OFCOM MOBILE TERMINATION
RATES CALL

Thursday, 1 April 2010
Ed Richards (Chief Executive): Good morning again. We are going to cover mobile termination rates. I shall hand straight over to Stuart McIntosh who will do his introduction and set out our proposals this morning right from the start. Stuart.

Stuart McIntosh: What I would like to do is set out the main highlights in relation to what we have put out today, and we will be happy to take questions after that. If I am repeating some of what you have already heard, you will be able to check to see whether I am consistent with what I said earlier.

As you know, the current controls on mobile termination rates are due to expire in March of next year, and the consultation document that we published today is a market review of the mobile termination market. It also sets out the rates that would come into effect next year and the glide path that we propose for rates up to 2014-2015, and that is assuming that we implement the proposals on which we are consulting. As I said earlier, and I just would like to re-emphasise this fact, it is a consultation at this point, it is not a decision or a statement by Ofcom. Once we have responses from stakeholders, we’ll obviously consider those and issue a statement setting out our conclusions later in the year, probably around Q4, which will be in good time for the implementation of the new regime in April of next year.

With that, I would briefly like to summarise the proposal particularly with regard to the rates, what they mean in terms of actual numbers, to whom they would apply and what they mean for consumers. This consultation follows on from a document that we published last year and in that we set out a broad range of options for setting termination rates, ranging from the current approach to more radical options like ‘bill and keep’ and capacity-based charging. Following that consultation, we have concluded that there are two main options that seem most feasible and appropriate at this point. The first is what we call LRIC+, which is long run incremental cost, plus a contribution to fixed and common costs, which is the approach that we have used for a number of years and use today. And second, pure LRIC, which is the method set out in the European Commission’s recommendation on termination rates, which was published last year.

I should be clear that the other approaches that we considered have not necessarily been rejected outright and some may well become more feasible and attractive in the longer
term. We can get into the distinction between LRIC and LRIC+ in the Q&A if that would be helpful. Suffice to say at the moment that we are consulting on adopting a pure LRIC-based methodology, and there are a number of reasons for that.

As we set out in the document, the economic arguments in respect of these two options are both finely balanced and, when I say economic arguments, I mean the extent to which the different approaches are likely to promote efficient tower structures in the retail market, and also promote effective competition. However, we see pure LRIC as having the advantage that it pushes the contest for revenue into the competitive part of the retail market and not the market for termination.

Secondly, the distributional arguments in terms of the impact on different groups of customers do not seem to argue against making a change at this point.

Finally, we do have to give appropriate weight to the European Commission’s recommendation, unless we have substantive reasons which are very specific to the UK market for not doing so. At this stage, we have not identified any significant factors that would lead us to adopt a different approach, i.e. not adopt the Commission’s recommendation. However, as I emphasised earlier, this is a consultation and I expect we shall get evidence on this point in response to the consultation, and we shall have to see where that takes us during the course of our further work.

Coming to the rates, as you will have seen, the rates that have come out of our cost modelling based on the pure LRIC methodology would, if implemented, mean that termination rates would go from 4.3 pence per minute for the 2G/3G operators today to 2.5 pence per minute in the year following, moving down on a glide path to reach 0.5 pence per minute by 2014/15. These rates obviously represent significant reductions but there are probably a couple of points that I would note.

First, they are not simply driven by the adoption of the pure LRIC methodology. Large reductions are also implied by our current methodology, which is because of the growth of data traffic and how that affects the allocation of certain costs between different types of services.

The second thing is that these changes are not out of kilter with what we have seen before. As the chart on the executive summary shows, termination rates have fallen from just under 25 pence per minute to roughly 5 pence per minute over the course of the past 15 years, so we are, therefore, talking about the continuation of a relatively well-established long-term trend.
To whom will these rates apply? As we set out in the document, they would apply in the form of charge controls to the now four MNOs and in the same way, so after year one transition, we shall have the same rates across the industry. H3G would no longer command a higher rate based on its 3G network. The second point is that they will provide a critical reference point for the rate set by other companies who provide mobile services. As you will see when you read the document, we are looking broadly at the definition of the market for termination, and have concluded that all providers who provide service to mobile numbers potentially have what we call significant market power. We do not necessarily believe it is appropriate and proportionate to apply charge controls to all of those other players, but we would see the rates set in respect of the MNOs as providing a key reference point for those rates in the event, for example, that we were brought a dispute where two or more operators had failed to reach agreement on those rates.

Looking, finally, at the impact of all of this on consumers, we would expect that to be largely beneficial. It will lower the floor on mobile call charges which will allow operators to offer and compete on a broader range of packages with potentially much larger ‘buckets’ of call minutes. It will lead to reductions in the prices of calls from fixed lines and, by significantly narrowing the spread between fixed and mobile termination rates, it will support the development of combined fixed and mobile offerings. I hesitate to say it will promote convergence but it might also do that.

I believe that has provided an overall summary as to our consultation proposals today, and we would be happy at this point to open the topic up for your questions.

**Question & Answer Session**

**Paul Howard (JP Morgan):** I have a couple of questions. I have not managed to read the whole document but do you include a cost/benefit analysis of this regulation and perhaps you can give a quick summary of that? Secondly, in terms of roaming prices, remind me what roaming tariffs are based on: are they on LRIC or LRIC-plus, what is the methodology there?

**Stuart McIntosh:** Hi, Paul, thanks for your question. Let me start off now but perhaps ask my colleagues to come in as well. In our document, we have set out an assessment of the impact of this on different players. We have not at this point concluded that analysis, because it will ultimately be based on further work by us and the input that we get from different stakeholders. However, there is analysis of that in the document and we
would expect to refine and develop that during the course of the work we shall be doing in the coming months. Ultimately, we shall look to reach a conclusion based on what comes out of that analysis, rather than look to do the analysis to support the conclusion, if you see what I mean.

On the question of roaming rates, I shall ask my colleague David Stewart to come in on that?

**David Stewart (Project Director):** The question of how the European roaming rates were set is not really answerable by thinking about specific price-setting methods like LRIC or LRIC-plus. As you probably know, Paul, there was a process that various European institutions went through to set those rates, so I do not believe there is clarity but that is a question to put to those institutions, the European Commission in particular.

**Guy Peddy (Macquarie):** Thanks for hosting the call. I have a couple of very quick questions. In your summary, you mentioned that one of the benefits of these cuts is to increase the potential for combined fixed and mobile offerings. I just want to understand why you believe that is a positive? Given the structure of the UK market, do you think that can realistically be achieved? Secondly, once the process around this mobile termination rate issue is completed by the end of this year, what is left to regulate in the mobile space, because this would almost bring mobile termination regulation to an end I would assume? Thank you.

**Stuart McIntosh:** Thanks for your question, Guy. With regard to the first one, we are not looking to prejudge the market outcome in terms of the nature of converged services, but we would like to see that the underlying cost signals result in the right retail prices being set in respect of consumers. What appears to be the case at the moment is that the gap between termination charges and costs in mobile are relatively high and are potentially distorting the balance between fixed and mobile. One of the things we are looking to do is to try to make sure that underlying distortion is corrected. If that leads to various players looking to provide various packages which are convenient to consumers, that is a good thing; we are obviously not looking to mandate that.

On your second point about what is left to regulate, in terms of economic regulation, termination rates have traditionally been one of the big focal areas within the industry. In the course of our mobile sector assessment last year and the year prior to that, we looked very closely at the nature of competition in the market and concluded that it is a reasonably competitive market, and we expect that it will continue to be so. With termination rates
coming down, it means that the regulatory issues in some respects in this area become less important, and we shall see where that goes in the longer term.

David Wright (Deutsche Bank): There was a similar survey carried out by the Swedish regulators 12-18 months ago which concluded, as have you, I believe, that with data traffic now increasingly growing on the networks, less cost should be allocated to voice etc which caused them to cut termination rates. However, the message which they also gave out very strongly to the operators was that they should consider raising data prices to cope with the increasing cost allocated to that to sustain the innovation and growth in that particular service. How comfortable would you be with operators reacting thus, raising data prices to allocate more of the cost of the network?

Stuart McIntosh: Thanks for the question, David. The first thing that I would say just so that we all remember and clearly understand, we do not regulate retail prices in the mobile sector. The level and balance of prices in the market, particularly vis-à-vis data and voice is really a commercial decision which the individual operators take. The outcome is a product of the competition between them. I do not think that we would look necessarily to send out a message of quite the type you mentioned that the Swedish regulator has sent out. That is an issue for the companies and an issue for the outcome of the competitive process in the market.

Nick Lyall (UBS): I am sure it is in the document and laid out quite clearly, but I have not had the chance to flick through it yet. Could you explain a little about your volume assumptions on mobile voice and what that might suggest now for substitution versus some of your fixed assumptions as well? Secondly, on the T-Mobile plus Orange merger, could you explain whether you have fully taken into account the combined market share of the new business, and whether that implies that perhaps a couple more changes could come as you finish the consultation?

Stuart McIntosh: We do not want to get too much into the detail on this call, but I shall ask one of my colleagues to say something.

David Stewart: The way we have looked at volume in line with a number of different market assumptions is that we gather data from all of the operators. We look at business plan projections based on real commercial assessments of future volumes and the source of that will be released in the model. You will be able to see the views we have taken on that, although the model is of a hypothetical operator rather than any particular operator.
Specifically on the impact of the merger, there is a very clear impact on this modelling process, which is that in 2007 when we modelled the market and looked at a hypothetical operator, we assumed a base case market share of 20%. This time round, in thinking about the changing market structure, we have assumed for our base case a market share of 25%. As your question flags, that has a modest downward pressure on price, although it is one factor among a number of factors.

Nick Lyall: Can we infer from that at all that there might be any change to the prices you have posted, or the prices you are consulting on just now for Orange and T-Mobile as you finish the process off – will this cause any change?

David Stewart: The important point to flag is that these are proposals which set out our thinking based on the evidence we have seen so far, so there is quite a lot to do still as far as considering people’s responses to those proposals, both the arguments as to how we should approach that and evidence. The question about the market share and the base case scenario is one of many issues about which we get a lot of interest and a lot of submissions.

James Britton (Nomura): I have two questions please. First, the European Regulators Group, before it was renamed, suggested last year that the regulators should set a glide path for ‘bill and keep’ when they did their next market review. Your are nearly there bringing rates down to 0.5 pence but can you explain why you have not done this explicitly, unless you have in fact done in the full report?

David Stewart: We considered and specifically decided not to adopt at this point an approach based on ‘bill and keep’. We are aware of the debate among European regulators as to the merits of that but we do not see it as appropriate for the UK market at this time. However, we believe it is important that there be commercial flexibility as rates fall for people to explore options for things like ‘bill and keep’ and capacity-based charging on a bilateral basis, particularly among smaller players. Therefore, the proposals we have set out are crafted specifically with that option in mind, particularly for those players who are being drawn into regulation for the first time.

James Britton: Great. The second question is why would you be confident that the cost savings for the fixed operators will end up in the pockets of the UK consumer? I am assuming that the fixed retention rate is no longer regulated so, as you said, it is all down to competition.
Stuart McIntosh: That is a fair question, James. During the course of last year, we did a fairly extensive review of the narrowband retail market, i.e. the fixed market, and concluded that market is now competitive as well. That allowed us to relax more or less all of the remaining restrictions that apply to BT. Therefore, we see there being a lot of competition in the fixed market and it is being reflected in the very significant market share that BT has had both on lines and particularly also on calls. We see those competitive pressures being quite strong and they will drive in the direction that I mentioned. While I would not wish to rest on it, at least one of the major operators in the fixed market went public over the weekend saying that, if there were to be further reductions on termination rates, they would pass those benefits on to consumers, which is what we would very much like to see but we think that competition will drive that.

Andrew Entwistle: You have already answered the question which was about the passing through of those rates to consumers, I could not work out how to cancel my question but I withdraw it!

Stuart McIntosh: I am glad that we anticipated it, Andrew.

Ottavio Avisorio (Société Générale): Thank you for hosting the call and it is relatively clear about your position and you have also set out the reasons for that. My question is on a related topic, which is net neutrality. Is it possible to give some colour about your current position and how that affects the mobile operator as well? Also could you say if there is any plan to have a consultation on this at some stage in the future, or will the consultation be held at a pan-European level?

Ed Richards: I shall pick that one up. The easiest way to answer it is to say that we are planning a consultation on the subject of net neutrality. We would expect that to come out in the coming months, so we shall publish a UK position on it in collaboration and co-ordination with other members of the body of European regulators, the entity that used to be called ERG. We are obviously discussing that with them in some detail. You will have to wait for the substance but, at this stage, we can just say that our general stance so far has been to take a slightly different approach to that which has been taken in the US, particularly in relation to fixed, because we see more competition here and, therefore, we have tended to place the emphasis on transparency and consumer choice. However, that is something we are looking at and shall look at in detail in the consultation alongside the issues raised around mobile as well.
Paul Marsch (Berenberg Bank): Just to follow on the question about the pass-through from wireline, the market solution has not really been that successful in passing on MTR reductions to customers originating calls on wireline networks, specifically from BT. You referred in passing in your commentary to reduced fixed and mobile retail rates as one benefit of this move. How do you answer that claim that the track record of the last few years is not really convincing in that respect? You have really just seen a transfer of profitability from mobile to wireline as BT has kept hold of that improved margin, rather than passed it through to consumers, so how do you answer that claim?

Secondly, and I have not had the chance to read through the document in detail yet, I wonder whether you can simplify for us what percentage of costs are you assuming are attributed to data traffic going forward? What I am trying to think of here is the percentage of revenues being derived from data traffic at the moment is pretty small, even though data traffic is way outgrowing voice traffic at the moment?

Stuart McIntosh: Thank you very much for your questions, Paul. On the first one, as I mentioned earlier, we looked quite closely at the way that competition is working in the retail market during the course of the work we did last year, which is why we came to the conclusion that the market is effectively competitive. I am not sure that we necessarily share your perspective regarding how this pass-through has worked through. However, if you have analysis and views on that, we would be delighted to have a look at it with you and to incorporate that in the work that we shall do in the next stage of this review. Therefore, I am very keen to see your analysis and the evidence you have there.

On the specific point, I do not have the costing analysis to hand but could probably take that offline and follow up with you on that.

Petri Allas (Redburn): Thank you for taking my question. You note in the document, and indeed that has been the argument for many stakeholders, that low end users would be negatively affected, particularly because especially pre-pay users have been paying less than the fixed costs of maintaining those users. Then in the same sentence, you pretty much dismissed that argument without really giving reasons why you don’t believe the low end users would be negatively affected on this. Therefore, I wonder whether you could elaborate on why you view it that way?

Stuart McIntosh: Perhaps I shall ask my colleague David Stewart to pick that up.
David Stewart: Sure. As Stuart said in his opening comments, the impact on consumers in aggregate and on different consumers is critical to us, and we looked specifically at this question about the impact on low end users. It was an issue that came out in the debate about European recommendation and something to which we are very much attuned. Our thinking so far, and let me stress this is only our thinking in developing proposals, and therefore may evolve as we get more information and analysis in the consultation, is that, to the extent that there is revenue to be offset in the retail market to accommodate the fact that the wholesale charges are falling, we do not see that as likely to be targeted on low end users. Those are among the most price-sensitive of customers and, to the extent that there is a consumer group who might bear a bigger proportion of the cost, it is the less price-sensitive consumers, because that is the rational strategy that a mobile operator would adopt over time to adapt to these changes. One of the things that we see in this market, therefore, is a high degree of dynamism, a high degree of market flexibility. One of the reasons why we believe that those impacts will be more measured than perhaps some of the submissions we have seen so far suggest is because that dynamism is expressed in the adaptability and the ability of the operators to change their tariff structures over time in a way that reduces some of those impacts.

Petri Allas: Although, arguably, some operators have said that the price-sensitive users might even drop out of the market and lose their ability to have a mobile altogether: is that an aspect you would look at?

Stuart McIntosh: This is an issue that has been raised before when we looked at termination rates. If you go back to that chart which we have in the executive summary, which is also in the main document, you will see huge reductions in the absolute level of termination rates and similar concerns have been voiced in the past. We are not indifferent to those in the sense that we want to understand whether there is a real issue, but they do not appear to have materialised in a way that people have suggested previously. We suspect that the same will be the case in this instance also.

David Stewart: At the risk of setting homework, Petri, section 9 deals with that in some detail.

Stuart McIntosh: We need to watch our time here a little, but we have time to take one or two more questions.

Damien Maltarp (Credit Suisse): Do you take into account any future spectrum costs and, related to that, do you take into account the fact that in the upcoming
auctions we shall see quite a diverse outcome in terms of operators having different amounts of spectrum?

David Stewart: The impact of questions about spectrum valuation varies quite a lot depending on whether one is setting prices using LRIC-plus or LRIC. We look at the question of spectrum valuation in some detail for the purpose of calculating LRIC-plus numbers and that is set out in one of the annexes to the document. I shall not go into the detail but suffice to say you are absolutely right that there is a great deal of complexity around that question and one needs to consider the different sources of data very carefully, and I imagine that we shall receive submissions on that point. Our proposals are based on LRIC and spectrum valuation becomes less important using a LRIC method.

Damien Maltarp: Just to be clear, in a pure LRIC model you do include some element of spectrum cost allocation?

William Godfrey: In principle, one might consider that the spectrum cost would appear in an incremental cost. As it happens, as we have modelled it, the spectrum costs do not appear and the reduction in traffic would not necessarily require incremental spectrum. However, these are proposals at the moment so we welcome views.

Stuart McIntosh: This is one of the reasons why we are making our cost model available, so that people can have full transparency in the way we are doing the cost modelling and the different cost components that factor into the different definitions and methodologies. We can take one final question if there is another one and then we shall have to close at that point. [no further questions registered]

Thank you very much for bearing with us and we apologise for the brief interruption to service that happened just after eight o’clock. I apologise also if you had to listen to my introduction twice, because we were not quite sure at what point we lost you. Thank you very much for joining us and we hope you found that useful and helpful.

- Ends -