DIGITAL BRITAIN – *the Interim Report*

TELEFÓNICA O2 UK LIMITED RESPONSE

MARCH 2009

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INTRODUCTION

1. Telefónica O2 UK[1] believes that we are better, connected.

2. We share the Government's belief that communications technology is transformative and has the potential to help address many of the major challenges facing the country – for example, it can deliver economic growth; help tackle climate change; change the way people learn and improve and transform the way public services are accessed and delivered.

3. In the past 10 years, O2 has invested more than £9 billion in 2G, 3G and fixed broadband networks. We want to see the UK continue to benefit from a world leading digital economy and so we welcome the Government's ambition to set a coherent action plan to secure the UK's place at the forefront of innovation, investment and quality in the digital and communications industries.

4. We think the Government is right: "A successful Britain must be a Digital Britain" and we welcome the opportunity to engage with government and contribute to the emerging public policy thinking that will shape the UK's digital future. We support the determination to develop the right framework within which the public and the private sector can work together to make Digital Britain a reality.

5. We believe the Digital Britain programme must be a holistic and coherent one. However, we also agree that it is sensible to try and break the programme down into separate work streams to work though the detail of many of the issues raised.

6. We set out our initial views on the Government's emerging Digital Britain action plan in this response. We understand that further details will be worked through in the course of the workstreams identified and so this response seeks to provide our initial feedback at this stage. However, naturally, if there are areas where further detail would be useful, we would be pleased to expand on the comments in this response.

7. Generally, for ease of reference we have ordered our response in the same manner as the subjects appear in the interim report: Digital Networks, Digital Content, Universal Connectivity and Equipping everyone to benefit from Digital Britain.

[1] Telefónica O2 UK Limited is part of Telefónica Europe, which provides integrated mobile, fixed and broadband services in the UK, Ireland, Germany, the Czech Republic and Slovakia. Together, we're Telefónica Europe, but customers know us as O2. Telefónica Europe is part of the Telefónica group. Telefónica is the world's largest integrated telecommunications operator, and the largest in Europe in terms of market capitalisation. Its activities are centered mainly on fixed and mobile telephony, with broadband as the key tool for the development of both. The company has a significant presence in 25 countries, across 4 continents, and has a customer base of more than 260 million worldwide.

EXECUTIVE SUMMARY

We welcome the publication of the interim Digital Britain report

8. We welcome the Government's desire to drive the development of public policy thinking in a consultative and collaborative manner with stakeholders through a number of action plans/ work streams under the overarching Digital Britain programme. The interim report provides a helpful summary of the Government's thinking and proposed direction of travel.

Some fundamental touchstones

9. We believe that the Digital Britain programme must have the following touchstones at its heart:

- The importance of ambition, along with a clear, coherent vision;
- We must strive for a sustainable Digital Britain – a Digital Britain with longevity;
- The need for a balanced, coherent and non-disruptive approach – supporting investment and competition;
- Technology neutrality – to avoid distorting markets and competition;
- Sound, robust evidence and assessment (including cost benefit analyses);
- Transparency and certainty - much has been said of the need for regulatory certainty, equally public policy certainty is also necessary;
- The right regulatory framework – ensuring the UK and European framework is calibrated to enable investment and competition;
- Digital Britain must be part of Digital Europe and a Digital World.

10. We return to these touchstones throughout our response.

Digital Networks

11. We are generally supportive of the 'Actions' the work programme sets out and we look forward to constructive and open engagement as the work moves forward. The Government has set an ambitious timescale for completion. We believe the touchstone principles we set out above have particular bearing to the work on Digital Networks, for example:

i) there must be a balanced and non-disruptive approach to next generation access - the transition from current to next must not squander the competitive gains of LLU;

ii) the public policy approach must be technology neutral – significant caution is needed in this respect when considering any minimum broadband speed of universal connectivity;

iii) the regulatory regime must be balanced – both investment and competition must be underpinned.

12. We welcome the Government's recognition that spectrum matters are central to the mobile market – and as such integral to Digital Britain. We continue to be actively engaged in a constructive dialogue with the Independent Spectrum Broker and we do not propose to dwell further on spectrum matters within this response.

Digital Content

13. Rights protection is clearly an important element of Digital Britain. However, we are not convinced that threatening customers or imposing levies is the right approach. We think it is better for ISPs and rights holders to work together to develop new services which offer people what they want, how they want it, for a fair price. We are concerned that much of the current debate is a distraction from this underlying issue – and indeed other market enabling matters such as addressing cumbersome rights clearance processes.

14. The suggestion of a Rights Agency is an interesting one and we welcome a detailed consultation on the matter.

15. We welcome the Government's decision against imposing net neutrality. We believe its introduction would simply be a barrier to the development of new business models.

Universal Connectivity

16. The market is generally adept at delivering optimum economic outcomes. Accordingly, we believe that the intent to drive demand and unblock barriers to take up is a fundamental and welcome ambition for the Digital Britain programme[2].

17. In this respect, we believe a key focus should be on promoting adoption – since this is clearly lagging far behind accessibility. Driving adoption feeds back into market drivers to address accessibility.

18. If intervention is to dictate a minimum speed, this must be set with caution – to avoid technological (and hence competitive) bias. And, furthermore, any intervention must be based on the issue that the Government wants to address. It is noticeable that if there were evidence then public policy rational should relate to B2B, home working, e-government and B2C applications – no more than 1MBit/s is required.

19. We believe universal service is a matter of social, not regulatory policy. O2 is firmly of the view that it is far more desirable and economically efficient to fund any universal service from general taxation, rather than from an industry levy, as the Government has indicated[3]. A "contestable" scheme is desirable, because it can introduce competitive pressures in the provision of the service.

[2] As the report recognizes, in reality: "*universal connectivity ultimately is all about demand*". We welcome the Government's clear willingness to take the high ground here. The Government has a significant and, in some cases, principal role in leading people to the digital world. We need a clear and robust action plan to identify and then address the barriers to take up - there is no sense in investing to provide universal access if barriers to take up are not addressed. We thus welcome the approach that the Government outlines in the report to understand what these barriers may be. And, in terms of addressing these barriers, we are supportive of the Government's ambition to develop a coherent and joined up strategy and action plan in this area (for example, the establishment of the Digital Inclusion Action Plan and the Public Service Delivery Plan).

[3] See page 58 of the interim report.

Equipping everyone to benefit from Digital Britain

20. We share the Government's view that education and skills, media literacy and online safeguards are all important components of the Digital Britain programme.

21. O2 and the mobile industry already have a history of engaging constructively in many of these areas and we continue to see that there is a role for a collaborative approach going forward.

22. We believe the focus of the work programme should be on identifying and addressing barriers to adoption.

Engagement

23. We look forward to playing our part in helping the Government develop the right public policy thinking to underpin Digital Britain.

DIGITAL BRITAIN

We should be proud of the UK communications sector, its achievements and strengths - but there is no cause of complacency

24. We share the Government's belief that communications technology is transformative and has the potential to help address many of the major challenges facing the country – for example, it can deliver economic growth; help tackle climate change; change the way people learn and improve and transform the way public services are accessed and delivered.

25. We are proud of what the UK mobile and communications has achieved in the past 10 / 20 years[4]. And, in many ways this is just the start. We want to see the UK continue to benefit from a world leading digital economy. And so we are pleased the Government recognizes the importance of the communications industry in the UK and welcome the close attention being paid to the important issues within the Digital Britain debate.

Some fundamental touchstones

26. We believe that the Digital Britain programme must include some important touchstones and that these are relevant to all areas of the work programme.

The importance of ambition and a clear, coherent vision

27. We agree that delivering Digital Britain will require an ambitious and clear strategic vision from government. We also agree that it is important to reflect on what the strategic partnership between stakeholders should look and feel like. For example, the report refers to

[4] For example, O2 alone has invested more than £9 billion in 2G, 3G, and fixed broadband networks in the past 10 years; we reinvest 40% of our profits and have created 6503 permanent jobs, many of which include opportunities for people to enter employment for the first time; anyone who wants a mobile can have one – including those who often socially excluded in other areas e.g. the unbanked; the mobile industry contribution to the UK economy is 2.3% of GDP (or telecoms is 3.7% of EU GDP) and there are more people who have access to the internet via a mobile device than fixed.

a new and stronger sense of co-operation between government, regulators and industry. It is right that we seek to shape this framework now and we look forward to developing a model of co-operation that is sustainable for all.

28. It is also important to be clear and transparent. For example, what is the desired end game and why (in economic, social and "treasury" terms (i.e. – delivering services more efficiently etc) and, furthermore, what does success look like? What are our measures?

A sustainable Digital Britain

29. The Digital Britain we strive for must be a balanced and sustainable one. It must be one that is sustainable for the customer, industry and society as a whole. The initiative must have longevity – it must set a strategic underpinning rather than be a tactical flurry.

30. Consider the destination that any particular policy path takes you and the risk of unintended consequences: For example, in respect of the debate about whether it is public policy that should set the speed of universal connectivity – or the market – bear in mind that it potentially leads to a continuum of having to revisit the minimum speed and reset the target from time to time to keep pace with what the perceived universal service should be. As speeds increase, so does the tension of delivering technical neutrality as well as the simple economics of rollout such that you may reach a point in which there is only a monopoly provider (and the associated regulation and dynamics that results) as well as creating profit shocks on that path (leading to market exit). The minimum target effectively starts rolling over time in a "snowball" effect which is very difficult to stop.

The importance of a balanced, coherent and non-disruptive approach

31. Supporting investment and competition in infrastructure, services, content and applications for the benefit of consumers, society and the economy; only intervening where there is demonstrable market failure; and with an eye to the dynamic effects on competition that may arise as universal connectivity is rolled out.

Technology neutrality

32. Any form of intervention carries with it the risk that it will distort markets and competition. Digital Britain is no different. It is essential that the initiative does not distort incentives to invest in one particular technology, platform or solution over the other. For example, in respect of universal connectivity, it is important that the debate on: what coverage, what speed etc does not end up creating competitive distortions by specifying service levels that are natural and economic to particular types of delivery.

Sound, robust evidence and assessment

33. We believe that the challenge ahead is complex and requires coherent long term vision and ambition. Lord Carter once remarked *"in a global recession, normal rules of engagement are suspended"*[5]. We do not disagree that there should be a "clean slate" approach. However, we do not believe this obviates the need for sound, robust and evidence based decision making. We believe that in considering any intervention – whether regulatory or indeed public

[5] The Times, 7 November 2008, http://business.timesonline.co.uk/tol/business/industry_sectors/media/article5100987.ece

policy – the Better Regulation principles[6] are still an important element for decision making including sound cost benefit analysis. We believe that they offer much for the Digital Britain process and we would encourage the Digital Britain analysis to use them as the sensible checks and balances that they present.

The right regulatory framework

34. We need to ensure the UK and European framework is calibrated to enable investment and competition. Furthermore, we need to find a way to break away from a mindset which seeks to regulate in a "cherry picking" and micro management fashion – without reference to the wider benefits of business models.

35. Investment is required to provide the infrastructure deliver this vision; and therefore we need the right regulatory environment to encourage investment in tomorrow's infrastructure. There has been much debate in the UK over the last few years to seek to find the right regulatory regime for, principally, BT's Next Generation Access investment. However, in a Digital Britain delivered by wire, wireless and broadcast, whether fixed or mobile, it is important that we have the right underpinning regulatory framework regardless of delivery platform or market.

Digital Britain is part of Digital Europe and a Digital World

36. The interim report rightly recognises that we compete in a global market. However, the success of the European mobile market provides clear indication of how innovation on a European scale can lay firm foundations for each member state.

37. We believe that the Digital Britain programme should include a clear strand in relation to the UK role in the development of a Digital Europe.

The start of another phase in the digital journey – longevity is key

38. We see the report as the starting point of another part of the digital journey. We believe that the Digital Britain programme must look beyond 2011/12 and ensure that it provides a sustainable and balanced investment environment that continues to ensure competition flourishes. Sustainability is key - industry investment cycles go beyond 5 years.

DIGITAL NETWORKS

What shape are we in – and what could make things better?

39. We are broadly supportive of the Government's intent to undertake strategic reviews of a number of areas in respect of Next Generation Access Networks[7] . We welcome the

[6] Any regulation should be: transparent, accountable, proportionate, consistent and targeted.

[7] To create a strategy group to assess the demand, supply and regulatory measures necessary to underpin market led investment and to remove barriers to the timely rollout beyond those declared plans, to maximise market led coverage of next generation broadband; to work with the main operators and others to remove barriers to the development of a wider wholesale market in access to ducts and other primary infrastructure; to accept the detailed recommendations of the Caoi report; to create an umbrella body to bring together local and community networks and provide them with technical and advisory support;

engagement the Government is seeking with industry to help it develop its public policy thinking and to reach the right underpinning framework for a sustainable Digital Britain.

40. The central question being whether there are steps government, industry and regulators can take to improve the capability and quality of our digital networks to meet growing consumer and business expectations, deliver what we need as a society and keep pace with our international competitors. As Lord Carter explains*: "We ask the question, will the market get to 60-65 per cent [adoption] if we provide the right regulatory environment? The second question is what to do about the 30-35 per cent left – currently we don't know enough,"*[8]

Ensure that any possible side effects are not worse than the benefit

41. We agree that the question "Could we make things better?" is an important one – but it must be coupled with a sound and robust analysis to ensure that the costs of any interventions (be they financial or indeed structural) are clearly identified. We must be clear that the costs of any intervention are justified by the benefits of any action.

42. For example, we discuss elsewhere the risks of setting a minimum broadband universal connectivity speed and the potential "snowballing" effect over time.

A case for public subsidy and intervention?

43. The report concludes that at the moment there is not a case for widespread UK wide public subsidy of next generation network deployment (and notes the risks that come with public subsidy - chilling private sector investment etc) but that the Digital Britain work programme will consider the value for money case around whether public incentives have a role to play in enabling next generation roll out beyond current market led initiatives.

The important of a balanced and non-disruptive approach

44. We believe that the public policy approach and regulatory regime must take a balanced and non-disruptive approach to next generation access. We believe that part and parcel of the consideration of any public subsidy must be to identify ways in which public engagement could be harnessed without distorting competitive dynamics.

Transition from current to next generation

45. As an investor in LLU[9], we welcome the emphasis the report places on the importance of a non-disruptive transition for existing LLU players. It is important that the competition and benefits delivered to date by LLU are not undermined.

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[8]To the House of Commons Business and Enterprise Committee, 10 March 2009

[9] For example, O2's Home Broadband service has been consistently praised for offering high customer satisfaction, great value and fast download speeds, and was the second fastest growing ISP in terms of new customers between July and September 2008. Furthermore, in February 2009 February: O2 ranked highest in customer satisfaction for both UK mobile and fixed broadband customers according to the J.D. Power and Associates UK Mobile and Fixed Broadband Studies.

Competition and Investment

46. Ofcom's recent Statement on Next Generation Access is a welcome step to providing regulatory clarity for all investors – both those with existing copper investments and those without. The Statement recognises the complexity and tensions inherent in trying to determine a framework which affords incentives for investment yet at the same time supports a sufficiently competitive environment to the benefit of customers. Ofcom also recognises that in reality, what next generation access may mean is the emergence of new business models in light of the economic challenges of next generation deployment[10] – something which the regulatory and competition framework should be very careful not to work against. We welcome an approach in respect of Digital Britain which underpins this.

Technological neutrality

47. Market intervention carries with it the risk that it will distort markets and competition. Digital Britain is no different. It is essential that the initiative does not distort incentives to invest in one particular technology, platform or solution over the other. For example, in respect of Universal connectivity, it is important that the debate on what coverage, what speed etc does not end up creating competitive distortions by, specifying service levels that are natural and economic to particular types of delivery.

48. Much focus has been placed on fixed rollout issues (ducts/ rating/ new build standards/ relaxation on the deployment of overhead lines). Clearly such efforts must be on a "technology neutral" basis such that barriers to both wired and wireless deployments are resolved. We would be pleased to discuss wireless aspects in greater detail.

49. The report also recognises that the market is approaching an unprecedented technology transition (being only part way through the transition from GSM to 3G technology with the start of 4G (LTE) technology likely to begin as early as 2011. Indeed, the level of investment in 3G (spectrum and infrastructure) is significantly greater than that which BT has announced to date in FTTC.

Spectrum

50. We welcome the Government's recognition that spectrum matters are central to the mobile market – and as such integral to Digital Britain. We continue to be actively engaged in a constructive dialogue with the Independent Spectrum Broker and we do not propose to dwell further on spectrum matters within this response.

Net Neutrality

51. We welcome confirmation that the Government does not intend to require "net neutrality", recognising the impact such a regulation could have on the development of new business models.

[10] Indeed, the mobile market already witnesses co-operation, for example, 3 and T-Mobile's co-operation in respect of 3G.

DIGITAL CONTENT

Generally

52. We welcome the inclusion of a Digital Content work stream in the Digital Britain programme. We note the Government's intentions in respect of broadcast – which is clearly an essential element of Digital Britain.

53. In relation to the other elements of the digital content agenda for Digital Britain, we welcome much of the initiative.

Illegal copying and piracy

54. We welcome the recognition that, in respect of illegal copying and piracy, new methods of legitimate access, based on new business models and incentives structures will be crucial. Indeed, one of our concerns with proposals to place policing responsibility on ISPs is that this risks distraction from the real issue: the underpinning need for new business models to reduce the incentives on illegal copying and sharing in the first place.

55. O2 believes that intellectual property rights must be respected and so we are very willing to engage in cross industry dialogue to see if fair and balanced solutions can be found. The report suggests that if the whole value chain is expected to benefit from new ways of content distribution, it is reasonable to expect the whole value chain to work together to tackle unlawful activity. Equally, there are examples of the Government funding enforcement regimes – Police Information Technology Organisation (PITO) and Data Retention being two examples.

56. Whilst the report is right in the sense that where it makes business sense to participate, then the market is likely to deliver. However, in many cases, much of the current debate about Peer2Peer arises because there is an asymmetric dynamic going on between the cost of policing (financial and customer relationship) ISPs are asked to bear and reward.

57. In this regard, it is imperative that any government intervention is subject to the Better Regulation tests.

58. Sharing of music between friends has always been one of the ways most people discover new music, and shared music experiences are one of the best ways for acts to build fan bases and gain exposure for their music. The key in the digital age is to create new models to discover and share music (and other content) in a way which ensures the people who create the music can be supported and rewarded.

59. People should be able to share and grow their passion for music as much as those who make music must be supported in creating that passion. Without them there is no music and without the fans there is no industry. So we think it is better for ISPs and rights holders to work together to develop new services which offer people the content they want, how they want it, for a fair price.

Net neutrality

60. As above, the Government's clarity in respect of net neutrality (that it sees no place for imposing net neutrality) is encouraging and we welcome it. The ability to differentiate on network quality is a pre-requisite for 2-sided business models. Exposing content providers to cost incentives is important for achieving an economic return on investment in capacity going forwards.

A Rights Agency

61. The suggestion that the creation of a Rights Agency forum could offer a forum in which industry can work together is an interesting one. As we say earlier, we believe constructive approaches can be found. However, we also believe that from the public's perspective and as a matter of law, a continuing role for the judicial system is essential for legitimizing actions taken by rights holders. There would be a fundamental problem with any proposed solution that sought to cut out the court and install an ISP as an arbitrator and enforcer of private rights as between rights holders and end users. We believe a review of the judicial process to examine whether there are any ways of improving rights holders' ability to enforce their rights through the courts should not be discounted.

62. We also note that the remit of the Rights Agency is not set in stone. A body which provided one stop rights clearance would be a significant step forward. Using the Rights Agency to reduce the complexity of rights clearances could be an attractive option – and help reduce the barriers to efficient commercial models in the digital age. At the moment, the tendency is for publishers to appoint separate collecting societies.

UNIVERSAL CONNECTIVITY

General

The structure of the Government's approach

63. Generally, we believe the Government's analytical approach is the right one: is the market likely to deliver what is required (of course there may be debate about what is "required"); if not, then is it justified to intervene, what form should that intervention take and how should any intervention be funded and structured? Different approaches are possible and each will have its advantages and disadvantages. It will be important to undertake a robust cost benefit analysis as part of the universal connectivity action plan. If there is intervention, then it must be clear that it is the right route to take (i.e. the benefits clearly outweigh any adverse effects[11]).

What will the market deliver?

64. The case for intervention is predicated on the presumption that the market will not deliver the desired social outcome (and that a digital divide is inevitable without government intervention). Although, as the report recognises, presumption can be a self-fulfilling

[11] For example, there may be an enduring regulatory legacy around access conditions and prices. We discuss this further below.

prophecy since it can chill investment, pending a decision on the detail of any universal connectivity government intervention.

65. We believe that markets are generally adept at delivering optimum economic outcomes. We are supportive, therefore, of the Government's proposal to assess what can be done to underpin market led investment plans and remove barriers to roll out – i.e. to help maximize market led provision of service.

66. We see the Government intent to drive demand and unblock barriers to take up as a welcome ambition for the Digital Britain programme.

67. Indeed, the responsiveness of markets is recognized in the interim report. Networks that are capable of providing broadband access are currently being rolled out and upgraded, and will continue to be for the foreseeable future. As the Government acknowledges, the market mechanism will provide for greater broadband accessibility by 2012, absent intervention. Policymakers need to consider whether the speed and extent of additional access is sufficient to address social concerns about accessibility, and if not, whether the possible adverse consequences of intervention (see below) outweigh the potential benefits.

The importance of technical neutrality

68. O2 would be concerned if the Government's plans for universal service were not technologically neutral, since this is likely to "bake into" regulation potentially inefficient methods of delivering service, and distort competition. On the face of it, there seems little merit in specifying the type of technology required to provide specific universal services. Instead, the Government should describe the level of the service it requires to be provided, and (subject to the design of the universal service scheme), let the industry get on and provide it.

Lessons from history

69. Before considering the future, we believe there are some lessons from the past to reflect upon. The Minister recently commented[12] that O2 and Vodafone were "given" their 2G licences in exchange for rollout to universality. Perhaps a better characterisation is that, at the time, BT and Racal were persuaded by government to take a considerable risk in developing a market which up until that point did not exist. At the time, public and private interests aligned; but the risk lay with the private sector.

70. Today there is a new alignment between public and private ambition. However, if we are to continue to invest towards this vision we need regulatory certainty; and an understanding with government that we should not be "taxed" - for want of a better word – ex post for the success we have achieved on the back of a multi-million pound risky investment, nor should we be "taxed" on future investment risks we take. For the Digital Britain agenda to be delivered requires a new contract between government and industry.

71. Indeed, at the 3G auction, in our view, the Government extracted a franchise fee – or tax – from the four existing mobile players in order that they have viable businesses going forwards. Players have collectively contributed over £22bn for seats at the table; we firmly

[12] To the House of Commons Business and Enterprise Committee, 10 March 2009

believe that this represents more than ample contribution to any universal connectivity fund if government were to proceed down the industry fund route.

Social outcomes

72. The interim report makes the case for intervention in order to provide citizens with the means of engaging fully in society. Principally, the concern is that markets will not deliver the necessary universal connectivity for the Government's desired social outcome.

73. In the remainder of this section we explain why we believe universal connectivity is a matter of social policy rather than regulatory policy. Further, we discuss our views about the most appropriate and efficient funding framework for such social policy (and where some options can run counter to the desire to promote demand) and finally we discuss why encouraging take up of broadband is more likely to lead to greater inclusion than driving accessibility on the margins. We also explain why it is crucial that any intervention is "technology neutral".

Funding of social policies

74. Universal service is, in reality, a matter of social not regulatory policy[13]. Since a universal service requires intervention to address a perceived market failure, it follows that it requires funding, above and beyond that which the market is able to provide. There are two broad choices in funding the provision of a universal service:

- General taxation; and
- Industry fund

75. We believe that the review needs to consider who really benefits from universal connectivity and how investments can be made in an efficient manner. The interim Digital Britain report highlights that the big winner is the Treasury and the taxpayer. The report paints a picture of a world where public services are delivered online and the size and efficiency of the economy are boosted. This world delivers efficiency savings for the public services and economic growth. The Treasury will benefit in the medium to long-term from both.

76. As such, any proposal for industry funding is effectively an indirect tax, as ISPs will inevitably pass any levy on to customers, something which may itself depress overall demand. Clearly, depressing demand on the one hand runs counter to the other elements of Digital Britain which are working hard to drive demand and reduce barriers to take up. Therefore we would recommend funding from general taxation, via a contestable fund.

77. In addition to the risk of depressing demand, there are further reasons which point to a funding model from general taxation:

i) The funding of a universal service, by whatever means, implies a "deadweight loss" because prices of goods that are targeted to fund the service must increase, causing a reduction in consumer surplus. The economic literature supports the view that the deadweight loss is minimised if the universal service is funded through general taxation, because the revenue is collected over as wide a base as possible, which minimises the reduction in consumer surplus. In addition, economic theory and other countries'

[13] Indeed, this has already been recognised with the Government's Home Access initiative: http://www.dcsf.gov.uk/pns/DisplayPN.cgi?pn_id=2009_0056

experience shows that the social cost of industry funding of subsidies is at least three times higher than via general taxation.

ii) Furthermore, concentrating the collection of revenue on telecommunications services through an industry fund (rather than on all goods and services) increases their costs, reducing demand. This conflicts with the object of the exercise, which is to stimulate demand for the service in question.

iii) Funding a universal service from general taxation has other benefits. The tax can be levied in a way that society might regard as more equitable. Furthermore, it is likely that collecting the revenue in this way would be less administratively burdensome, particularly as new forms of technology render traditional definitions of telecommunications providers redundant (it is likely to be harder to collect revenue from a large number of disparate providers, compared to a small number of well defined providers).

iv) Funding universality from general taxation also provides appropriate social and political incentives – the benefit of universal connectivity must be balanced against alternative government spending or tax reduction.

v) Collecting revenue from the industry also suffers from the drawback that it is likely to distort competition. This is because, regardless of the criterion chosen to determine the proportion of the fund individual providers must meet, it will weigh more heavily and, in likelihood, disproportionately, on some providers.

78. Accordingly, O2 is firmly of the view that it is far more desirable and economically efficient to fund any universal service from general taxation, rather than from an industry levy, as the Government has indicated[14].

Contestability

79. If the Government does decide to intervene to provide for universal access in rural areas using mobile, on the premise that this will promote the provision of on line services, there would seem to be a number of options available. O2 sees merit in utilising the principle of contestability in designing a universal services scheme, because it can introduce competitive pressures in the provision of the service. There must also be transparency and, furthermore, funding cannot be state aid for one party or another.

80. Contestability is likely to ensure that service can be provided more efficiently, with whatever technology is most appropriate. Contestability can be used to select a single universal service provider, or, if economic, a number of providers. As we mention, a number of different approaches may be used:

(i) Auctions Auctions can be used to reveal the smallest subsidy required for the Universal Service to be provided and which operator or operators are best able to provide the service.

[14] See page 58 of the interim report.

However, auctions require that very specific service levels need to be determined accurately. In the case of broadband coverage in rural areas, this would include the geographic area, the service level required and the number of providers[15].

Furthermore, they deny the opportunity for potential providers to offer different service level/cost options to the Government. Potential bidders are required to submit bids on the basis of the service level described at the beginning of the auction.

Nevertheless, auctions are thought to be appropriate in circumstances where coverage is to be provided for the first time, and as a means of minimising costs.

(ii) Comparative selection ("beauty parade") This can be useful when it is preferable to assess a range of criteria, so that a choice can be made between the service levels and the extent of any subsidy. Again, the literature suggests that this approach is appropriate to introduce coverage into new areas.

However, because a comparative selection is designed to take into account a number of criteria, it may not lead to a least cost outcome.

(iii) Vouchers These can be given to particular groups of customers, who would select the provider of their choice. In this way, the provision of a service is subsidised. The advantage of this approach is that subsidies can be targeted, by the allocation of vouchers. Competition is introduced into the system, as vouchers can be redeemed with any provider. Furthermore, the approach is technologically neutral. It is up to providers to determine the most efficient method of meeting the service requirements.

However, vouchers may not be appropriate to support the extension of coverage into new areas, because there is no certainty that any individual operator would get enough customers to justify the investment.

(iv) Play or Pay Under this approach, a subsidy level is established and operators can select either to provide service using the subsidy, or decline to provide service and contribute to the subsidy fund.

The benefit of this approach is that least cost operators are encouraged to provide service. Higher cost providers are likely to choose to contribute to the fund. The level of subsidy is key. Too low, and there may be a lack of provision; too high and inefficient providers would be encouraged to offer service. However, the level of the subsidy can be varied to regulate the number of providers offering service. Where there are few economies of scale and where competition might be expected to lead to innovation and efficiencies, there is a case for a higher subsidy to encourage entry.

The system requires thorough policing because operators might be expected to offer poor service as a means of avoiding contributing to the fund.

81. We would welcome the Government's views on these issues; if it wishes to persist with a scheme funded by industry, we would welcome its response to the points we have raised in this response.

[15] Although, more than one infrastructure provider might result in benefits from competition, a higher level of subsidy might be required.

The risk of an enduring regulatory legacy

82. As we mention above, if there is intervention, then careful thought must be given to the structure of that intervention and the consequential path that follows. For example, the creation of local monopolies can lead to enduring access and pricing regulation. Pricing regulation is notoriously contentious and challenging, particularly if there is significant disconnect between the basis upon which regulated prices are set in the monopoly area and existing retail prices set on a competitive market basis.

Driving Universal Connectivity

Is accessibility the issue?

83. In O2's view, the Government needs first to be clear about its objectives. The interim report's case for intervention to provide citizens with the means of engaging fully in society appears to suggest that the provision of online services (both commercial and public) can be ubiquitous only if access to broadband of sufficient speed is universal – there is a virtuous circle of wider accessibility spawning more services which, in turn, improves take-up, rewarding investment.

84. However, the Government acknowledges that although accessibility is in excess of 90% of households, take up is only around 60%. That means that around a third of all UK households are able to access broadband, but choose not to. On the face of it, one would think that encouraging these households to take up broadband, thereby increasing the stock of households with broadband, is more likely to promote the provision of additional on line services, from both the commercial and public sectors, than increasing accessibility, marginally.

85. As the report recognizes, in reality: "*universal connectivity ultimately is all about demand*". We welcome the Government's willingness to take an active role in leading people to the digital world through demand side initiatives and to address barriers to take up.

Many of the issues are intertwined

86. The level of concern that the interim Digital Britain report shows for the risks of an increasing 'digital divide' is the leading proponent for a digital universal service commitment. However, whilst the report focuses on matters of coverage, inclusion, universal service and media literacy independently, we believe the work must also appreciate that many of these issues are intertwined and must be considered together in order to have any real impact.

The issue of affordability must be addressed

87. For example, whilst the report recognises that consideration should be given to "*the point at which a level of service can be delivered ubiquitously at proportionate and reasonable cost*"[16] there is little corresponding discussion about how a 'proportionate and reasonable cost' can be achieved. Of deeper concern, is that even a reasonable cost may not be sufficient to drive take-up in those that the report identifies will have the most to gain from broadband access,

[16] Page 56 Interim Digital Britain Report

namely those seeking online healthcare, employment or social services and advice (typically in the DE demographic).

88. Ofcom's Consumer Experience Research finds that:

a. Only 70% of the population owns a pc or laptop at home of which 65% have internet access. In the DE socio-economic group this falls to only 48% with only 43% having internet access.
b. "*Non-ownership of an internet connection due to involuntary reasons remains highest among DEs, the 75+ age group and those on an income below £17.5k*."[17]
c. "*There are indications that broadband customers spend more each month on their service compared to dial-up customers. Self-reported spend data suggest that broadband customers spend around £18 each month compared to £13 among the small sample of dial-up customers*"[18]

89. It is essential that the issue of affordability is addressed at the earliest opportunity.

Priorities

90. A media literacy plan is supported by O2 and we believe there is the opportunity to make significant progress in resolving matters of voluntary non-ownership of the internet and broadband. However, the more difficult and more pressing task is to resolve issues of *involuntary* non-ownership, particularly when the economy is resting in a period of increasing unemployment and financial uncertainty (both for individuals and businesses). We believe the priority should be to initially focus on addressing the barriers to adoption.

91. The affordability issue is compounded for those suffering from multiple social exclusion factors. The Ofcom Consumer Experience Research observes that "*the software required by some people with visual impairments to enable them to use a computer/internet was considered to be useful and high quality, but too expensive*"[19].

92. The interim report makes the case that universal access to broadband is clearly desirable and beneficial to the UK economy and society. However, the benefits can only be realised if the right tools are available, in the right environment. Only then can one be more confident in the success of a media literacy plan to deliver increased take-up and use amongst those who will benefit most.

Resolving involuntary exclusion – a catalyst?

93. Resolving involuntary non-ownership (in particular, who will bear costs, not only of the service itself but also the relatively high upfront costs of PC and laptop equipment), will only serve to provide greater certainty and, consequently, stronger commitment to the overall goals outlined in the report.

94. We foresee that unless these matters are explored fully, not only will the industry find itself cautious in its commitment to universal connectivity, but citizens too will be reluctant to invest

[17] P.47 Consumer Experience Research 2008; Profile of those who have not taken up communications services for involuntary reasons.
[18] Data from Ofcom's communications tracking survey, Q3 2008. P.34 Consumer Experience 2008
[19] P.50,Consumer Experience 2008;

in computer equipment or broadband packages, if they consider that "*giving everybody free internet access*"[20] is just around the corner. Rumour and conjecture must be replaced by certainty if success is the desired outcome.

95. In its policy briefing discussing super-fast broadband, the National Endowment for Science Technology and the Arts (NESTA) suggests that *"the lump-sum cost to service providers of granting five years free, basic broadband access to those claiming Income Support at £1.175 billion……The Department for Work and Pensions should work with broadband service providers to ensure the correct households are targeted[21]".*The Communications Consumer Panel's (CPP) research on what consumers want from the digital future states "*While they expected that those who could afford it would pay for internet provision, they wanted government to ensure that access is possible and affordable for all. There were specific suggestions to expand infrastructure and to provide free equipment or subsidies where required*"[22]. The Digital Inclusion Plan considers possible access to equipment through libraries and private sponsorship using the £20 million investment by the North West Development Agency to provide broadband access in Cumbria[23], as an example of local government solutions to the problem.

96. Whilst O2 has not explored the accuracy of NESTA's cost estimate or viability of its proposals, it and the CCP research demonstrates that there is a real appetite, from consumer level upwards, for further discussion and agreement on how to ensure that there are clear, decisive plans to deal with affordability that, in turn, will allow a full and thorough cost analysis to be completed.

Holistic approach – and the devil is in the detail

97. A note of caution. It is clearly in no ones interest for the report to encourage uncertain promises of co-operation that providers may later not be able to deliver on should the concept of universal connectivity evolve. For example, if having committed to universal connectivity investment in infrastructure, the obligation is then extended to provide free access to those on income support, at either a commercial loss or to the detriment of loyal paying customers who would need to be charged higher prices. Rather, we would welcome a more detailed plan that would allow the development of plans to deliver a Digital Britain that is realistic and achievable.

98. It is important to consider options as an *integral* part of discussions about a universal connectivity obligation and its respective funding arrangements. The ability for communications providers to provide an open and clear assessment of their ability to participate in a universal connectivity programme is dependent on ensuring that there has been a thorough and detailed consideration of all the factors which could impact on that assessment. There is much detail to be worked through. In Annex 2 we discuss some preliminary points.

99. The same principle was recently applied when BT found itself unable to confirm its commitment to NGA investment until Ofcom provided it with some certainty that its wholesale

[20] P.21 No one should miss out: consumers say what they want from the digital future'
[21] http://www.nesta.org.uk/assets/Uploads/pdf/Policy-Briefing/Getting_up_to_speed_NESTA_policy_briefing.pdf
[22] P.21, 'No one should miss out: consumers say what they want from the digital future'
[23] P.26, Delivering Digital Inclusion: An Action Plan

access prices would not be capped. Broadband providers must similarly be assured that the Digital Britain programme addresses adoption barriers for low-income users (and disabled users who require high-cost speciality devices), before an accurate cost benefit analysis can be carried out and the risks (and the cost of managing those risks) properly determined.

Content, services and applications

100. Broadband itself is of no real importance to citizens or consumers, but rather the access it provides to valuable or necessary content and communications. It is the demand for *that* content (whether social or commercial in purpose) that will drive demand for better, greater, stronger and easier access. Broadband is one element of obtaining access. However, the quality and durability of hardware devices, the affordability of upfront costs to buy equipment and the on-going commitment and affordability to access that content are all elements that will, collectively, make the report's visions of universal broadband service a reality.

101. Given that the 'necessity' element of the report's vision lies within the content, not the access, parallels can be drawn to the games market. There, natural market forces demonstrated that the computer games and pc markets developed in tandem. The demand for higher quality interactive gaming resulted in better equipment and access to that content. It is essential that where regulatory intervention takes place, that it does so with as little interference of natural market forces as possible. If a universal service obligation is required, it should retain as many characteristics of the natural market environment as possible.

EQUIPPING EVERYONE TO BENEFIT FROM DIGITAL BRITAIN

102. We share the Government's view that education and skills, media literacy and online safeguards are all important components of the Digital Britain programme.

103. We are encouraged by the Government's commitment to a collaborative approach between government, industry and stakeholders in this area. We believe a collaborative approach has worked well to date and we look forward to continuing to contribute in this important area[24]. O2 already has a history of engaging constructively in many of these areas (please see Annex 1).

104. It does strike us that there is a considerable amount of media literacy work going on throughout the UK. Ofcom is well placed to co-ordinate rather than deliver this activity. However, there seems to be very little robust information about which forms of communication and education are most efficient and effective in improving broadband adoption and media literacy in the various segments that have been identified. The Action Plan must address this deficiency so that the efforts of those delivering media literacy can be better focused.

[24] And we are supportive of the development of policy principles and guidelines. In the privacy stream of this work, one area that could usefully be covered is "behavioural advertising" – to develop customer confidence in this business model.

CONCLUDING COMMENTS

105. We think the Government is right: "A successful Britain must be a Digital Britain" and we welcome the opportunity to engage with government and contribute to the emerging public policy thinking that will shape the UK's digital future.

106. The Digital Britain we strive for must be a balanced and sustainable one. It must be one that is sustainable for the customer, industry and society as a whole. The initiative must have longevity – it must set a strategic underpinning rather than be a tactical flurry.

107. We would be very happy to discuss any of our comments in more detail.

TELEFÓNICA O2 UK LIMITED
MARCH 2009

ANNEX 1

Media Literacy, online safeguards and education and skills

O2 already has a history of engaging constructively in the important areas of many of these areas. For example,

- In respect of the UK mobile industry Code of Practice on New Forms of Content[25] (of which O2 was a founding member) has been adopted as the blueprint for Europe); the code covers:
  - Classifying commercial content;
  - Introducing age verification & access controls for 18 rated content;
  - Introducing Internet parental controls;
  - Taking down illegal Internet content;
  - Taking action against unsolicited bulk communications and malicious communications;
  - Providing customers with information and advice.

- The operators have established a "common STOP" procedure to enable customers to quickly and easily cancel subscriptions to premium rate text services. To do this customers simply need to reply with the word STOP to the originating short code.

- Malicious communications - O2 has a dedicated Nuisance Call Bureau to help customers encountering problems with malicious calls or bullying.

- Illegal content **-** O2 was the first mobile operator to join the Internet Watch Foundation and works closely with the IWF and police to report, block access, and take down illegal sites.

- Information and advice **-** Protection requires partnership with parents. We have a programme of public education, awareness raising and stakeholder dialogue. O2 has worked with Childnet International to create a dedicated child protection web site for customers, point of sale materials and a printed guide for parents. See http://protectourchildren.o2.co.uk/ . O2 also published Childnet's checklist for parents, a checklist designed to help parents know which questions to ask when buying a mobile for a child, and is working with Childnet to train its front line staff, so they are more able to offer real, useful, honest, practical advice to parents about their children's use of mobiles. More than 100 Child Protection Champions have been trained within O2's customer services department, and this programme is now rolling out in the retail part of the business. 38. O2 also joined forces with other mobile operators to create a new dedicated website for teachers, offering information and advice on how they can best manage issues associated with the mis-use of mobile phones.

[25] The Code of Practice on New Forms of Content was developed by the five UK mobile operators in partnership with the children's charities, police and Home Office. It was a world first when launched in 2004 and has been widely recognised as a model of best practice. Following the launch in the UK it has been adopted by mobile operators in a number of other countries and forms the basis of the EU's new framework for Safer Mobile Use.

- Partnering - O2 has also partnered with Childnet International and the Personal Finance Education Group (pfeg) to produce a short film on mobiles and child protection. The film focuses on the dilemma many parents face, balancing parental preferences against children's needs. What are the concerns of parents? What is O2 doing? Where can I get help and advice? You can access the film: http://www.o2.com/media/film_children_protection.asp

- We have launched a book aimed at children aged 8 to 12 to help promote internet safety. It was created with help from children in this age group and in collaboration with Childnet International.http://www.o2.com/TheCybernuts/

- We are a signatory to the Media Literacy Charter. The Charter promotes the development of the creative and critical skills citizens require to get the most out of modern media content and the opportunities to communicate and be creative in a digital world.

ANNEX 2

Universal Connectivity – the devil is in the detail

The ability for communications providers to provide an open and clear assessment of their ability to participate in a universal connectivity programme is dependent on ensuring that there has been a thorough and detailed consideration of all the factors which could impact on that assessment.

There is much detail to be worked through, for example:

i) Pre-pay mobile is generally recognized as doing more to bring mobile communications to a universal audience than any government or regulatory initiative. However, the current underpinning active and passive access business models mean that the PAYG broadband model cannot be built in the same fashion as the PAYG mobile model.

ii) Contributions from a variety of sources (for example, call termination and out of bundle revenues) can mean customers are connected who would otherwise be uneconomic to retain. This must be recognized and clearly understood by regulators and stakeholders.

iii) The Report presents a clear intention that many essential government and social support services will be provided online. If this goal is achieved, those low-income/low-use citizens will find themselves needing to be low-income / high-users of data, which in turn, could result in higher costs than those consuming data on a casual basis, say for entertainment content only.

iv) Even if a low-cost / high-usage solution could be found, the current broadband pricing model is not one which can be withstood for a long period of time, particularly if the cost of regulation and universal connectivity must now also be factored into consumer tariffs.

v) Additionally, there remains uncertainty about whether service providers whose customers default on payments will be required to continue supplying access at a loss, in order to ensure they are not denied access to essential government service content. If service providers are required to do so, how can that access be monitored to ensure that only the essential services are accessed and which costs could be involved in developing this type of monitoring and metering programme? There is no 'incoming and emergency calls only' equivalent to broadband access, but a solution to these issues must be considered and properly costed.