12 Views of Orange

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General view of DGT's proposals

12.1. Orange told us that it believed Oftel's reluctance to rely on its existing powers to resolve interconnection disputes under European telecommunications law was based on a legal interpretation of the relevant legislation (subsequently transposed into UK law). Orange believed that this hinged on the difference between the powers given to Oftel under, on the one hand, section 6(6) and, on the other, section 5(1)*(c)* and paragraph 1 of Part II of Schedule 3 of the Telecommunications (Interconnection) Regulations 1997. The former conferred a general power to resolve interconnection disputes by imposing 'reasonable' terms and conditions, while the latter conferred a specific power to impose cost-oriented interconnection charges where an MNO had significant market power in the relevant market. In Orange's opinion, Oftel, not having found any of the four MNOs to have significant market power in the relevant market, was seeking to establish a specific national power via a licence modification to regulate mobile termination rates as cost-oriented charges, because it had doubts about its right to do so under the existing European telecommunications legislation.

12.2. Orange observed that Oftel had used a utility model approach to the economic regulation of communication markets. Such an approach was appropriate when dealing with static, monopolistic markets for homogenous products and services, and where technology was stable. Communications markets such as the mobile market were not, however, utility markets: they operated in a fast-changing technological and capital-intensive environment. Orange believed that Oftel had failed to consider fully the dynamics of the mobile market in its analysis and conclusions, especially in respect of the forthcoming generation of mobile services.

12.3. Orange acknowledged that competitive pressures were not yet fully effective in respect of call termination charges but disputed whether regulatory intervention was the most appropriate means of bringing to consumers the full benefits that they might expect from a fully competitive market. Oftel had acknowledged the existence of some factors that it thought might be expected to bring further pressures on call termination services over time. Given the relative immaturity of the mobile market, it was logical to expect that some competitive aspects of the market, such as outbound services in general, would be more developed than others. Orange said that Oftel, in finding only that competitive forces were not fully developed in call termination services, had failed to identify any non-transitory market failures. In Orange's view, what was needed to meet Oftel's twin objectives of promoting competition and protecting the consumer was more competition, not more intrusive regulation.

12.4. Orange believed that the introduction of a price control on GSM call termination would inevitably bite also on 3G mobile services, which could prove particularly damaging to consumers at a time when MNOs were faced with the huge costs of 3G investment. Orange said that this sent a message to potential competitors that the returns available for competing in this high-risk market were vulnerable, putting in jeopardy the public and consumer benefits of the Government's plan to put the UK at the forefront of the broadband revolution. A blanket regulation of the kind proposed by Oftel would reduce rather than increase competition by further weakening the weaker mobile operators, undermining competitive forces based on innovation and reinforcing the market position of the most profitable operator.

Legal and regulatory

12.5. Orange said that in its opinion the introduction of the new EC regulatory regime on 25 July 2003 had a direct impact on our ability to report on any remedies and that we were precluded from recommending any modification to its licence because:

(a) such a recommendation would be irrational or disproportionate or both; and

(b) because it would unlawfully frustrate the new EC regulatory regime.

Irrational or disproportionate

12.6. It was, in Orange's submission, uncontroversial that our duty was to report in accordance with our terms of reference, ie to report on whether modifications to Orange's licence could remedy any

adverse effects on the public interest that we had identified: it was not our function to speculate on what might happen under the new regulatory regime or on what Oftel would or could do in July 2003. Orange added that any report by us was subject to judicial review and that we should act in such a way as would be found proper in the event of such a review. Finally, said Orange, its licence and any modifications to it would cease to have effect after 25 July 2003.

Irrational remedy

12.7. Orange suggested that it would be irrational to recommend any modifications to its licence, since these could not remedy any adverse public interest effects in the limited time between the date such modifications could come into effect and 25 July 2003. Orange added that it would be beyond our statutory remit to recommend any modification that depended for its effectiveness on Oftel's ability to maintain it in force after that date. A glide path, by definition extending beyond that date, would obviously be beyond our statutory remit. Similarly, a one-off price reduction that was intended to have effect beyond that date would also be beyond our statutory remit.

Disproportionate remedy

12.8. Orange said that a licence modification along the lines suggested, if imposed, would have effects on its business far beyond the time it could be in force and would therefore be disproportionate. This was the case irrespective of whether a glide path or a one-off price reduction was recommended. A one-off price reduction that was intended to have effect only until 25 July 2003 was neither appropriate nor necessary.

Frustration of new EC regime

12.9. Although Orange argued that it was beyond our remit to consider such matters, Orange submitted that to recommend any licence modification would compromise the new EC regime. Unless the European Commission agreed otherwise, national regulatory authorities had the power to impose obligations only on operators with SMP in one of the markets defined in the forthcoming Recommendation under Article 15(1) of the Framework Directive. Whether Oftel had that power in this case depended ultimately on whether the final version of that Recommendation identified call termination on an individual mobile network as a relevant market, and Orange disputed our right to pre-empt that question.

12.10. Orange further suggested that even if the Recommendation under the Framework Directive were to define call termination on individual mobile networks as a relevant market, a recommendation by us on the lines we had provisionally indicated would be contrary to the objectives set out in the Access and Interconnection Directive; but that, since it would be beyond our statutory remit to recommend any modification that would apply or have effect beyond 25 July 2003, it followed that it was not open to us to consider this further.

Market definition

12.11. Orange told us that it did not consider Oftel's definition of the market, 'call termination on each 2G mobile network', to be appropriate. Customers, particularly in the mobile market, purchased a bundle of services and there was a clear economic link between termination and other services. Orange believed that the level of available termination revenues was an inseparable element in the package of terms, including the terms of subscription, call and other charges, offered directly to subscribers by the MNO. It was artificial to separate call termination from the overall mobile market for competition analysis purposes. Moreover, Orange considered that the relevant market should include consideration of all the technologies, including GSM, GPRS, UMTS and PAMR, that provided mobile services. Orange added that Oftel's definition also failed to take due account of the dynamic interaction of pricing for different mobile services: it was normal in a multi-product setting in a competitive market for prices to be determined at least partly by relative demand. Profit from call termination might be invested in stimulating further demand, by, for instance, subsidizing handsets, or investment in research and development.

12.12. Orange also believed that it was not possible or, even if possible, commercially sensible, to separate in real time 3G voice calls from 2G calls. Consumers would make calls to mobiles and receive calls on their mobiles and would not think about the technology of making those calls.

12.13. Orange therefore believed that the definition 'call termination on each 2G mobile network' needed reconsideration in the light of the evidence of call substitution.

Competition

12.14. Orange said that it was clear that there was intense competition in the mobile market:

(a) Prices had been and were continuing to fall.

(b) Service innovation was rapid.

(c) Tariff changes offered customers increasing value for money.

(d) There were low barriers to consumer switching.

(e) There was high consumer satisfaction.

(f) There was high consumer penetration.

12.15. As a result, said Orange, the four MNOs taken together were not generating excessive profits, even on Oftel's assessment. The one MNO that Oftel did assess as generating excessive profits had seen the level of these profits eroded by the forces of competition.

12.16. Orange agreed that substitutes for call termination, although they existed, were limited, but maintained that there was no reason to think that MNOs would not want to attract more and longer calls to their networks. The problem was that they could not do this simply by changing their call termination charges, which were wholesale charges not flowing automatically through to retail customers. Orange believed, however, that one development which should ultimately provide competitive pressure on termination charges was the increasing practice of bundling off-net calls with on-net calls in inclusive minutes offered to subscribers. Other possibilities were resale partnerships with FNOs where an MNO offered lower call termination to an FNO in return for the FNO reselling the MNOs' services to its customers, but any exclusive arrangements of this sort could infringe non-discrimination regulations. Interconnection incentives encouraging the fixed operator to reduce its retail rates, perhaps through a 'reverse' friends and family concept also risked falling foul of anti-discrimination regulation. Thus, it appeared to Orange, anti-discrimination requirements themselves stood in the way of increased competition in call termination and might usefully be reviewed.

12.17. Orange told us that there were several factors that exerted competitive pressures on call termination charges, which argued against Oftel's view that call termination constituted a 'bottleneck'. Among these factors, Orange cited the following:

(a) the evidence of widespread closed user groups;

(b) the evidence of increasing call substitution activities;

(c) dynamic technological developments, such as dual SIMs, fixed-line SMS capability, future VoIP arbitrage; and

(d) the impact of 3G.

12.18. Orange recalled that Oftel, in its Consultative Document of February 2001,[1] had proposed, in Chapter 7, that there might be no further regulation after the current price cap if there were evidence in the mobile market of growing competitive pressure. Orange pointed out that the market was effectively

[1] *Review of the Price Control on Calls to Mobiles.*

competitive since other services were competing away excess call termination income to the extent that any excess existed. Orange considered it important to note that Oftel was implicitly recognizing that call termination services could not be considered in isolation and that consideration should be given to the interaction between call termination revenues and all other aspects of the mobile service, including hand-set subsidies and on-net retail sales.

12.19. Orange noted other competitive developments including premicells and private wire, network competition for closed user groups, which was delivering very low on-net prices, and the emergence of multi-SIM adaptors, allowing arbitraging the established price structure.

12.20. We asked Orange what it believed would happen to call termination charges in the absence of regulation. Orange replied that in the total absence of regulation it believed that there was a mechanism already in place, without the need for a specific price control, which would prevent any rise in call termination charges. First, MNOs had no right to raise unilaterally their call termination rate: these had to be agreed bilaterally with other connecting operators. It was thus entirely possible for the other party in such a negotiation to refuse to agree any increase in call termination rates proposed by the MNO. Second, there was power under European telecommunications legislation granted to the national regulatory authority to resolve interconnection disputes and to impose 'reasonable' terms and conditions to resolve the dispute. There would therefore be no incentive for an MNO to propose a unilateral increase in termination rates because it could not enforce such an increase upon an unwilling operator.

12.21. It was therefore Orange's conclusion that any belief that termination rates would rise in the absence of a specific price control on call termination rates was not correct.

Increasing consumer awareness

12.22. Orange pointed out that over 13 per cent of personal users and 31 per cent of SMEs[1] took the cost of being called on a mobile phone into consideration in their mobile purchase decision. Both Oftel and the DTI agreed that barriers to switching between MNOs were low.[2] This indicated that the level of inbound call prices affected the choices of mobile networks at the margin, although that margin represented about 1 million consumers. Consumers concerned about the cost of calling a mobile phone had options, such as limiting the nature and duration of calls or using other media.

12.23. Orange pointed out that Oftel research[3] had highlighted that 51 per cent of SMEs believed it important that customers could call their businesses on its mobiles, and that 72 per cent of SMEs were satisfied with the amount that it cost others to phone mobiles. These findings did not suggest that SMEs were insensitive to the cost of their inbound calls. Orange added that the Oftel research had shown that where the cost of calling mobiles was considered important, there was high awareness of steps that could be taken to reduce the cost, such as keeping calls short, mobile network choice and call-back.

12.24. Orange disputed the importance of Oftel's research finding that consumers found information on mobile products confusing. Whilst it was clear that improvements could be made to provide clearer, more understandable information to consumers, some confusion on the part of consumers was an inevitable result of the increased choice of services, products and tariffs available to them. Moreover, many mobile phone users were new to the service. Orange believed that there was good evidence that the consumer knowledge base was increasing rapidly.

12.25. As regards the CPP principle, Orange said that research findings and its own experience suggested that the overwhelming majority of users received most of their calls from direct family and friends. The existence of such closed user groups meant that call recipients were likely to be concerned about the cost of calls made to them. Familiarity would also be likely to reduce ignorance of the identity of the MNO being called. Businesses buying mobiles to maintain contact with their employees would also be fully informed.

12.26. Orange believed that the various forms of substitution available to consumers would have an inevitable impact on the MNOs' revenue streams and provide them with an incentive to keep their prices

[1] *Review of Price Control on Calls to Mobiles*, Oftel, February 2001.
[2] *Switching suppliers—a research study commissioned by the Consumer Affairs Directorate, DTI, November 2000.*
[3] *Review of Price Control on Calls to Mobiles*, Oftel, February 2001.

competitive. Orange commented that this restraining effect was difficult to estimate but observed that in Germany, the Netherlands and Spain, where call termination intervention had not taken place, prices had fallen at about the same rate as in regulated markets.

12.27. Orange invited us to consider whether it was appropriate to contemplate the imposition of price controls on an industry that showed clear evidence of being intensely competitive and no signs (even on Oftel's own analysis) of generating excessive profits. Orange submitted that regulation could not be justified in respect of operators which had never made an operating profit (T-Mobile) or which had only just done so for the first time (Orange). It said that even Vodafone, assessed by Oftel as generating excessive profits, had seen the level of those profits eroded by the forces of competition.

12.28. In Orange's view, competition in the mobile market was about the acquisition and retention of customers, and encouraging the greatest possible (efficient) usage of the network. Orange looked at CLV and did not separate out individual service elements in order to evaluate its success. That competition in the sector was intense was demonstrated by falling prices, rapid service innovation, tariffs that offered customers increasingly greater value for money, low barriers to consumer switching between networks, high customer satisfaction and high consumer penetration. Reducing termination revenue from MNOs which were not enjoying excess profits led to increased prices for calling from mobiles (or for mobile subscription). Not only would this slow the rate of further penetration, but would reverse penetration rates, leading to a number of current users dropping out of the market. For those customers who owned a mobile but not a fixed-line telephone, there was the significant risk of forcing them out of the communications market altogether. These were the poorest group of mobile users, Orange maintained.

12.29. Orange told us that recent moves by MNOs to bring mobile-to-mobile off-net calls within a 'bundle' of inclusive minutes offered to mobile subscribers had reduced the price of such calls; in due course, this should have the effect of increasing the competitive pressure on MNOs to reduce their call termination charges, it suggested. So far as fixed-to-mobile calls were concerned, Orange said that if a greater competitive focus was to be generated on calls to mobile from the fixed market, there needed to be a link between the retail prices charged by FNOs for originating calls and MNOs' termination charges. This could be encouraged, in Orange's view, through initiatives such as resale partnerships with FNOs where, for example, an MNO would offer a discounted call termination charge to an FNO in return for the FNO reselling the MNO's services to the FNO's customer base. Another possibility involved interconnection incentives, where an FNO generated incremental calls to FNOs, perhaps through some form of 'friends and family' concept. However, Orange thought that a difficulty with exclusive arrangements of these sorts was that they might infringe non-discrimination regulations, particularly in the case of any arrangements with BT, the dominant supplier of fixed services.

12.30. Orange drew our attention to falling prices, rapid service innovation, tariff charges that were offering customer increasingly greater value for money, low barriers to switching, high consumer satisfaction and high consumer penetration as evidence of the intensity of competition in the mobile market.

12.31. Orange stated that, without regulation, and assuming that it was considered that there was no downward pressure from market forces, the only valid base for a regulatory cost benefit analysis would be to assume that termination charges would remain constant in current prices. It estimated that its gross revenue would fall by £[✄] over the four-year period, but this would fall to £[✄] if the lower termination charges it would have to pay on off-net calls were taken into account. Orange noted that the netting of termination revenue losses and interconnect cost savings would in itself assume a competitive distortion as it would assume that MNOs would not pass on savings in lower mobile interconnection costs to their own mobile customers. Converting Orange's calculations to 2001/02 prices and its loss to NPV terms, we calculated that the NPVs were –£800 million for the four-year period and –£630 for the three-year period.

12.32. Based on its price control assumptions, Orange told us that it would need to increase retail charges per customer by around £30 a year to recover the reduction in its gross revenue or £20 to recover its net reduction in revenue.

The question of market power

12.33. Orange noted that Oftel's own analysis had concluded that Orange did not have market power, a conclusion based on Oftel's attempt to establish what the competitive level of pricing should be

in the mobile market. Orange said that the information provided by Oftel in its Mobile Market Review Statement[1] had not been sufficient to allow interested parties to form a critical view of this, and that Oftel had declined repeated requests for further details.

12.34. Orange had, however, understood that Oftel's analysis had considered the full costs and revenues of providing mobile services and had not attempted to separate those arising from outbound and inbound services. It was on the basis of this that Oftel had made its judgement that Orange did not possess market power, but had still decided to propose price cuts on its call termination services. Orange considered this perverse: to force a competitive firm to reduce prices had no justification in economic theory and would be likely to cause an inefficient reduction in investment and in competition, by damaging Orange's financial position.

BT's calls to mobile retention

12.35. On the general question of the promotion of competition, Orange questioned the validity of the DGT's estimated benefit to the public of his call termination charge control, since it doubted whether price reductions would be passed through to consumers under the proposed new BT retail price control framework. This was because the new framework would allow BT to adjust the retail prices of individual services upwards or downwards provided the overall value of the basket did not exceed RPI–X for the relevant control period. Since the competitive pressure on fixed calls to mobile was likely to be lower than that on other types of fixed services, Orange believed that BT could offset some or all of its margin on more competitive services by increasing its margin on mobile calls. Orange therefore suggested that the DGT should postpone any decision on the regulation of BT's calls-to-mobile retention until our inquiry was concluded.

Technological changes

12.36. On the possibility that calls to mobile might be delivered to a user-nominated fixed line, Orange said that the technology for this already existed and was in use in some overseas markets, but billing changes would be needed to give any cost-saving benefit. On the possibility of calls to mobiles being handed over to the mobile network at the BSC nearest to the receiving party, Orange said that this was possible with current technologies, but that it was unlikely to have any appreciable impact on fixed-calls-to-mobile retail prices. On the possibility of converting a fixed-to-mobile call to an on-net call, Orange said that this was now in use by some business users, and believed that it could put pressure on call termination rates if it became widespread, but the cost of the necessary equipment was likely to make it uneconomic for individual consumers in the foreseeable future. As to the use of alternative, unregulated signals to deliver calls to mobiles, Orange said that this was possible, given the right equipment, but that lack of transparency was likely in operation. As regards the possibility of delivering voice calls to mobile as lower-cost data calls, Orange believed that this could result in lower termination rates in the short term, but that it would become increasingly irrelevant in the longer term if the charging model moved to 'both parties pay'. Orange told us that the use of dual-SIM devices or of multiple network identities on one card was unlikely to have a significant impact on call termination services.

Profitability

No industry excess return in the mobile market

12.37. Orange said that there was no evidence that it was making excess profits. Oftel had calculated Orange's adjusted HCA ROCE to be –7.1 per cent, rising to 10.8 per cent for 2000. Comparing this with the industry cost of capital for the mobile sector of 15 per cent (as proposed by Oftel in its MMR statement), the conclusion was that Orange was generating below-normal returns. Since Oftel's methodology for calculating ROCE included revenues, cost and capital employed for both outbound and inbound calls, it was clear that Orange could not be considered to be benefiting from market power in the form of persistent excessive levels of profitability.

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[1] *Effective competition review: mobile*, 26 September 2001.

12.38. Orange said that Oftel's assessment of ROCE compared with cost of capital was an analysis of financial result, which took no account of risk and expectation before the event. It did not believe that sufficient allowance had been made for uncertainty in the market or for any temporary good fortune that MNOs might have had in the market, such as favourable economic conditions. In addition, the analysis did not take fully into account the investment made by MNOs to establish their existing market positions. Orange reminded us that it had made losses in its early years as a new entrant and had only just reported a full-year profit for the first time. It believed that any analysis should consider ex post risk adjustment for investments that had been extremely risky at the time they were undertaken. Orange believed that if the ROCE test were to be applied to the mobile market, then it was logical to expect that it should be applied at the industry level rather than to individual MNOs, and that adjustments might also be required to take account of firms having left the market.

12.39. Orange believed that the analysis should be extended beyond call termination: NERA's profitability analysis (see footnote to paragraph 12.23) had confirmed that the mobile market as a whole was not making excessive returns. It had calculated that the adjusted HCA ROCE for all operators had fallen from 20.3 per cent in 1998 to 10.8 per cent in 2000. Orange noted that Oftel had not offered a view in either its Competition Review Statement[1] or its Review of charge control Statement[2] as to whether this potentially serious downward trend for the industry was likely to continue: its conclusions on profitability in the Competition review Statement[3] had focused on the position of Vodafone. From NERA's finding that Vodafone's ROCE had consistently and substantially exceeded the cost of capital, Oftel had concluded that Vodafone possessed significant market power in the mobile market. Orange maintained that the use of Vodafone's ROCE was neither an appropriate benchmark to assess competition in the market as a whole nor sufficient justification for a blanket intervention affecting all four major MNOs.

12.40. Orange told us that it had conducted its own review of Vodafone's published statements in an attempt to identify what factors had influenced Vodafone's lower capital employed. Orange said that it identified Vodafone's practice of entering into operating leases for equipment, which had removed certain assets from its balance sheet. Further analysis had strongly suggested that leasing might result in the overstatement of Vodafone's ROCE and thence the degree of market power Vodafone might possess. Over and above that, the downward trend of Vodafone's ROCE suggested that any supernormal profits might merely reflect Vodafone's position as first entrant into the market.

12.41. In Orange's opinion there was no justification for regulating MNOs without market power: Oftel's desire to do so seemed to stem from the fact that it believed Vodafone to be earning persistent excessive profits. Even if that were so, and Orange thought it arguable that it was not, then it would not of itself justify regulating Orange. Orange quoted Oftel's statement[3] that 'Oftel maintains it is appropriate to apply regulation only to those operators with market power'.

Pricing

12.42. Orange told us that call termination charges should be set by the market and not by regulation or in relation to the regulator's cost model. Orange believed that mobile prices and charges were fair. It believed that it was artificial to try to examine the profitability of separated mobile services because:

(a) There was a very large base of common costs and any attempt to measure the profitability of separate services necessarily involved an artificial and arbitrary allocation of common costs between services.

(b) There were significant linkages between different services on the revenues side, further exacerbating the artificiality of any separation.

12.43. With regard to the differences in cost to it of wholly on-net calls and on-net to off-net calls, Orange told us that a wholly on-net call was more costly, the mobile-to-base and base-to-mobile elements costing proportionately more than the land element. Consequently, an on-net to off-net call, containing only one radio link, was less costly to Orange in terms of capacity usage: it was the call termination charge which increased the cost to Orange for a call to an off-net mobile above that of a

[1]*Effective competition review: mobile*, September 2001.
[2]*Review of charge control on calls to mobiles*, September 2001.
[3]Paragraph 3.3 of *Effective competition review: mobile*, September 2001.

wholly on-net call. Asked whether this meant that wholly on-net calls were charged at below cost, Orange replied that this had historically been so, the reason being that it wanted to attract communities of users (for example, families or groups of friends) to Orange.

12.44. In reply to our question as to what it believed would happen if call termination charges were not regulated, Orange replied that it was unlikely that the MNOs would end up charging identically. That was because they would probably experience different time-of-day profiles, making it difficult to compare the actual average time of day rate. Orange agreed that, as with call origination, the MNOs would have an incentive to offer different pricing structures to different customer groups. It believed that many factors would influence the final level of charges, including service quality, traffic volume, balance of inbound and outbound calls, and, to some extent, costs. Orange said that originally its call termination charges had been very low and actually below cost, but this tactic had not worked: it had done little to secure subscriptions or generate additional or longer calls. Orange believed, however, that this might have been due to its lack of coverage at the time.

12.45. Orange disagreed that there were insufficient incentives for MNOs to reduce termination charges: even those MNOs not subject to existing regulation had been doing so. In particular, Orange had been attempting for some time to negotiate with BT to introduce discounts, linked to termination charge reductions, on the price of calls to Orange mobiles in order to stimulate incoming traffic and increased customer retention. This fact alone indicated that there were incentives for MNOs to reduce termination charges.

12.46. Orange did not accept that, in the absence of price competition, it would be possible for MNOs to increase charges. Orange was disappointed that we had ignored or discounted Orange's submission which made it clear that it was not possible for any MNO to raise its termination charges unilaterally. It was inaccurate and misleading to suggest that there was any risk of mobile termination charges increasing, unless another MNO or FNO were to agree to such an increase, and presumably no other MNO would if this were commercially disadvantageous. Orange accepted that the intensity of competition in call termination had not been as high as in some other parts of the mobile market, but it believed that this could and probably would change over time.

12.47. We asked Orange what it believed would be the reaction of the other three MNOs if, in the absence of regulation, one MNO were to raise its call termination charges. Orange replied that a unilateral decision to raise call termination rates was not possible. MNOs did not have the right to do this: such rates had to be negotiated and agreed bilaterally with other interconnecting operators. It was thus entirely possible in such a negotiation to refuse to agree any increase in call termination charges proposed by the MNO. Orange added that there was power under European telecommunications legislation granted to national regulatory authorities (Oftel in the UK) to resolve interconnection disputes and to impose 'reasonable' terms. The likely outcome should an MNO seek to raise its termination rates was therefore that the other operators potentially affected would refuse to accept the increase. If the MNO concerned persisted, then the dispute would come before the regulatory authority (Oftel) for resolution. Orange believed that, on existing evidence, it seemed highly unlikely either that Oftel would agree such an increase or that any MNO would even consider asking for one.

Public interest

12.48. Orange told us that it was strongly of the opinion that the charges made by Orange for call termination did not operate against the public interest, and therefore disputed the need for Oftel's proposal of regulation in that area. Orange gave the following reasons for its view:

(a) There was no consumer outcry over mobile termination prices. Oftel had produced no significant evidence that this was an area of general consumer concern. Orange's own market research indicated that the price of calls to mobiles was of little or no concern to consumers.

(b) The mobile market in the UK was widely regarded as highly competitive. Oftel's studies had found that overall, MNOs were not making excessive profits, by reference to ROCE. Customers were benefiting from high levels of innovation and investment by MNOs, generating new services and products, increased choice and improvements in tariff structures. Orange accepted that competition in the call termination market had not been as intense as elsewhere in the mobile market, but believed that that could and probably would change with time.

(c) Mobile penetration in the UK had increased very significantly, with more than 70 per cent of the population now using a mobile phone, and call volumes increasing. This did not suggest any market failure.

(d) Market entry (Hutchison 3G) and exit (Dolphin) argued against any suggestion of market failure.

(e) The recent auction of 3G mobile licences had removed any prospective excess profits from the marketplace, as well as demonstrating the need for operators to win 3G licences in order to sustain their 2G businesses as well as to participate in the 3G market.

12.49. Orange believed that these points lent no support to Oftel's proposal for a blanket regulatory regime. Orange suggested that an objective review would recognize that the 'success' of the UK mobile phone industry had not yet generated excessive profits for all MNOs. In Orange's view, even if the profitability level of Vodafone was an issue of concern, and a detailed analysis were to show that regulatory intervention against Vodafone were justified, the appropriate type of intervention could not be a blanket price control on all four MNOs. That would disproportionately harm the three MNOs least able to 'afford' the price control.

12.50. Orange said it believed that, as a principle, ex ante regulation should be used only if there was a detriment to consumers and that this arose as a result of a lasting market failure. Neither criterion was met in the case of call termination charges and Orange therefore believed that there was no justification for the imposition of a price control on Orange's termination charges or on those of any other MNO. Orange believed that it was highly unlikely that reductions to mobile termination charges brought about by regulation would be fed through to consumers in the absence of pass-through regulation and that this must have a significant impact on any price cap or other remedy. In the absence of such regulation, Orange believed the issue to fall between fixed-only and mobile-only customers. However, while the assumed regulation would disadvantage mobile-only customers, there was no guarantee that fixed-only customers would benefit.

Distributional arguments

12.51. Orange believed that the distributional effects of Oftel's proposed regulation could result in the disadvantaging of the poorest telephone users. Fixed-line-only callers made only a small percentage of calls to mobile and would not benefit to any degree, while mobile-only callers, the poorest sector, would lose when lost revenue from call termination charge regulation was recovered from higher mobile calling prices.

Possible consumer detriment from present tariff structures

12.52. Orange told us that it had considered whether, in the absence of any abuse of market power the level of call termination pricing itself, in relation to prices for other mobile services, created a consumer detriment. Orange observed that, based on the results of its LRIC modelling exercise, Oftel considered that mobile termination rates were in excess of its definition of cost. As Orange had shown (see Chapter 7), Oftel's LRIC model resulted in understating the real cost of call termination. This, taken together with the lack of evidence of excess profitability (paragraph 12.37 et seq), suggested that there was no public interest issue to warrant regulating all MNOs. In the interests of a comprehensive debate, however, Orange felt it desirable to consider whether the profits from call termination, subject to the way they were calculated, worked for or against the public interest.

Should the 'detriment' be seen as a subsidy?

12.53. Orange, in response to our enquiry as to whether it advanced the work of our inquiry to see any consumer detriment as a subsidy from fixed telephone owners who called mobiles to mobile phone owners, reiterated that it viewed it as prejudicial to regard the existing situation as detrimental to the consumer. In any event, if there was to be an externality allowance, there would inevitably be cross-subsidies between consumers, and to describe such subsidies as unfair would be to take a very extreme position.

12.54. Orange said that in the mobile phone market, competitive prices would reflect demand as well as costs. When there existed a large element of common and fixed costs, a firm needed to allocate these across all its services. Orange did not believe it right to examine a single service in isolation and simply conclude that the service was 'overpriced'. What mattered from a competition standpoint was whether, taken as a whole, a firm was able to maintain supernormal profits. If it did not, and Oftel agreed that Orange did not, then the implication must be that 'profits' from call termination were subsidizing 'unprofitable' services elsewhere, as would happen in the case of efficient Ramsey pricing.

12.55. Orange believed that the value consumers placed on a product had an important role in determining the economically efficient price in the presence of common costs, in the form of Ramsey prices for the products. The mark-up over marginal cost on a product should be the greater the more inelastic was the demand for it, minimizing the distortion to consumers' purchasing behaviour resulting from charging above marginal cost. It was not true that economic efficiency demanded that consumers should make an equal contribution to shared costs. On Ramsey-pricing grounds, it was economically efficient for consumers of some products to make a larger contribution to shared costs than others. Orange emphasized that demand-based pricing was a normal feature across all sectors of the UK economy.

12.56. Orange believed that cross-subsidization implied by the use of Ramsey pricing fostered innovation and allowed faster access to new services, especially in high-risk environments where not every new product succeeded. This was particularly important in respect of mobile phone services, as the industry had introduced new technologies such as 3G. This important dynamic had not been recognized by Oftel. If its proposals were introduced, MNOs would lose the financial ability and incentive to introduce new services.

12.57. Orange accepted that the use of Ramsey pricing resulted in higher mark-ups on services that had relatively inelastic demand compared with the other outputs of the firm, but believed that the structure of prices minimized the total social cost of raising the revenue necessary to cover fixed costs and was therefore the efficient solution. Orange said that under Ramsey pricing it became important to consider whether the consumers paying for the services charged at above cost were the same as those purchasing the products priced at marginal cost. In some cases, such as with new cars and car spares, these would be the same group and no consumer detriment arose. In the case of mobile phones, however, because of the CPP principle, the two groups of consumers did not coincide and Oftel believed that there was limited incentive for MNOs to reduce charges to the competitive level. Orange did not, however, agree with criticisms that Ramsey pricing was somehow unfair. Landline users, for example, did benefit from the greater ability to contact users of mobiles, while elderly people not possessing mobile phones might obtain very large benefits from being able to contact children or grandchildren who might otherwise be hard to reach. Whilst accepting that those without mobile phones might be poorer than average, another group poorer still and more socially excluded included those who had mobiles but no fixed line. Oftel's proposal could have a negative effect on such a group.

12.58. Orange told us that since our last inquiry into mobile phone termination charges, the proportion of calls to mobile originating from a mobile rather than a fixed line had grown substantially, from nearly 60 per cent in the year to 31 March 2001 to a figure estimated by Orange to be approximately 70 per cent in the year to 31 March 2003. Demand-based pricing for mobile services had resulted in the use of revenues from call termination to contribute towards lower entry costs in the form of handset subsidies and pricing discounts. In Orange's view, competitive forces were sufficiently established to allow them to work naturally to maximize consumer welfare: the time for market-distorting regulatory interventions was past.

12.59. On the question of distributional public detriment, Orange told us that there was increasing coincidence of fixed and mobile ownership. It drew attention to an Oftel estimate that in 1998 approximately 50 per cent of people calling mobiles did own a mobile themselves. Oftel's latest research (August 2001) had shown that some 74 per cent of fixed-line users had a mobile phone and therefore had easy access to both communication methods. The already discounted on-net rates and growing inclusion of off-net mobile in the bundle meant that mobile to mobile was becoming an increasingly effective substitute for fixed calls to mobiles. This increasing overlap implied that customers would concern themselves more about the cost of calling mobiles and that the majority of fixed callers to mobile would benefit from cheaper mobile origination rates.

12.60. Orange cited the effect just mentioned as an example of the changing and largely unpredictable nature of competition in the mobile market. Each new development led customers to change their methods of calling mobile phones, which in turn led MNOs to alter their charging systems. The system

of free bundled calls to off-net had rendered Oftel's position on call termination charges obsolete, since it was largely based on the high cost of off-net calls. That developments such as this took place emphasized the sharp contrast between the unpredictability of the market and the principles and models used by Oftel, which implied (mistakenly) that very accurate forecasts could be made about the development of the market, the risks involved, what the maximizing structure looked like and how and when products would be adopted.

Comments on the DGT's LRIC model

General

12.61. Orange told us that its basic objection to the use of the LRIC model was that it took one service, isolated it, worked out a socially optimal price for it, set that price and expected the MNOs to work from there. That was not how the market set its prices. Orange said that the use of an LRIC model presupposed both an acceptance of Oftel's competition framework and an acceptance that a price control constituted a proportionate intervention. By definition it was a forecast of the costs of an efficient operator in a mature market which would ignore many significant start-up costs.

12.62. Orange's principal objections to Oftel's model were as follows:

(a) The LRIC model used by Oftel took a single, static, ten-year forward view of a network operator's costs based on actual historic and assumed usage profiles. Given the dynamic and uncertain nature of the mobile market, such an approach could not be relied upon to predict an MNO's future costs with any acceptable degree of certainty.

(b) Oftel had made no attempt to assess the LRIC model's sensitivity to forward-looking risk: its argument that risk was addressed through the industry cost of capital figure, as incorporated within the calculation of economic depreciation, was inadequate. The beta factor, which formed one of the key variables within the cost of capital, was based on a five-year backward-looking average of financial market performance which might be unrepresentative of future market conditions.

Relevant costs excluded

12.63. Orange believed that important relevant costs were excluded from the model, as follows:

(a) LRIC modelling by definition represents a forward-looking assessment of the costs of an efficient operator in the provision of incremental service offerings, which would tend to ignore the recovery of many significant start-up costs, such as the establishment of a brand through advertising and marketing as well as introductory pricing necessary to attract customers. Such start-up cost, typical of any new business, needed to be recovered through a subsequent period of positive returns. Simply to consider the profitable business in isolation would lead to an overstated view of returns.

(b) The adoption in isolation of a theoretical 'bottom-up' approach rather than a 'top-down' model for a dynamic technology-driven market risked understating true costs, and, unless suitably adjusted, would compound existing risks, further increasing costs and discouraging further investment.

(c) A network-based LRIC model, by definition, excluded those non-network costs necessary to provide call termination. These were essential to the provision of mobile services and comprised both subscriber-driven costs and general business expenditure. The latter should be treated as common costs. The French regulator took account of such costs by using an HCA top-down methodology.

(d) Although the concept of modern equivalent assets was applied to network components, no adjustment had been made to uplift 2G spectrum costs to reflect a proportion of the values attributed to 3G spectrum, which would have been lost if a 3G licence had not been acquired.

(e) Subscriber acquisition and other costs were treated as a separate access service (which Orange considered contrary to the MMC's view at its last inquiry), understating the true cost of termination.

(f) No account was taken of the quality of a network, in large measure resulting from greater investment, with consequent higher costs.

12.64. The nominal weighted average cost of capital used by the DGT was much higher than Orange's calculated cumulative average return on capital of 2.6 per cent.

12.65. It was not clear whether the model adequately took account of the different costs of 900 MHz and 1800 MHz MNOs.

Definition and allocation of common costs

12.66. Orange believed that the notion of a 'minimum coverage network' was unrealistic, failing to reflect properly the level of common costs of a mobile network. It believed that common costs could be most accurately described as the overlap between hypothetical 'termination only' and 'origination only' networks. This had resulted in the difference between true common costs and the 'minimum coverage network' being allocated on the same basis as capacity costs, rather than subjecting them to Ramsey pricing. Whilst Ramsey pricing methodology was accepted as appropriate for the allocation of common costs, Oftel had simply applied the same allocation basis as that used for capacity costs, which failed to recognize the different relative price elasticities for mobile services. It was not valid to assess the profitability of individual services in isolation when allocating costs on a common basis.

12.67. Orange found it not entirely clear how Oftel had reached its conclusion on the value of the network externality and had been informed by the DGT in October 2001 that he was unable to give it any further information about its calculation.[1]

Economic depreciation

12.68. Orange told us that the LRIC model's application of economic depreciation derived economic asset lives that were unrealistic and materially in excess of physical lives. Examples were three-sector macro cell equipment, given a 20-year economic life against an actual life at ten years or less, and handsets, given an economic life of 50 years, against two years actual. The fundamental flaw essentially lay in its inability to allow for the replacement of equipment due to issues such as compatibility, functionality or serviceability. Nor did the LRIC model include an allowance for the value of assets whose lives expired during the early loss-making phase of the business that were not covered by revenues during that period.

Cost drivers

12.69. Orange said that the LRIC model incorporated a simplistic single average hour factor method of calculating network capacity, which tended to understate both network capacity and associated costs, given that the maximum capacity of individual network components did not necessarily coincide. The theoretical variations in demand within the LRIC model between 2002/03 and 2006/07 resulted in temporary reductions in the number of sites and back-haul links, which bore no relation to reality. The model made no allowance for the associated costs of decommissioning, mothballing or the cost of stranded assets. Finally, Orange said that although the LRIC model incorporated a mechanism to reflect the differential costs associated with variations in the quality of service, that had not been reflected in the final calculation. That differential remained a key factor for Orange in the achievement and maintenance of its competitive market position and financially represented a significant additional investment.

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[1]'Oftel is unable to let you have any further information about the calculation of the network externality': email from Oftel, 30 October 2001.

Views on our suggested off-line changes

12.70. Orange expressed its concern at our approach, which it considered took account only of a limited number of parameters, and did not deal with the principal objection that Oftel's LRIC model used a bottom-up approach which gave significantly different results from a top-down model. It was not valid to change individual design parameters without giving due consideration to the consequential impact of such changes on the model.

12.71. Orange believed that, since the Oftel LRIC model reflected the complex, dynamic interrelationships of network components, with a variety of cost volume relationships and planning horizons, any attempt to adjust through external means would destroy the accuracy and value of the model and confidence in any output.

Non-network costs

12.72. Orange did not accept that only a small percentage of non-network costs were admissible in the LRIC model, and rejected the arguments in favour of excluding the majority of such costs.

12.73. The 'two business' argument, that an MVNO would bear customer support activities while the network operators would merely produce and sell wholesale airtime did not reflect market reality. Such a business model had existed in the early days of mobile telephony, but even then the service providers' business had depended critically upon the market support payments made by the MNOs. This had given the service providers access to two revenue streams, one from the MNOs and the other from their retail customers, with the service providers setting their retail charges taking account of the revenue from the MNOs.

12.74. With regard to the 'allocation of costs' argument, Orange said that mobile networks were characterized by substantial fixed and common costs and relatively small incremental costs. The LRIC model sought to exclude most non-network costs, such as subscriber costs. Orange believed that there was a clear justification for a proportion of non-network costs to be recovered through call termination charges. Orange did not think it defensible to use EPMU for the allocation of common costs. Economists accept that the use of EPMU fails to produce a proper assessment of whether prices are set at socially optimal levels. This view had been supported in a recent report prepared for the European Commission by Europe Economics.[1]

12.75. In its own proposal, to the network common costs Orange had added relevant non-network costs, including subscriber acquisition costs, using Ramsey pricing and Rohlfs's model methodology, which Orange considered more robust than the Oftel Culham model.

Externalities

12.76. Orange commented generally that it was important to remember that the present inquiry was not a utility price determination process: it was adjudication on a proposed licence modification affecting the MNOs, which were not subject to continuous regulation of all services. Since the proposed regulation took the form of price control it was for us to determine whether there was a market failure necessitating such a control. The analysis of costs and prices in the inquiry was not merely an element in setting the appropriate price control, but was an element in the process of deciding whether such a control was needed at all.

12.77. Orange believed that the DGT's analytical framework adopted by the DGT for quantifying the externality adjustment was a highly stylized and simplified model of reality. It simplified by assuming that there were only three services, each with a single price, and by analysing the optimal pricing pattern in a static equilibrium setting. The estimates were unreliable and could not be relied upon either as a basis for concluding that current prices were against the public interest or for setting the level of any

[1] *Cost Structures in mobile networks and their relationship to price* Final Report for the EC by Europe Economics, Contract No 48544.

price control that might be adopted. Orange believed that the DGT had produced little firm evidence on the proper values for inputs into the calculation: even the values within the ranges regarded as reasonable by Oftel led to wide variations in the resulting externality adjustment, while those outside this range led to even wider variations. Orange said that these uncertainties did not mean that a zero externality adjustment should be adopted; rather, they meant that it was difficult to conclude with any confidence that MNOs' present pricing diverged significantly, if at all, from levels acceptable in terms of economic welfare.

Network externality surcharge

12.78. Orange told us that it believed the DGT had attempted to minimize artificially the common costs inherent in a mobile network in order to avoid the debate over the appropriate allocation of common costs. Orange considered this to be a significant factor when considering the costing and pricing of a portfolio of products and services. Orange believed that the economically efficient way to allocate common costs was to use Ramsey pricing, in this case making a further adjustment to take account of the network externality. The DGT had allowed for network externalities by using, in effect, an adjusted Ramsey pricing methodology, but Orange believed that there was a methodological flaw in his approach, which Orange believed to be due to the way in which the DGT dealt with the double counting inherent in a demand-based system rendering its results unreliable. Orange had also found that the Oftel LRIC model in general could not be solved for larger values of the common cost, in many cases failing to reach a solution.

12.79. Orange told us that it believed it perfectly possible for the R-G factor to exceed 2 and that there was no basis for supposing that it was close to 1, as suggested to us, now that the network had grown in size. In Orange's opinion the range adopted by Oftel in its calculation of the externality surcharge, 1.3 to 1.7, was not excessive and might even be too low. As to possible negative externalities, Orange did not believe these to be significant, nor in any way to cancel out the positive externality arising from new customers joining the network.

12.80. As to whether the externality surcharge was fully passed on to consumers in the form of lower-priced handsets, monthly fees and charges for outgoing calls and related services, Orange was confident that competition for subscribers would ensure this.

12.81. Orange did not believe that the incidence of switching between MNOs and of handset upgrades removed the case for the handset subsidy. The existence of a second-hand market in handsets did not undermine that argument, and might even strengthen it because of the possible effect in reducing the degree to which the purchase decision had been sunk.

12.82. Orange did not believe that the surcharge was unfair to those fixed-line users who would never themselves have a mobile as anyone calling mobiles from fixed lines were themselves directly benefiting from being able to contact those who did have them.

12.83. Orange told us that regulation of the call termination charge was likely to put upward pressure on other charges, in particular subscription and outgoing call charges. By increasing charges to those who relied on mobiles as their only form of telephone connection, who were generally poorer and more socially excluded than either fixed-only subscribers or those with both fixed and mobile phones, such regulation was likely to have detrimental distributional effects.

Application of the network externality surcharge

12.84. Orange told us that it believed the cost benchmark used by Oftel in calculating the optimal level of the call termination charge was wrong: the correct starting point should be the marginal cost of each service. Orange believed that Oftel's use of its LRIC estimates as a proxy for the marginal costs of CFM and FTM was inappropriate as those contained many costs that were common across services. Once common costs, including network common costs, were correctly identified, however, it was

essential that those were allocated within the same Ramsey-based model and not via EPMU. Only then did Orange believe that the resulting retail prices would be socially optimal and the number of subscriptions at the correct level.

Externalities in fixed-line networks

12.85. Orange said that it did not have detailed knowledge of the effect of regulation on fixed-line operators, but believed that there was no a priori reason to suppose that the magnitude of any externality charge applied to fixed lines should be of the same magnitude as that applicable to mobile, given the differences in the costs and demand elasticities.

The cost of Oftel's proposals

12.86. Orange believed that the true cost of Oftel's proposals would be much greater than that estimated in Oftel's cost benefit analysis, which Orange believed should be released to all parties. Oftel's approach appeared to assume a rebalancing between inbound revenues and all other services, and believed this to be unrealistic given the fierce competition among outbound services. The consequences of remedies such as price regulation were potentially serious: they would affect the whole of termination traffic and thence revenues from all services. Orange told us that the financial viability of marginal firms, and especially that of T-Mobile as an operator which had not yet reported an operating profit, would be adversely affected, leading possibly to increased market concentration.

12.87. Orange estimated that, taking the impact on call termination revenue and interconnect savings together, and also taking into account the broader impact of competitive distortions arising from the regulatory intervention, the net negative effect of the proposed price control on Orange would be £[✄]. Orange, although an efficient operator in a highly competitive market, had never made persistent excessive returns and could not be expected simply to absorb this negative financial impact. Orange disputed our apparent belief that price control regulation, and in particular price control without a glide path, would have no appreciable effect on the mobile phones retail market, the capital markets, MNO incentives or threaten the viability of any MNO.

12.88. In the light of the estimated negative impact on Orange's finances, it would be compelled to recover this from its retail products and services: the 'waterbed effect'. Orange estimated that this would require an average increase in retail charges per customer in the region of £[✄]. Thus the effect of the assumed price control would be to require mobile phone users to pay more for no additional benefit. Orange estimated that some 25 per cent of customers would give up their mobile phones if their costs increased by £[✄] a year, requiring a higher increase on the remainder, and resulting ultimately in a significant decrease in mobile phone penetration in the UK.

12.89. Orange believed that the assumed regulation would have significant effects on investment incentives throughout the industry. Consequently, Orange believed that Oftel's cost benefit analysis should include the costs to the UK of weakened competitive forces in the mobile market. It should also include the costs of the proposals on the development of 3G services. Whether or not these were directly affected, the possibility that charge controls could be extended from 2G to 3G must affect the views of investors in the industry.

12.90. Orange also submitted that there was no guarantee that rebalancing of tariffs in the way apparently desired by the CC would take place, leading to the hoped-for increase in network usage and reduction in churn. It was illogical to expect higher mobile tariffs to stimulate network usage. Nor could it be assumed that any rebalancing would focus on the removal of handset subsidy rather than on increasing outgoing prices (which would have the effect of reducing usage and increasing churn). Orange said that there was intense competition in subscriber acquisition and retention and that any MNO seeking individually to remove handset subsidies would find that its own churn rates would increase (as upgrading of handsets would become more expensive) and that its net connections would fall (as new subscribers and subscribers switching from other networks would not wish to pay higher handset prices). As a result, no MNO could be the first to remove handset subsidies. The entry of H3G would make it all the more unlikely that any MNO would risk strategies that were likely to result in loss of customers to another (in this case a new) operator. The net result of the CC's proposals would be a reduction in usage rather than an increase in usage, with no reduction in switching levels. Moreover, it would entrench regulation in the mobile sector and create a perpetual need to regulate mobile termination.

Views on remedies and subsequent discussions

12.91. Orange's views on some possible remedies appear throughout this report. This section records its views on other remedies and questions discussed during the inquiry.

General

12.92. Orange said that it did not believe that our analysis of call termination costs was founded on a robust economic basis; did not accept that there was any substantive evidence to support the view that there was insufficient competition in the mobile call termination market, and was of the opinion that our preferred remedy, charge capping, would not benefit consumers in the absence of an explicit control on FNOs' retention rates. Only if a robust economic analysis showed that call termination rates were not at a socially optimal level could we properly determine whether there was an effect adverse to the public interest and, thereafter, consider the question of remedies. Orange believed that the use of what it termed a 'simplistic' cost model was not adequate for this purpose.

12.93. Orange was strongly of the view that neither the DGT nor we had demonstrated that call termination rates were not set at or close to socially optimal levels, and in the absence of such proof could not determine that there was an effect adverse to the public interest. We had failed to take due account of Orange's detailed submissions on:

(a) the economic justification for using Ramsey pricing principles;

(b) definition and allocation of common and joint costs;

(c) allocation of non-network costs; and

(d) the effect of externalities.

12.94. Orange believed that its submissions had shown that there was substantial evidence to indicate that current mobile termination charges were at or close to economically efficient levels. Orange believed that it was incumbent upon the CC to provide an economic analysis of the socially optimal call termination charges before it could conclude that there was a price distortion of the kind asserted in our remedies letter, followed by a demonstration that such price distortion gave rise to significant consumer detriment before we could justify proposing any remedy.

12.95. Orange believed that as a matter of law, any remedy recommended by ourselves must remedy specific adverse effects which had been identified by us. Orange believed that a price cap remedy was highly unlikely to benefit either fixed or mobile consumers: fixed customers were guaranteed no benefit in the form of reduced fixed to mobile prices without corresponding obligations being placed on fixed operators to pass through the reduced call termination charges and to improve transparency. In the case of mobile customers, a price control would do nothing to remedy the alleged adverse effects of handset subsidies and high churn that we had claimed to identify, nor would it solve the alleged problem of the current lack of strong competitive constraints for mobile termination. It would, however, entrench regulation in the mobile sector and create a perpetual need to regulate mobile termination which, in Orange's view, could not be in the public interest. Orange strongly disagreed that there was any justification for a one-off adjustment of the initial price to which any RPI–X formula should be applied. Such a change would be highly disruptive, with a significant impact on mobile customers, mobile competition, mobile network costs and investment. Orange believed the impact on investment to be of particular concern since a significant one-off reduction in call termination charges would inhibit future investment in mobile network infrastructure and in 3G services through both a cashflow effect and a regulatory risk effect, ie it would heighten investors' fears that any future possibility of reasonable profitability high profits would be removed by regulatory intervention.

12.96. Orange reiterated its opposition to a remedy involving a charge cap, since that was highly unlikely to benefit either fixed or mobile consumers and would entrench regulation of the mobile sector, creating a perpetual need to regulate mobile termination which could not be in the public interest. Orange particularly objected to the idea of a one-off adjustment to the initial price to which any RPI–X formula should be applied: such a change would be very disruptive, with a negative impact on mobile customers, mobile competition and network costs and investment.

Additional comments

12.97. Referring to our current views, as expressed in the remedies letter, Orange agreed that, while it disagreed with our view as to the correct definition of the market, it considered that the market definition, as it thought it should properly be defined, was not likely to change over the foreseeable future.

12.98. Orange argued that pass-through regulation and improved price transparency offered significant possibilities of improvements in the competitive dynamics of call termination. As already noted, Orange believed a price control on fixed-to-mobile calls would only be effective if conjoined with pass-through of reduced termination charges into FNOs' retail prices for such calls. More generally, Orange considered that the incentive for MNOs to compete on fixed-to-mobile calls by reducing their termination charges was critically weakened by the fact that the FNOs set the retail price and this was no longer required to reflect the mobile termination rate. Orange therefore thought it essential that pass-through regulations were imposed on FNOs (or at least on BT). Alternatively, or in addition, similar effects could be achieved, said Orange, if FNOs (or BT, at least) were required to show on their customers' retail bills a breakdown between the termination charge and the amount of the FNOs' retail retention. Orange also told us that it would be willing to undertake to continue to reduce its termination charges by RPI–9 per cent: a step which it envisaged might be accompanied by such a transparency measure.

12.99. Orange strongly disagreed that implementing an RPP regime for mobile call termination would be in the public interest: this would have significant distorting effects, being exceptionally disruptive for consumers and MNOs and be totally unjustified. Orange did not accept that the proposal put forward by Vodafone on the value of bilateral agreements represented a remedy because it did not address the fundamental issue of calls from fixed line to mobile. On the question of a price squeeze test for fixed-to-mobile services, Orange believed that this was not required and would be unduly onerous.

12.100. Orange believed that to tie call termination charges to retail service prices would have a distorting effect on those services and that we should seek remedies which are more clearly targeted at the relevant public interest issue. Nor did Orange believe that the use of bilateral agreements would be effective.

12.101. On the question of unfair competition between MNOs and FNOs, Orange did not accept that there were any general or specific areas of unfair competition between them: the two types of operator competed in different markets, faced different competitive conditions and had different cost bases. In particular, the mobile market consisted of four roughly equal-sized players, while BT still dominated the fixed-line market. Orange believed our concerns about specific areas of allegedly unfair competition to be either incorrect or misplaced, but said that if we could demonstrate that there was an unfair balance of competition, and that this was adverse to the public interest, then it should be dealt with by means of a specific remedy. Orange said, in the event that such an unfair balance of competition could be found to exist, that it would support a proposal to introduce a non-discrimination requirement to remedy any such imbalance between fixed and mobile operators. Such a remedy would also have beneficial effects in reducing termination rates and increasing competitive pressures in the general termination market by bringing into the general market those consumers who cared most about the cost of being called. It did not, however, support a price squeeze test.

12.102. Orange said that any related suggestion that the customers of FNOs were subsidizing those of MNOs was critically dependent on whether prices in the mobile call termination market were in excess of cost. In Orange's view we had not demonstrated that this was so. The suggestion that the present level of mobile call termination charges allowed MNOs to compete unfairly against FNOs was dependent upon an assumption that they competed in the same market, that MNOs charges were above costs, and that there is a regulatory asymmetry in the setting of fixed operator termination charges, none of which Orange believed to be the case

12.103. On the question of the inclusion within the market definition of voice calls using 3G technology, Orange believed that it was impossible to attempt to separate these from calls using 2G technology: it was therefore essential to consider whether any proposed regulation could have a sufficiently serious impact on 3G services as would operate against the public interest.

12.104. As regards segmentation of the market, Orange agreed that MNOs did seek to segment the market and offer a wide variety of tariffs, based on customers' different usage patterns. This was a common approach in any competitive market and was beneficial, as it widened access and expanded it.

Orange did not, however, agree that tariffs were complex, nearly all tariffs were relatively simple to understand. In any event, for most consumers, only a small proportion of the tariffs offered were relevant to their personal usage patterns, further simplifying the choice. Orange told us that, while there were certainly a large number of tariffs, all fell into common patterns (for example, number of inclusive minutes or monthly subscription charge), so that comparisons were relatively easy to make. For most consumers, it said, only a small proportion of tariffs were relevant to their personal usage, further simplifying the choice.

12.105. As to the suggestion that MNOs were locked into a type of competition that brought about an undesirably high level of customer churn, while distorting the volume and direction of traffic on each network, Orange was surprised that such a contention should be put forward without any evidence. There was no indication of any analysis done to produce a benchmark as to the level of switching that would be considered economically efficient. Moreover, the CC had, in other inquiries, such as that into banks' charging, suggested that a low level of switching was a sign of ineffective competition. Customer switching, at whatever level must in Orange's view be beneficial to customers, who derived benefit from having a strong level of flexibility in their choice of network provider and in their ability to upgrade their phones at regular intervals. Orange suggested that Oftel's encouragement of MNP, which was clearly designed to assist switching, appeared to indicate that Oftel believed switching activity to be beneficial.