OTT service provision? It seems to Telefonica that, in such circumstances, Ofcom might mistakenly decide that seeking incremental benefits to the mobile number portability porting process might be a sufficiently worthwhile pursuit. However, it is quite

⁵ See paragraphs 14.33 – 14.37

⁶ Second paragraph in "About this document"

conceivable that addressing interoperability and barriers to switching between OTT providers would generate greater benefits to consumers.

For the avoidance of doubt, Telefonica is not necessarily suggesting that Ofcom is not deploying its resources appropriately. However, it is not clear to us how Ofcom will be able to demonstrate that it is tackling the areas of most important to consumers, in circumstances where it has decided not to consider the impact of important developments in the market.

Jurisdiction. Ofcom speculates, at paragraphs 14.43 – 14.48, about the circumstances in which consumer protection legislation might be applied to OTT providers and the extent to which deregulation might be desirable to ensure greater consistency.

Telefonica believes that it is essential to ensure that there is a level playing field when it comes to regulation, in the interests of adequately protecting consumers and ensuring that competition is not distorted. However, it seems to Telefonica that there is potentially a problem relating to jurisdiction in seeking to extend and then enforce a regulatory regime to entities outside of the EU. This is relevant to OTT service providers, because they can, in principle, be based anywhere. The potential problems in regulating these entities, and the policy implications, are not addressed by Ofcom in the review. In Telefonica's view, this is a serious oversight.

Q25: Are there any areas where you think that regulation could be better targeted or removed in future? What would be the benefit of deregulation as well as the main risks to consumers and how these could be mitigated? Please provide evidence to support your proposals.

As noted above, Telefonica favours a regular, systematic review of ex ante regulation to determine whether it remains necessary, or whether it should be reformed or removed.