TalkTalk
For Everyone

Narrowband Market Review

TalkTalk response to July 2017 consultation

July 2017

NON-CONFIDENTIAL VERSION

1 Summary

1.1 This paper responds to Ofcom's brief consultation dated 6 July 2017, which supplements Ofcom's earlier consultation for the 2017 Narrowband Market Review. TalkTalk is grateful for the chance to respond, and to Ofcom for issuing a supplementary consultation on two important issues which have emerged as a result of the original NMR consultation. This section briefly sets out the core views of TalkTalk; more detail is provided in sections 2 and 3.

1.2 With regard to **price notification remedies in the WCT markets**, TalkTalk does not agree that these are necessary. In wholesale markets, counterparties to the SMP operator are themselves well-resourced and knowledgeable companies. The price cap which Ofcom has proposed is a straightforward one, with the same price cap at all times of day and no pricing flexibility. The benefits of notifying prices *ex post* to Ofcom are therefore unclear– purchasers of WCT are themselves likely to notify Ofcom in the event that a firm charges above the WCT price cap.

1.3 Concerning **IP interconnection**, although the statement set out by Ofcom in its consultation paper regarding how Ofcom will interpret the fair and reasonable charging condition is helpful, it does not go far enough. As set out in TalkTalk's July 2017 supplementary response on interconnect related issues, we continue to believe that the most appropriate approach is for Ofcom to impose a charge control on IPX interconnect circuits and termination at the same level as the charge control which it is imposing on TDM-based circuits and termination.[1] This would allow CPs to make efficient choices between technologies without having those choices distorted by BT's network choices or charging policies.

2 Price notification remedies in WCT markets

2.1 In its consultation, Ofcom amends its 2016 NMR Consultation, withdrawing the proposal to require price notification of pricing changes (§2.3), and instead proposing a condition whereby all 315 telephone providers with SMP would have to notify Ofcom annually, after the event, of the prices that they had charged in the preceding regulatory year for fixed termination.

2.2 The FTR price cap proposed by Ofcom in its earlier NMR consultation is relatively straightforward. Ofcom has proposed a price cap on FTRs which would apply to all operators with SMP, and unlike in the 2013 NMR, does not propose to permit pricing flexibility to any operators (§13.69 of 2016 NMR Consultation). Operators other than BT were previously permitted to charge above the Benchmark FTR in some circumstances (§13.66 of 2016 Consultation).

[1] As TDM circuits are within a basket, a suitable basket would have to be constructed for IPX products which would lead to the same average price per minute of IPX connectivity.

2.3 Furthermore, Ofcom proposes a single Benchmark FTR which would apply to all operators including BT (§13.77 of 2016 Consultation). This Benchmark FTR would apply at all times of day, aiding simplicity (§13.73 of 2016 Consultation).

2.4 There will thus be a single regulatory price cap which applies at all times and to all operators. This makes monitoring compliance with the price cap very straightforward.

2.5 It is therefore unclear what Ofcom's proposed price notification is aimed to achieve. There will be strong incentives on CPs to enter into a dispute via Ofcom with any operator which charges in excess of the Benchmark FTR, and it will be simple to determine when such breaches are occurring. Ofcom is therefore likely to find out about breaches well before the end of the regulatory year due to disputes and its regular contacts with stakeholders.

2.6 Furthermore, even on Ofcom's own estimates, and in the absence of a hard cap on CPs other than BT in the course of the current charge control period, there has been little charging above the Reference FTR. Table 13.4 of Ofcom's 2016 Consultation sets out that in 2014/15 there was less than £700,000 of revenue earned in excess of the Reference FTR, amounting to 5% of revenues. This £700,000 figure would be expected to decrease substantially in the next regulatory period, for several reasons:

- as set out at Table 15.2 of Ofcom's 2016 Consultation, the Reference FTR is expected to fall substantially over the period, by a third between 2015/16 and 2019/20. As such, even if the 5% rate of charging above the reference FTR were maintained over the next period, the excess charge per annum would be expected to decrease by over £200,000 by the end of the period;
- the imposition of a hard cap on CPs other than BT, and the prospect of fines for breaching that cap, will create much greater incentives for smaller CPs to ensure that their FTRs are no higher than the Reference FTR, which would be expected to reduce the proportionate rate of overcharging from the 5% that Ofcom previously found;
- the greater clarity offered by a single, universal, hard price cap means that purchasers will be much more willing and able to dispute prices both with the supplying CP, and, if that is unsuccessful, with Ofcom. The clarity of a hard cap also means that CPs setting charges in excess of that cap are likely to be more inclined to reduce their charges under pressure from their customers.

2.7 Ofcom has presented no evidence that a cost benefit analysis of its price notification proposal would lead to the conclusion that the costs of compliance to the industry are greater than the benefit to the industry in terms of reduced interconnection charges. Given the points set out at §2.6, above, the total costs of excess charges to the industry and its customers, across all 315 providers, would have to be below £500,000 per annum for the net effect of the proposed regulation to be beneficial. This should include the cost of Ofcom resources to review the data (a cost which is recharged to the communications industry). This implies that the cost of compliance with the regulation, and review of data by Ofcom, could be no more than £1600 per provider, and indeed would likely need to be well below this level.

2.8 Removing this regulation would permit a more focussed approach from Ofcom to determining breaches of the charging cap for WCT. Rather than expend efforts on determining whether hundreds of providers have fully complied with the cap, after the event when this can no longer have an impact on pricing, Ofcom should instead widen its investigation whenever it receives a dispute regarding the WCT rates of a particular CP, to also cover all of the other counterparties of that CP. This would enable Ofcom's resources to be concentrated in the area where they are most likely to find breaches of the price cap.

2.9 Overall, therefore, Ofcom should remove its proposal that WCT rates are notified to Ofcom following the end of the regulatory year. Rather, it should encourage disputes from CPs taking WCT products from other CPs, and then investigate fully any CPs where there is *prima facie* evidence that there has been charging in excess of the WCT price cap.

3 IP interconnection

3.1 Section 3 of Ofcom's consultation sets out supplementary considerations regarding CPs interconnecting to BT's network for the purposes of delivering voice traffic. Ofcom has previously, in section 17 of its 2016 Narrowband consultation, set out that it proposed a price cap on BT for interconnect via TDM, which in turn Ofcom considers to be an efficient technology choice.

3.2 Following that previous consultation, Ofcom received submissions from a range of stakeholders including TalkTalk.[2] These submissions, including that of TalkTalk, set out concerns regarding Ofcom's proposals on interconnection. In particular, TalkTalk set out that it is, and remains, concerned by the lack of regulation to be applied to IP interconnection, and the low likelihood that IP interconnection will act as a viable competitive constraint on TDM interconnection over the upcoming regulatory period.

3.3 As set out in TalkTalk's 3 July submission, [✂]. In turn, this means that TDM does not and will not act as a competitive constraint on the pricing of IPX by BT, as [✂]. BT would therefore be able to profitably impose a small but significant and non-transitory increase in price (SSNIP) on IPX, [✂]. Furthermore, Ofcom's General Conditions means that it would not be possible to switch demand away from BT entirely, as all operators are forced by Ofcom to interconnect with BT's network. The lack of regulation of IPX, and [✂], acts to impede firms switching from TDM to IPX.

3.4 Ofcom's finding that BT does not hold SMP over IP interconnection is wrong, and is based on a fundamental misunderstanding of competition economics and the manner in which BT would be able to exploit its market power. Such a conclusion cannot stand.

[2] TalkTalk supplementary submission dated 3 July 2017.

3.5 It would already clearly be profitable for BT to impose a small but significant non-transitory increase in price over and above the competitive level on IPX traffic, given its market power. This market power will only increase over the course of the regulatory period, as TDM technology becomes increasingly outdated, and demand shifts to IPX.

3.6 The reasons underlying the profitability of this price increase are as follows:

- there is no scope for BT to lose traffic volumes as a result of the price increase. The General Conditions compel all operators to interconnect with BT, so there is no scope to withhold demand. Moreover, all operators apply the same charges for voice calls irrespective of the CP which the receiving party is served by (as long as the receiving party is located in the UK). There will hence be no substitution of calls to recipients based on other networks. Market level reductions in demand will be negligible.[3]
- Substitution from IPX to TDM traffic cannot act to constrain BT's market power. By definition, given that it is regulated, BT will earn a normal rate of return on TDM traffic. As such, the constraint on BT is not losing demand to another provider (which would involve both the loss of variable margin and the contribution to fixed and common costs) but losing demand to itself (losing only the excess margin over and above the normal level). This can be looked at through the lens of critical loss analysis. BT would need to lose more than 50% of its IPX demand in the case of a 10% increase in the price of IPX for the profit-maximising price increase to be lower than 10%.[4] As the break-even loss of demand would be 100%, it would always be profitable to impose some price increase over the competitive level. It is implausible that BT would face an elasticity of demand in excess of 5 when there are a number of providers which operate IP-only networks and which will effectively be captive customers with a zero elasticity of demand.
- BT will also benefit in the downstream retail market by raising its rivals' costs. By imposing a SSNIP on IP interconnection, they can potentially give BT Retail an advantage in the downstream market for voice telephony. Although this advantage is likely to be small, it nonetheless exists, and will increase the incentives on BT to impose a SSNIP.

3.7 BT therefore has market power over IPX interconnection which is not constrained by regulation of TDM. It has both the incentive and ability to impose a SSNIP on IP Interconnection. Indeed, it has recently effectively done so by changing the manner in which it charges for transiting calls between an IP exchange and a TDM exchange. Given that an operator using IPX interconnection has no choice but to interconnect with an IP exchange, this is effectively an unavoidable cost increase for operators using IPX. This charge increase appears unrelated to any additional incremental costs incurred by BT, but seems to result from an internal reclassification.

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[3] [✂]

[4] See Oxera (2008), *'Could' or 'would': the difference between two hypothetical monopolists*, November at Table 1.

3.8 Ofcom has essentially proposed in its current consultation to take no pre-emptive measures which might prevent BT from exercising its market power. Rather, it states that:

> *our interconnection requirement would apply to the delivery of traffic to BT's DLEs via IP interconnection, with the effect that it would need to be provided on fair and reasonable terms, conditions and charges.*
>
> *… we would look to consider whether the charges for the delivery of traffic to BT's DLEs via IP interconnection are fair and reasonable. We would expect that the commercial agreements made when telecoms providers had the option of buying TDM interconnection would provide a suitable starting point for considering this*.

3.9 In effect, Ofcom appears to be saying that it would await complaints by CPs before determining what the appropriate price for IP interconnection would be, and that the appropriate price would itself depend upon the previous agreements which BT has entered into.

3.10 TalkTalk does not consider that such an approach is an adequate counter to BT's significant market power in IP interconnection. There are a number of reasons underlying this:

- <u>the approach fails to give pricing certainty to other CPs</u>– as set out in TalkTalk's 3 July submission [✂].
- <u>the approach creates incentives for gaming</u>– Ofcom sets out in its consultation that the fair and reasonable charge will be dependent on the commercial agreements signed between BT and its counterparties for the supply of IP-based interconnection. This will provide strong incentives for BT to game its regulatory system and increase prices to counterparties. BT will be aware that reducing the price on its commercial agreements has three effects– it will reduce BT's margins in the short term from the operator on the commercial agreement for IP interconnection; it will reduce BT's margins in the longer term from operators taking IP interconnection from BT on the basis of a 'fair and reasonable' margin; and it will increase the likelihood that operators will switch from TDM-based interconnection to IP-based interconnection, which is more efficient for these other operators and will enable them to compete more effectively against BT Retail. All of these factors will reduce BT's incentives to offer improved pricing on a commercial basis, and the second of these is explicitly solely due to Ofcom's proposed form of regulation.
- <u>the approach is highly likely to lead to complex disputes being made to Ofcom</u>– other CPs will be unable to observe the full range of commercial agreements which BT has in place with the various CPs with which it has IP interconnection. There will therefore be a complete lack of clarity for CPs as to whether the terms they are being given by BT are indeed fair and reasonable or represent BT charging at an unreasonably high level. This will lead to CPs disputing charges with Ofcom on a protective basis– being unable to determine whether their charges are in line with Ofcom's fair and reasonable obligation, CPs will have little choice but to dispute BT's charges in order to protect themselves from BT's SMP.

3.11 The option proposed by Ofcom is therefore one which fails to meet its regulatory duties across a range of different metrics:

- it will delay switching to the most efficient technology (IP interconnection), reducing productive efficiency;
- it will lead to there being cost differences between CPs using TDM interconnect and IP interconnect which do not reflect the underlying differences in the cost of providing those services, reducing allocative efficiency;
- it may lead to slower development of products based around IP interconnection, reducing dynamic efficiency;
- it will lead to regulatory gaming, making it more difficult for Ofcom to regulate interconnection markets in an effective manner in the future as pricing data are distorted by gaming;
- it will lead to an increased volume of disputes, consuming resources of Ofcom, BT and other CPs.

3.12 Ofcom should therefore amend its current proposals, and re-consult on one of two options:

- setting a hard price cap for IP-interconnection and termination where the donating CP interconnects at the lowest technically possible level of the BT network, at the same rate as for TDM interconnection (where this is also at the lowest technically possible level), as proposed in TalkTalk's 3 July supplementary submission on interconnect. This would enable technology neutral interconnect choices to be made by CPs, would avoid regulatory gaming, and would avoid any disputes between operators being referred to Ofcom. However, it would also probably lead to BT making supernormal profits on interconnection, as TalkTalk estimates that the cost of IP Interconnection is already lower than the cost of TDM-based interconnection, and is likely to fall further over the course of the next regulatory period. This approach would also fail to maximise allocative efficiency, as the choices between interconnect technologies facing CPs would not depend upon their underlying costs.
- setting a hard price cap for IP interconnection and termination on a cost-reflective basis. This would be the optimal approach, as it would have all of the advantages of a hard price cap at the same level as the price cap for TDM interconnection, but would also maximise allocative efficiency. However, it would also require Ofcom to undertake a much more detailed and rigorous analysis than the first option, including a top-down or bottom-up assessment of the efficient costs of IP interconnection, likely rates of efficiency gain, and the manner in which common costs should be allocated to IP interconnection products. Despite these costs, such an analysis could be proportionate given the substantial benefits from an efficiently regulated IPX interconnection market. If Ofcom wishes to adopt this approach it should do so as expeditiously as possible, setting an interim price cap to prevent BT abusing its market

power while it conducts a full assessment of the costs to BT of providing IP interconnection.

3.1 Ofcom’s proposal will be worse for consumers, competition, and the level of investment in updated voice technologies than either of these options. It is inappropriate to leave BT with unregulated SMP in a market which is becoming more significant over time. To do so would be a breach of Ofcom’s regulatory duties.