



OPTA Consultation on Integral Tariff Regulation for End-users and Interconnection Services

Response from BT Ignite Nederland B.V.

EXECUTIVE SUMMARY

BT Ignite Nederland B.V. (hereafter called BT Ignite) welcomes OPTA's consultation on Integral Tariff regulation (reference : OPTA/EGM-IBT/2001/203548).

BT Ignite refer OPTA to the main body of this report for detailed comments on the individual questions. The key messages are as follows:

General Price Squeeze Issues

- BT Ignite believes that the price squeeze problem is caused by KPN's retail tariffs being low but their interconnection prices being high by international standards. The latter is surprising given that demographics and operating conditions in the Netherlands suggest that Dutch interconnection prices should be amongst the lowest in Europe. KPN call termination prices may not be truly LRIC based whilst their call origination prices are far higher than in most European countries. Analysis of relative retail and interconnection tariffs leads to the view that a price squeeze is more likely to occur in the Netherlands than anywhere else in Europe.
- BT Ignite therefore strongly supports the need for a price squeeze test in the Netherlands. The current test needs to be both applied in a rigorous manner and further refined if a sustainable competitive market is to develop. KPN must be required to prove they are acting in a non-discriminatory manner.
- BT Ignite believes that other issues relevant to the price squeeze issue are
 - The provision by KPN of cost efficient points of interconnection
 - The size and basis of the retail uplift within the current test, which needs urgent review.

Wholesale Price Cap Issues

- BT Ignite believes it is desirable to migrate tariff regulation of interconnection services to a multiple year system. However:
 - Setting any price cap control of the form PI-X is not a straight forward task. It will require work and input from all parts of the industry.
 - The key tasks involved are firstly establishing a reasonable set of starting prices and secondly calculating an appropriate "X". The new tariff regime

should not be introduced unless rigorous work on both these has been undertaken, with this work being shared with the whole of the industry.

- Further work on starting prices is required. The starting prices should not be current interconnection prices. BT Ignite looks forward to hearing how OPTA intends setting starting prices for any price cap.
- Setting X is a discrete modelling task that is not straightforward and requires dedicated effort. BT Ignite looks forward to hearing how OPTA intends to undertake this modelling.
- The potential for over- or under-recovery of costs can be managed by firstly building robust models in consultation with the whole industry and secondly by ensuring appropriate regulatory intervention if problems arise.

Separated Accounts Issues

- BT Ignite fully support OPTA's proposals to oblige KPN to keep separate accounts for its Retail and Network business. The proposal to adopt a non-discriminatory "purchase model" is essential to a fair competitive playing field, and will also provide useful data in support of price squeeze tests.
- It is essential that such accounts meet the objectives of the EC Interconnection Directive, and adhere to the principles of the EC Recommendation on Accounting Separation and Cost Accounting. Data from the accounts should be published. There should be adequate consultation with market players over the methodologies employed, and the form and content of reports.
- BT Ignite believes that the level of wholesale-specific charges should be investigated, to ensure they are reasonably incurred, efficient and allocated appropriately.

Biba-specific Issues

- BT Ignite believes that unbundling of the biba tariff (on the "flower structure" approach) is potentially commercially attractive. However, if this was done, it would require careful implementation to avoid exploitation by KPN.
 - However, a solution to the biba problem cannot be achieved without action at the wholesale level. The resolution of the outstanding issues on local interconnect is essential to ensure the correct economic signals are given to competing operators. The roll-out plans of those operators are of secondary importance, and in any event will be influenced by the changes to the interconnect arrangements.
 - BT Ignite does not favour the introduction of local call resale at this time.
 - There is merit in OPTA's proposal to enable operators to obtain local interconnect charges where a call would have been handled at the local level in KPN's network. However :
 - It would be workable only if local interconnect prices are efficient

-
- OPTA are encouraged to address the underlying problems, such as structural inefficiencies in interconnect
 - OPTA are urged to assess whether a KPN have exploited flexibility in the retail price cap to lever advantage in biba calls – and therefore whether revisions to the price cap rules may be required to reduce pressures on biba tariffs.
 - Once these other issues have been satisfactorily addressed, the need for such a measure should be reviewed.

Amsterdam, January 2002.

Olaf J.M.Olmer
Regulatory & Anti-Trust Specialist.

MAIN REPORT

1. Introduction

BT Ignite welcomes OPTA's consultation on Integral Tariff regulation (reference : OPTA/EGM-IBT/2001/203548).

BT Ignite recognises the competitive benefits brought about by the price squeeze test and support the main thrust of OPTA's recommendations for removing remaining barriers to the development of competition in the Netherlands. BT Ignite considers that the best long term interests of the consumer are best served by the promotion of competition through the removal of structural imbalances and barriers to entry rather than through the micro-management of KPN's retail tariffs.

For reasons that are explained in the main body of this response BT Ignite considers that it is now time to move away from retail price controls to wholesale price controls. In addition, this move to wholesale price controls must be supported by KPN's published separate accounts. In the interim, whilst structural imbalances and barriers to entry are being removed, BT Ignite believes that some special measures are warranted.

This response is organised as follows:

- Section 2 gives a brief introduction to why the price squeeze is a problem. It concludes that whilst KPN's retail tariffs are quite low by international standards their interconnection tariffs are high. This section concludes with BT Ignite encouraging OPTA to continue to apply and develop the price squeeze test.
- Section 3 gives the answers to the questions that are raised in Chapter 3 of OPTA's consultation document on "Price squeeze: issues and solution directions".
- Section 4 gives the answers to the questions that are raised in Chapter 4 of OPTA's consultation document on "The biba issue and solution directions",

BT Ignite would be happy to meet with, or engage in further correspondence with OPTA in order to explore further any of the issues in this response.

2. Price squeeze in the Netherlands

2.1 Introduction

The key problem in the Netherlands is that KPN's Retail, end-user, prices are relatively low whereas KPN's wholesale, interconnection prices are relatively high. Without an adequate system of checks in place this means that KPN can abuse their market power by cross-subsiding their retail activities from their upstream wholesale activities. So although end-users may benefit in the short term from lower retail prices the relatively high interconnection charges limit the extent to which effective and fair competition can flourish.

This in turn may have implications in the long term for consumer choice and if allowed to continue would clearly be contrary to OPTA's stated mission:

“OPTA stimulates sustained competition in the telecommunications and post markets. That is to say: a lasting situation in which private individuals and business end users can choose between providers and services in such a way that the price and quality of supply in the various constituent markets is created by effective market incentives. In the event of insufficient choice OPTA protects end users.”

Clearly then the relationship between retail and wholesale prices needs careful management if consumers are going to have sustained options for choice.

This section therefore provides some evidence to support the views that KPN's retail tariffs are relatively low and their interconnection tariffs relatively high and then draw some conclusions for what this means for price squeeze and the setting of price caps.

2.2 KPN's retail prices are relatively low

Evidence to support this statement is provided by the recently published 7th Report on the Implementation of the Telecoms Package⁶. Annex 1.3 of this report compares a variety of retail tariffs across the EU. So for example:

- Chart 8 shows that Netherlands residential tariffs are on average 4th lowest out of 15 EU countries
- Chart 9 shows that Netherlands business tariffs are on average also 4th lowest, again out of 15
- Charts 10 and 11 shows that Netherlands local call charges are relatively low: 6th lowest (out of 15) for a 3 minute call and 5th lowest for a 10 minute call
- Charts 12 and 13 show Netherlands national calls charges are the 4th lowest for both a 3 and 10 minute call.

The conclusion is that retail tariffs in the Netherlands are amongst the cheapest in Europe.

6) COM(2001)706

2.3 KPN's Interconnection prices are relatively high

Annexe 2.2 of the 7th Report on the Implementation of the Telecomms Package presents relative interconnection prices across the EU.

- Chart 1 shows that Netherlands local interconnection charges are 8th lowest out of 15 EU countries and lie just below the EU average
- Chart 2 shows that Netherlands single transit interconnection charges are 5th lowest out of 15 EU countries
- Chart 3 shows that Netherlands double transit interconnection charges are 3rd lowest out of 15 EU countries

However these results are based on simple comparisons that can be criticised: they only measure the cost of a 3 minute peak rate call (i.e. not across all time periods) and do not include all relevant interconnection charges, for example port charges.

A more realistic view of KPN's interconnection tariffs is presented by benchmark comparisons that take a wider view of interconnection charges. These reflect a basket of different call types across all times of day and include all interconnection charges that other operators have to pay, such as port charges. For example, the latest Ovum comparisons, released as part of their Ovum interconnection service, relate to charges at September 2001.

- On call termination KPN's tariffs are exactly mid-table (7th) out of the 13 EU operators that Ovum include in their survey. KPN's average termination rate according to the Ovum methodology is over 50% higher than those of BT and eircom, and 30% higher than Deutsche Telekom's .
- On call origination KPN's tariffs are the second highest of the 13 EU operators surveyed. Only Portugal Telecom has higher call origination rates. KPN's average rate according to Ovum is nearly 50% higher than that the median operator surveyed and is double eircom's.
- KPN's tariffs show the biggest difference between call origination and call termination of all the countries surveyed. Indeed in some countries call origination charges are lower than call termination charges.

The conclusion is that KPN's interconnection charges are at best average in Europe and probably higher than average.

However BT Ignite would expect that interconnection prices in Europe should be amongst the lowest in Europe given the favourable operating conditions that KPN enjoy:

- The Netherlands is a relatively compact country. It is the 3rd smallest of the EU countries, however it has by far the highest population density. Its population density is nearly 40% higher than any other EU country.

-
- Penetration of telephony is high in the Netherlands. Chart 9 in Section 1.1 of Annex 1 of the 7th Implementation Report shows that the Netherlands has the 3rd highest ISDN/PSTN penetration behind Luxembourg and Denmark.

These two factors should mean that local traffic calling intensities in terms of originating calls per square kilometre are much higher than anywhere else in Europe. Since traffic volumes are the key driver of local conveyance costs and there are great economies of scale in telecommunications networks this means that it is reasonable to expect that KPN's local service call related unit costs should be lower than those in other EU countries. In addition the Netherlands has a relatively flat landscape which should also result in lower operational costs.

BT Ignite therefore believes that call related interconnection unit costs should be lower in the Netherlands. Hence, since interconnection prices should be cost orientated, it is reasonable to expect that Dutch interconnection prices should be amongst the lowest in Europe. It is therefore surprising that KPN's interconnection tariffs are as high as they are, despite call termination prices being set with reference to a bottom-up LRIC model that has had input and exposure to the industry. BT has no explanation for this expect perhaps to question whether the current bottom-up LRIC models really do estimate the forward looking costs for an *efficient* operator.

Some support for this view is given by paragraph 76 of OPTA's consultation document. This paragraph suggests that KPN's current network topology might be relatively inefficient. There are "*relatively few connections for each switch*". It is common practice for LRIC models to adopt a modified scorched node assumption in which the current node positions are taken as given but the equipment located at a particular node may change. So, for example, local processor sites might be modelled as remote concentrator sites under this assumption. BT Ignite does not know the extent to which modified scorched assumptions have been adopted in the Dutch bottom-up LRIC model and the extent to which these have been carried through into call termination interconnection prices. However it is clear that any such inefficiency would be implicit in call origination prices as these are based on KPN's EDC model.

BT Ignite's conclusion from the above is that it is doubtful over whether current interconnection prices are truly LRIC based and whether they will therefore send the right economic signals to influence the build/buy decision. This issue is discussed further in Section 4 in the answers to the "biba" issue.

The above also has implications for setting an interconnection services price cap because a key stage is to set reasonable starting prices (or P0s as they are often called). BT Ignite is not convinced that KPN's current interconnection prices do form a reasonable starting point. This point will be referred to again in the answers to questions IIa and IIb.

2.4 The likelihood of a price squeeze in the Netherlands

The combination of relatively low retail (end-user) tariffs and relatively high interconnection prices increases the likelihood of a price squeeze.

OPTA may care to note that the ratio of end-user to interconnection tariffs is much lower in the Netherlands than elsewhere. In their Interconnection Service Ovum present some comparisons of retail and interconnection prices. They compare peak and off-peak retail and interconnection tariffs for both local and long distance services using a consistent, albeit relatively simple, methodology. These comparisons show that the ratio of retail to interconnection prices are lower in the Netherlands than anywhere else in the world with the exception of Japan for local calls.

Further there are large differences between the ratios in the Netherlands and those in the UK and Ireland, countries that also adopt a price squeeze test and where there are published separated regulatory accounts. For the Netherlands Ovum estimate the ratio of peak rate local retail tariffs to interconnection tariffs as being 1.99: this compares to ratios of 5.79 in Ireland and 6.13 in the UK. For peak rate long distance tariffs the ratios are 2.82 in the Netherlands, 7.47 in Ireland and 9.21 in the UK.

As noted above these comparisons are relatively simple and can be criticised but they do support the view that the chances of a price squeeze are much higher in the Netherlands than in any other EU country.

2.5 Conclusions

This short section has argued that retail tariffs in the Netherlands are relatively low whereas interconnection tariffs are relatively high. Further, that it is surprising that Dutch interconnection tariffs are relatively high given that the demographics and operating conditions in the Netherlands would suggest that interconnection prices should be amongst the lowest in Europe. Comparison of the ratios of retail and interconnection tariffs with those in other countries lead to the view that the chances of a price squeeze are higher in the Netherlands than anywhere else in Europe.

BT Ignite therefore strongly supports the need for a price squeeze test in the Netherlands. If the telecommunications market in the Netherlands is to become truly competitive then it is essential that tests are taken to demonstrate:

- KPN is not pricing anti-competitively. Its prices must be above its costs for all the key established PSTN services, including all discount schemes.
- KPN is not acting in a discriminatory way. KPN must be shown to be purchasing interconnection services on the same basis as it charges other operators. This is fundamental requirement of the EU's Interconnection directive and is carried forward into the new legislative proposals.

Finally, BT Ignite questions whether there is a need to continue with *retail* tariff regulation in the form of price caps when the current controls end in July 2002. The

main purpose of such a price cap would be to provide some consumer protection in the absence of any competition. But retail prices seem to be relatively low in the Netherlands, so this protection could be achieved by introducing a relatively loose set of caps of the form PI-0% and/or focussing them on some non-competitive products and services such as line rental. This loosening of the retail price controls does not however imply a reduced requirement to regulate interconnection and wholesale prices nor, as noted above, to test for a price squeeze. It is the control of interconnection prices that will form the focus of much of BT Ignite's answers to the questions that OPTA raise.

3. Questions on Price squeeze: issues & solution directions

I: The interested parties may feel there are other issues that pertain to the (causes of) price squeeze in addition to those stated in this document. If this is the case, the interested parties are asked to provide the Commission with any relevant information.

Firstly BT Ignite endorses OPTA's statements in paragraph 13 of their consultation document that

- squeeze tests will continue to be necessary
- the introduction of any new forms of interconnection tariff controls will never fully eliminate the requirement to undertake the price squeeze test.

As noted in Section of this response BT ignite believes it essential that the price squeeze test continues to be developed and to be applied in a rigorous manner.

BT Ignite believes there are 2 other issues that are relevant to the price squeeze issue:

1. The importance of the provision by KPN of cost-efficient points of interconnection, particularly at the local level.

This is an important issue as interconnection circuits (or joining links) are a further significant element of a new entrant's cost base. High costs of these circuits will therefore decrease the capability for a new entrant to compete with KPN. They therefore contribute to price squeeze effects indirectly. Although this issue is mentioned briefly in the "BIBA issue" chapter, a full discussion of the different types of interconnect needs to take place.

BT Ignite's experience is that there are 3 main types of physical interconnect provided across Europe:

- Co-location
- End of span interconnect (or customer sited interconnection) and
- In-span interconnect (ISI).

The first 2 offerings represent expensive means of securing interconnect and are usually only cost-efficient in a small number of locations. ISI, on the other hand, represents the most cost-efficient means of interconnect and could be deployed in a larger number of locations.

BT Ignite note that, although co-location and end of span interconnect are available in the Netherlands, KPN has yet to define its ISI offer. BT Ignite urges that KPN be required to develop its ISI offering (at charging levels commensurate with existing offerings in the rest of Europe) as soon as possible. BT Ignite will refer to this issue later.

2. *The size and basis of the retail uplift*

BT Ignite has already stated⁷ that it believes the retail uplift of 23% (used in the price squeeze test) to be insufficient. BT Ignite urges that the retail uplift calculations should be carried out using the principle of cost causality and not set at an arbitrarily (low) rate. BT Ignite expects cost information that would enable a more robust calculation of the retail uplift will become available from KPN's published separate accounts and urges that this element of the price squeeze test be re-visited as soon as this information becomes available.

There is a further, very important, point to make about the operation of the price squeeze formula, in relation to the retail "uplift" of 23%. When the original consultation decision was made, BT Ignite understands that the 23% retail uplift was based on information provided by KPN from their accounts. Unfortunately, this was not transparent to other market players. Presumably, the figure was based on an assessment of retail costs (for all or some of KPN's retail services) compared with the network costs for those services. However, the cost causation factors of retail costs is quite different to the factors which cause network costs to arise. It is quite possible, therefore, that the retail uplift will need to be reviewed on a regular basis, particularly in response to changes in network charges, or changes in the underlying accounting data on retail costs.

Additionally, the network charges (e.g. the rates for special access and interconnect termination services) have changed, as a result of more recent EDC analysis, and the development of the BU-LRIC model. BT Ignite believes that it would be totally inappropriate to continue to calculate the retail uplift using the 23%, since the cost basis of network charges has now changed. It would certainly be illogical to assume that, because network charges have reduced (either via EDC analysis or through using BU-LRIC cost analysis), retail costs have changed in the same proportion. But this is what would have been implied by the 23% uplift.

BT Ignite therefore urges OPTA to review the 23% uplift, in the light of the recent changes in network charges and retail costs.

Finally, although not strictly speaking a matter relating to the price squeeze, it is important not to forget issues relating to quality of service. The consultation rightly notes the requirement on KPN, through their designation as an SMP operator, to act in a non-discriminatory way. Part of the solution that OPTA are proposing in this consultation is for KPN to demonstrate that they are purchasing network components and facilities in a non-discriminatory way through the adoption of accounting separation. BT Ignite welcomes this, whilst being concerned that this is not already happening as it would appear to be a requirement under the interconnection directive. However BT ignite believes this obligation should also be extended to demonstrating proof of non-discrimination with respect to quality of service. BT ignite has already raised this issue with OPTA as part of the discussion on interconnecting leased lines.

⁷ In response to the original Price Squeeze Consultation, November 2000.

A potential model are the obligations that BT has in the UK under Condition 65 of its licence. Under this condition BT has to provide Oftel with a report that demonstrates that BT is not discriminating in the quality of service that it offers other operators compared to those that it gives itself. The report covers network quality, interconnect link provision and restoration and private circuit provision and restoration. The reports are public and BT Ignite has already provided a copy to OPTA .

BT Ignite believes that KPN should be required to provide similar information both to OPTA and to the industry to demonstrate that it is not behaving anti-competitively.

II.a. Interested parties are asked to provide the Commission with their viewpoints and insights with reference to the desirability of a possible migration to a multiple-year system for tariff regulation of KPN's interconnection and special access services, and to the applicable requirements in that respect with reference to a system of this type;

II.b. When replying, interested parties are also asked to provide detailed comments on the considerations put forward by the Commission in this respect, in particular with reference to the question of whether the current situation in the market is suitable for sufficient predictability of the correct cost and volume developments.

BT Ignite believes that it is desirable to migrate the tariff regulation of KPN's interconnection and special access services to a multiple-year system. BT Ignite considers that the key benefits to new entrants for migrating to such a system are:

- The lower regulatory administrative burden for all parts of the industry: OPTA, KPN and the new entrant operators. OPTA refer to this advantage in paragraph 24 of the consultation document.
- Interconnection prices will become more predictable over the period of the price cap. This gives benefits to the whole industry in terms of being able to plan with greater confidence. Interconnection prices are a major input cost and a key determinant for many new entrant pricing strategies. This is the advantage outlined in paragraph 23 of the consultation document.

BT Ignite also agrees that the move to price cap style regulation could create the right economic incentives for KPN to improve its efficiency in delivering interconnection services. The extent to which this is successful will depend on the way that the price cap is designed, in terms of the "X" that is set, the starting prices at the beginning of the tariff control period and the way in which quality of service can be safeguarded.

A well designed price cap regime may well also help to reduce the scope for price squeeze but, as noted above, they will not eliminate the need to undertake price squeeze tests. A well designed price cap system in conjunction with rigorously applied set of price squeeze tests can:

-
- Promote economic efficiency in interconnection service provision which should lead to lower interconnection prices in the longer term and hence lower end user-retail tariffs
 - Promote sustainable competition and hence consumer choice

However neither of these is guaranteed.

There are potential disadvantages or rather risks in introducing a price cap system for interconnection services. These are discussed by OPTA in paragraphs 25 and 26 of the CD. The second of these is that this may not be the time for the regulator to distance itself from decisions on interconnection services. BT Ignite believes this will only be a risk if insufficient time and effort is taken to build a robust system, which has adequate checks and balances in place. Work will be required to set stretching but achievable values for “X” and a reasonable set of starting prices. These are not straight-forward exercises: some of the work required is outlined later in this answer. Some of the risks could be mitigated by creating a set of “sub-caps” within the overall wholesale tariff control. So, for example, there could be a sub-cap for originating services, for terminating services and a separate cap for KPN’s wholesale specific costs. This is similar to the network charge control system currently in place in the UK.

The first risk that OPTA identify is that KPN may over-recover or under-recover the costs of an efficient operator⁸. BT Ignite considers that in the short term there is a greater risk that KPN will over-recover their costs (or as Opta say make “windfall profits”) through making “*unexpected cost reductions*”. Such over-recovery is more likely because KPN’s wholesale costs have until now been subjected to any detailed external scrutiny, largely because KPN has not published any separated regulatory accounts. They are therefore likely to include a number of inefficiencies or cost mis-allocations. These risks could be mitigated by delaying the introduction of a price cap system until KPN produce separated accounts that have been subjected to greater public scrutiny.

Any PI-X price cap tariff control system will in any case include some forecasting risk. The “X” will usually be set with reference to forecasts of various factors such as demand, unit costs and improvements in efficiency. The only thing that is certain is that these forecasts will be wrong! The challenge for the regulator is therefore to design a system in which the risks are minimised.

Some regulators have tried to reduce these risks either by introducing mid-term periodic reviews – for example to deal with events that are outside the control of the company – or through incorporating “error correction mechanisms”. Again these are factors that OPTA will need to consider if and when they decide to introduce a price cap for interconnection services.

⁸ OPTA use the terms “windfall” losses and gains in their consultation document though BT Ignite believes these terms are usually used to describe the losses or gains that occur when a change in the cost recovery system is made

To summarise the above discussion BT ignite believes that

- *It is desirable to migrate tariff regulation of interconnection services to a multiple year system. This form of price control provides the right incentives for cost control and provides the stability and certainty that new operators require for their investment plans. However,*
- *This should only take place once sufficient work has been undertaken to design a system. This will include separate modelling work on starting values and the value of “X”.*
- *Some of the risks in adopting such a system can be minimised through careful design of the system. This can also limit the potential for rapid over- or under-recovery of costs.*

There is however a further key question that the consultation document does not ask explicitly: *When should such a price cap tariff regulation system be introduced?*

To answer this it is necessary to consider what needs to be in place for such a system to work effectively. There are two key stages to setting a price cap of the form PI-X:

- Setting reasonable starting prices
- Setting the X

The latter task will include consideration of the extent to which future costs and volume developments can be predicted, which is the main subject of Question IIb.

BT Ignite believes that some of the work to set reasonable *starting prices* has already been undertaken in the Netherlands. Ideally LRIC models would have been built and re-run over several years with results of the model stabilising or showing a discernable trend. It could be argued that the Netherlands meets these conditions. LRIC models have been developed and re-run over the past couple of years. However the discussion in Section 2 of this response

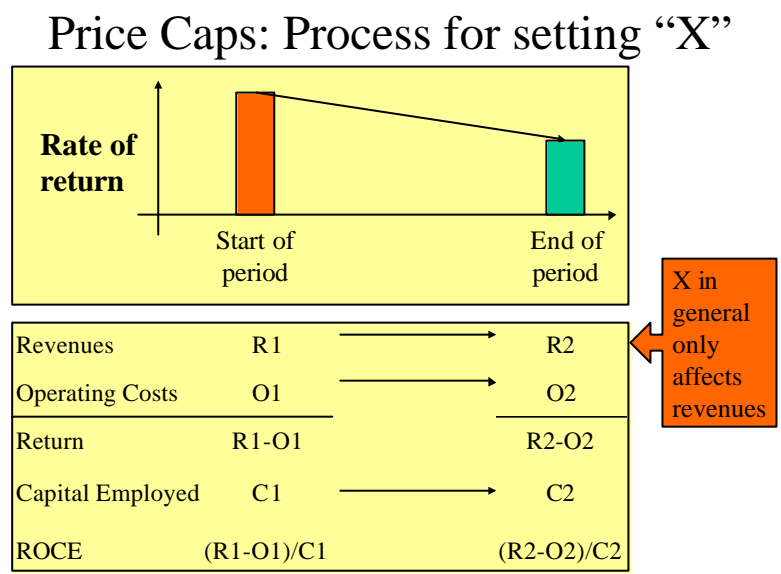
- Has lead BT ignite to conclude that call termination prices may not be truly LRIC based.
- Demonstrates that call origination prices are significantly higher than in other EU member states. This is partially due to their being based on KPN’s EDC model.

BT Ignite would therefore object strongly to the use of the current interconnection prices as the starting prices in any price cap. BT Ignite believes that the following is the minimum work that needs to be undertaken before a reasonable set of starting prices can be established:

1. The call termination LRIC models need to be reviewed to understand why Dutch interconnection prices are as high as they are. Alternatively the current “LRIC based” call termination prices need to be adjusted to exclude KPN’s relative inefficiency (see for example the discussion at the end of Section 2 of this response).

2. A set of true LRIC-based call origination prices need to be developed. These need to be shown to be as a minimum consistent with benchmark prices in other countries.
3. Checks need to be made with the new starting prices and retail prices to ensure that the new system does not institutionalise a price squeeze.

BT Ignite believes that *setting a reasonable X* is not just a question of estimating appropriate efficiency gains. The calculation of a reasonable X is a discrete modelling exercise that usually involves forecasting revenues, operating costs and capital employed. “X” is usually a variable parameter within these models that is set in such a way that the business under consideration earns the required rate of return at the end of the tariff period. This process is outlined in the figure below:



Clearly, the models to estimate “X” for a network business can be specified in a variety of different ways. OPTA may wish to look at the model that OfTel developed in 1996/97 when constructing the Network Charge Controls in the UK for the first time. An outline of this model was published in Annex F of OfTel’s December ’96 consultation document “Network Charges from 1997”.

Whatever the form of the final model it is likely that it will need to consider at least some of the following:

- Market demand and market share forecasts by service. These combined with routing factors will give estimates of network demand by component.
- Operating cost cost/volume elasticities. These estimate how operating costs vary as volumes change and are used to estimate operating (non-capital) costs.
- Estimates of static efficiency gains: how unit operating cost might be expected to decrease if there were no changes in volumes
- Asset price movements and asset/volume elasticities. These are used to generate the required capital expenditure and model forecasts of mean capital employed.

A further key consideration for any modelling exercise will be technical progress. This is likely to be important over the short to medium term as circuit switched traffic migrates to IP platforms. This makes the modelling exercise more difficult – but not impossible, and may lead to consideration of revised depreciation models.

The issue raised in question IIb concerns the forecasting “risk” alluded to in the first part of the answer to this question in setting X. This forecasting risk will be associated not only with technical progress but also and with volume and cost forecasts. It will never be possible to predict exactly what will happen both in terms of network usage and unit cost movement. The challenge therefore is to make the forecasts as robust as possible, to seek views from as wide an audience as possible and to build error correcting mechanisms into the design of any price cap and/or keep the initial regulatory periods relatively short – say 2-3 years.

To summarise the above discussion on when the tariff regulation system should change to a multi-year system, BT Ignite believes:

- That setting any price cap control of the form PI-X is not a straight forward task. It will require work and input from all parts of the industry.
- The key tasks involved are firstly establishing a reasonable set of starting prices and secondly calculating an appropriate “X”. The new tariff regime should not be introduced unless rigorous work on both these has been undertaken, with this work being shared with the whole of the industry.
- Further work on starting prices is required. The starting prices should not be current interconnection prices. BT Ignite would welcome OPTA’s views on how it intends to set starting prices for any price cap.
- Setting X is a discrete modelling task that is not straightforward and requires dedicated effort. BT Ignite looks forward to hearing how OPTA intends to undertake this modelling.
- The robustness of the value of X will depend on the quality of the forecasts. Forecasting risk can be managed by firstly building robust models in consultation with the whole industry and secondly by developing a regime which builds in appropriate intervention when necessary.

III. Interested parties are asked to comment on the Commission's plan to oblige KPN to keep separate sets of accounts, a measure advocated by the European Commission, whereby KPN's retail business would purchase from KPN's network business under the same conditions and cost basis as the parties interconnecting via KPN. Question

BT Ignite fully supports the Commission's plan. Only by obliging KPN to keep proper separated accounts can the key accounting objectives of the interconnection directive (cost-orientation, transparency and non-discrimination) be assessed and proven.

Separated accounts specifically recognise the "vertically-integrated" nature of an incumbent operator such as KPN, which has been notified as having Significant Market Power in both the retail and interconnect (wholesale) markets. Proper accounting separation should help to prevent possible abuses of such market power. This would include price / margin squeeze, but also could extend to cover such issues as potential over-charging and cross-subsidies.

BT Ignite is also fully in favour of KPN being obliged to publish its financial reports – only by doing this can market players gain confidence in the system and its outputs.

However, the extent to which the accounting system (and its resulting statements) meet the regulatory objectives will depend on the precise nature of the system. This includes the inputs and assumptions used, the calculations and allocation methodologies, and the nature of the outputs and reports. Some of the key aspects will be considered in the following paragraphs.

EC Recommendation

BT Ignite believes that the EC "Recommendation document" concerning the implementation of accounting separation and cost accounting systems would provide a useful starting point for the intended migration of KPN's costing systems.

The key aspects of the Commission Recommendation which BT Ignite would like to highlight are :

1. There are at least four broad business lines for which separated accounts should be produced – Core Network, Local Access Network, Retail and Other (further disaggregated accounts within these business lines may be considered appropriate)
2. As well as being based on cost-orientation, the costing system should be sufficiently detailed to allow the allocation of costs to unbundled network components and to determine the cost of unbundled interconnection services
3. Public consultation on allocation methods is considered desirable

-
4. There is a clear indication that accounting systems should be based on Current Cost Accounting methodology
 5. Efficiency factors may be necessary, to ensure that costs reflect those of an efficient operator
 6. The reports should include P&L and balance sheet for each business, together with a reconciliation with the accounts of the company as a whole. Transfer charges between the businesses should be clearly identified
 7. Publication – there is clear indication that information should be made available to interested parties to demonstrate non-discrimination. In particular, the importance of a statement showing the average cost of network components is highlighted.

BT Ignite believes some of the above issues highlight areas where further clarification may be required on OPTA's intended approach. In particular BT Ignite believe that OPTA should :

- Oblige KPN to produce separate reports on the Local Access business, as distinct from the Core Network business – an appropriate level of supplementary detail may be necessary to support pricing of local loop unbundling services;
- Require not only reports on the Retail business, but, as necessary, a dis-aggregated set of reports on some of the key products and services within the Retail business. In particular, this would help in the assessment of price squeeze, by providing information on retail costs for the various retail services. Such information may provide a more rigorous approach to identifying the retail costs, compared with the current 23% uplift.
- Consider what level of supporting detail that KPN should be required to produce to support interconnect rates (see also comments below)
- Address the issue of the appropriate cost basis (e.g. current costs)
- Oblige KPN to publish its methodology documents, as well as the outputs of the system itself, and ensure that the system and its outputs are independently audited.

BT Ignite believe that OPTA should consider consulting with the industry over the appropriate methodologies and outputs to be produced by the system. In particular, the content of published reports may be a contentious issue. OPTA should seek to achieve the right balance between transparency and publication on the one hand, and respect for genuine commercial confidentiality of KPN on the other. BT Ignite notes that two other regimes in the EC (UK and Ireland) have decided that publication of reasonable amount of data is necessary so that market players gain confidence in the system and its outputs – and this can generally be achieved without compromising the commercial confidentiality of the reporting operator. If OPTA were to adopt a similar approach, based on market consultation, then they would have BT Ignite's support.

Reports required for proving cost-orientation, non-discrimination and transparency.

BT Ignite believes there are some deficiencies in the Commission Recommendation, especially in the area of proving the cost-orientation, transparency and non-discrimination of network charges.

The regulatory objectives would be facilitated by the publication of three specific reports :

- (a) Output of Network Costs
- (b) Output of Unit Charges of Network Services
- (c) Output of detailed transfer charges between the Core Network business and the Retail Business

A brief description of the content of these reports is presented in **Appendix 1**. Again, BT Ignite would be happy to discuss these issues in more detail with OPTA, if required.

Cost standards and network charging

Section 3.3.3 of OPTA's consultation document proposes that KPN should present its financial reports in a way that makes it possible to determine whether KPN's retail organisation purchases wholesale services from KPN's network against the same terms and tariffs as its competitors. **BT Ignite fully supports this principle.**

OPTA also state that KPN should apply the EDC system, by which the terminating service should be valued based on the BU-LRIC tariffs – thus keeping the existing regulation model which applies EDC to originating access and BU-LRIC to terminating access.

There are therefore two possible cost standards used for network charging : EDC and BU-LRIC. BT Ignite believes it is essential to reflect the relevant transfer charges for each of the services the use these two approaches in a non-discriminatory manner. To do this would require a detailed assessment of the usage made by KPN retail of both special access services (priced on an EDC basis) and interconnect termination services (priced on BU-LRIC), in order to ensure that the charging principles are applied in a truly non-discriminatory way.

In addition, this highlights the fact that network charges (or interconnect prices) are not necessarily the same as underlying costs, and there needs to be some way of relating charges to costs. Therefore, it is essential that the KPN system can present information to support the cost-orientation of such network charges.

It is apparent that the main network components can be used by both special access (EDC) services and termination (BU-LRIC) services. This raises a question of how a fully integrated cost model can support both cost bases.

BT Ignite believes that this can be achieved by presenting data on how the network charges relate to underlying costs. This would require an integrated approach to costing the network, and a clear statement of how costs relate to the various charges that are used. In turn, this will require a decision will to be taken on the appropriate basis for presenting the network costs (i.e. should it be on an EDC approach or a LRIC approach or Fully Allocated Costing approach, should it be based on historic costs or current costs?). BT Ignite would prefer to see an integrated statement of network costs on the basis of current cost accounting, fully allocated costs.

BT Ignite would welcome OPTA's views on :

- How KPN's accounting system would be designed to prove cost-orientation and transparency of network charges, as well as non-discrimination;
- Whether a fully integrated approach will be taken to costing the network, hence providing a clear statement of the costs (preferably on a current cost basis), and how these relate to the network charges.

IV. Interested parties are asked to state their viewpoints and insights regarding the question of whether the introduction of financial reporting along the lines of a purchase model would necessarily mean that KPN's retail traffic would actually have to use the wholesale-specific facilities and services (such as the wholesale billing system and the Carrier Services organisation).

BT Ignite agrees with OPTA's conclusion that the implementation of an "actual" purchasing model (whereby KPN retail would **actually** have to use the provisions and facilities of the Wholesale-specific activities) would **not** be appropriate. OPTA have correctly identified that there are alternative solutions that could be implemented which would be preferable.

To impose actual purchasing and account management processes to the Retail / Network transactions within KPN would involve additional costs - at least in absolute terms, although economies of scale should mean that unit costs of these activities would reduce significantly. However, the goal of economic efficiency would not be achieved by imposing such a requirement.

V. Interested parties are asked to submit viewpoints on the judgement that the principle of cost orientation needs to be interpreted more broadly in the case of wholesale-specific costs, and in such a way that KPN can earn back its wholesale-specific costs through proportional allocation of these costs to all the traffic that uses KPN's network.

This question raises some important issues, which can be summarised as :

- Have the wholesale costs been correctly identified, and are they at a "reasonable" level?

-
- What issues does cost-causation raise?
 - How should such costs be recovered via network charges (both within interconnect / special access charges, and in transfer charges to KPN retail)?

Cost identification

BT Ignite is concerned by OPTA's statements that the wholesale specific costs are the principle cause of a price squeeze (as stated in paragraphs 41 and 47). BT Ignite believes that such costs, assuming they are efficiently incurred and analysed appropriately in the accounts, should be minimal in size.

BT Ignite is not aware of any specific data as to the size of these costs within KPN, either in total, or in terms of unit costs per minute. Therefore, it is impossible to comment on whether the Wholesale costs included within the interconnect charges are reasonable or otherwise.

However, there are some key principles that should be followed in the identification of such costs, as follows :

- They should only relate to activities specifically relating to supporting other operators (such as customer support, billing, selling, etc.)
- They should only include costs that are proper to interconnection (I.e. network) activities. Specifically, if the Carrier support or Carrier billing unit is (or has been) involved in selling retail products to other carriers (such as leased lines), then such costs should **not** be recovered from interconnection conveyance services.
- Such costs should be efficiently incurred – the assessment of this may require some sort of benchmarking with available data from other markets.

OPTA correctly point out that, as these costs are currently recovered solely from other operators through interconnect and special access services, there is no incentive for KPN to ensure these costs are at an efficient level. Indeed, if anything there is an incentive to exaggerate the size of such costs.

Further, it is worth noting that published data is available from BT in the UK, which indicates the following :

- BT imposes a “Product Policy and Planning” (PPP) charge, which currently (as of 1/4/2001) is levied at 0.036 pence per minute (approx 0.06 Euro cents) – these charges are included in the charges for basic call conveyance interconnect services;
- BT's Regulatory Financial Statements for 1999/2000 indicated that the CCA fully allocated costs for the PPP activity was 0.042ppm (0.068 euro cents / min)

Hence, there is some evidence to suggest that Wholesale-specific costs should be very minimal (perhaps under 0.1 euro cents per minute).

BT Ignite urge OPTA to require KPN to provide proof that their wholesale-specific costs :

- *relate only to interconnect activities;*
- *are efficiently incurred.*

Cost Causation and Allocation

The principle of cost causation states simply that costs should be allocated to those services or activities that cause the costs to be incurred. In the case of Carrier support and Carrier billing costs, they should be allocated to the services that give rise to those costs. OPTA have indicated that this means that such costs would be “exclusively allocated to those parties interconnecting with KPN, and not to KPN retail” (paragraph 46 of Consultation document, and similar comments appear in paragraph 43).

BT Ignite cannot agree with these statements. The wholesale-specific costs (sales, customer support, billing, etc.) relate to **all** aspects of the relationships between the KPN network business and other carriers. This would include :

- the **selling** (and customer support & billing) of interconnection services to other operators (such as special access origination, terminating interconnect, LLU, etc);
- the **buying** (and negotiation and payment) of interconnection services from those same operators (i.e. buying and paying for call termination on other networks).
- The selling of **other services** (such as retail leased lines, exchange lines, apparatus products) to other operators.

It is therefore essential that a properly calculated unit cost, based on cost causation, should reflect the various activities supported by the Wholesale unit. Therefore, even under cost causation, some costs should be allocated to :

- KPN retail calls terminating on other operators e.g. KPN to other fixed operators, KPN to Mobile operators (including KPN mobil);
- other interconnect and special access services (e.g. LLU)
- retail services (where the Wholesale unit sells such products to other carriers)

The strict application of cost causation would not, however, result in allocation of such costs to the **entirety** of KPN’s retail services (e.g. they would not be allocated to KPN “on-net” calls, since these services did not cause the carrier support and carrier billing costs to arise).

Reflecting wholesale-specific costs in charges to Operators & to KPN Retail

BT Ignite is of the opinion that there are two related but separate issues here : costing and charging. “Costing” is concerned with issues such as cost identification and causation (as discussed in the previous 2 sections). “Charging” relates to how such costs are **recovered** from the services using the costs. OPTA’s proposal (as outlined

in section 3.4.4. of the consultation) specifically relates to charging (i.e. cost recovery).

OPTA appear to accept that strict application of cost causation would not result in costs being allocated to KPN retail activities (although as already indicated, BT Ignite believes that even under cost causation, **some** costs **would** be attributable). OPTA then argue that this “cost asymmetry” is the cause of price squeeze, and therefore propose that wholesale-specific costs should be earned back through “proportional cost allocation”, on the basis that this is more likely to favour sustainable competition.

BT Ignite agree that the promotion of competition within the context of a level playing field is of paramount importance. Further, it is apparent that the charging solution for wholesale-specific costs may in part depend on the output of the costing analysis. Thus it may be that the existing high level of wholesale-specific costs have created regulatory and commercial problems, and that these problems are significant enough to justify basing the **charges** on principles other than cost causation. In particular, it may be necessary to impute these costs to KPN retail for the purposes of price squeeze tests, in order to ensure sustainable competition.

Given the earlier comments about the lack of detail (at least available to BT Ignite) on the level of wholesale-specific costs, and also given the other structural issues which are currently inhibiting competition (such as lack of adequate local interconnect and ISI arrangements), BT Ignite are happy that OPTA has proposed a more equitable solution to the recovery of these costs.

However, the principle of cost causation should only be contravened in exceptional circumstances. OPTA is therefore encouraged to examine closely KPN’s wholesale-specific costs, and, where necessary, benchmark these against international best practice. Once the costs are assessed by OPTA (and proven, to the satisfaction of market players) to be reasonable, then it may be possible to revert back to levying these charges on the basis of true cost-orientation.

Finally, BT Ignite believe that KPN should have clear incentives to keep these costs to a minimum. One of the best ways of doing this, once the industry is confident that the initial level of cost and charges are reasonable, is to impose a price cap on this charge in conjunction with quality of service-targets. Such a price cap would need to be devised in a way that reflects the likely behaviour of wholesale-specific costs over time, as the volume of interconnected calls changes. BT Ignite believe that such costs are likely to exhibit a high fixed element, therefore, as interconnect volumes increase, the unit costs should decrease significantly.

VI. Interested parties are asked to submit viewpoints on the judgement that the policy intentions formulated in Paragraph 3.4.4 for wholesale-specific costs incorporated in the EDC reporting should also apply to other types of wholesale-specific costs.
--

BT Ignite consider that other wholesale-specific costs should be treated in the same manner as described above. That is, that such costs should be allocated to wholesale traffic or transactions only when it can be demonstrated that existing structural imbalances have been removed. In the interim, whilst such imbalances are being removed, BT Ignite would favour the approach proposed by OPTA which would allocate such costs across all wholesale and retail traffic.

Additionally, there are some costs that could be deemed to be of general benefit to the entire industry (and hence to all customer groups, whether of the incumbent or of competing operators). An example would be CPS system set-up costs. The introduction of CPS benefits the competitive process, and thereby, potentially, benefits all customers in the market. To the extent that CPS creates general competitive pressures in the market, this will benefit the customers of the incumbent network operator on whom CPS obligations are imposed. Therefore, such costs should be shared equitably across all industry players, rather than only those carriers that “order” CPS from the incumbent operator. This approach has been taken in both the UK and Ireland.

BT Ignite believe that some other costs may need to be considered, notably the “Port” (access gateway) charges, and any other charges that are related to the physical interconnection of networks. We also have some reservations about the level of access gateway charges, particularly at local switches – further comments are included in Section 4.

In any case, there should be a clear transfer charge between KPN’s network and retail businesses for the usage of such costs, insofar as these are incurred by retail services (i.e. principally, this will be retail services that involve some sort of interconnect, such as fixed to other fixed operators, and fixed to mobile). Indeed, it could be argued that such costs should be treated in a similar way to wholesale-specific costs. Thus, in the interests of a level competitive playing field, and pending resolution of the structural imbalances, such costs should be recovered using a proportional cost allocation approach.

Again, departure from strict cost-orientation principles is only warranted in exceptional circumstances, or where there is clear industry-wide benefit from the cost or activity (as is the case with CPS costs).

In the case of collocation, BT Ignite is not clear whether OPTA mean “LLU-specific” collocation, or other arrangements for physical interconnection of networks (e.g. hand over of voice traffic) at KPN exchanges.

- In the case of LLU-style collocation, KPN should ensure that its retail services (such as DSL) would bear a fair charge for any collocation facilities that are used (e.g. in housing the DSLAM equipment at exchange sites). Such charges should be non-discriminatory, compared with LLU collocation charges.
- For “voice traffic collocation”, there should be a fair treatment of such costs between the other operators’ usage of such facilities and KPN retail’s usage of

these facilities. Hence, if collocation arrangements enable the conveyance of both-way traffic, then KPN retail should bear a fair proportion of the charge.

4. Questions on the biba issue and solution directions

BT Ignite re-affirms that there is still a real problem in biba, caused by a combination of low retail tariffs relative to wholesale costs, and impediments in the wholesale market that make it impossible for competing operators to achieve the same network cost base as KPN.

VII.a. Interested parties are asked to submit their viewpoints and insights on the solution direction in which biba would be unbundled. Please include your views on both variants.

The current commercial pressures on BT Ignite mean that unbundling of the biba tariff may be an attractive proposition. In particular, it may enable BT Ignite to compete for “regional” and “national” biba traffic, where currently it has difficulties in doing so.

However, the extent to which this is the case would depend on exactly how the tariff was unbundled, and, crucially, on the resulting price levels for the unbundled services. The precise definition of the tariffs, and the level of retail tariffs relative to wholesale prices, would determine the viability of such a solution.

In fact, it is true that unbundling of biba is **only** likely to be commercially beneficial to competing operators if it is **combined** with other measures to remove the current obstacles in KPN’s wholesale prices. Such obstacles include : the high “access gateway” charges at the local level; the difficulties in obtaining acceptable commercial terms for widespread local interconnect; and the lack of proper “in-span” interconnect arrangements with KPN. The issue of cost-efficient local interconnect arrangements is discussed further in answer to question VIIIb, which also highlights other reasons why true widespread local interconnection with KPN may not be economically efficient for other operators.

If these wholesale issues are not resolved, then the unbundling the biba tariff (under either the “network burden” or “flower structure” approaches) could actually **harm** competition further. This is because KPN may be able to market “local biba” services at a low price (based on a lower network load), and competing operators may still be unable to match these lower costs.

If OPTA was to decide in favour of unbundling biba tariffs, then BT Ignite would prefer this to be done on the basis of the flower structure. However, such a change would need to be carefully designed and implemented to ensure KPN was not able to exploit the change for its own commercial benefit. The “network burden” approach would be particularly inappropriate, and could lead to customer confusion and be unworkable in practice, for reasons that OPTA have already identified.

Additionally, there may be a further consideration that was not specifically raised by OPTA - this relates to the issue of the retail price cap. BT Ignite feel that it is possible that KPN has exploited the flexibility within the price cap regime to target price

reductions on biba, resulting in competitive advantage. It certainly seems likely that there is an imbalance in the returns earned by KPN on biba compared with buba traffic (especially as the price squeeze issue has been most severely felt on biba). Rigorous accounting separation data would provide more information on the relative returns for each type of call.

If there is evidence of KPN exploiting the price cap in this way, or evidence of an imbalance in returns between biba and buba, then BT Ignite believe OPTA should consider reviewing the price cap arrangements. It may even be necessary to require KPN to re-balance the biba and buba tariffs (perhaps by preventing further reductions in biba tariffs). This may reduce pressures on biba margins for competing operators.

A combination of relaxation (or even removal) of the price cap for biba calls, together with positive actions on removing impediments to interconnect, would help reduce the price squeeze pressure on biba calls overall. It may also remove some of the causes of the subsidies between “local” and “regional” biba calls.

However, BT Ignite understand that there may be other reasons that mitigate against the unbundling of biba tariffs, including :

- it is likely to be unpopular with consumers
- it could hinder internet access or other service provider arrangements
- it is contrary to the trend of simplification seen in the rest of Europe

Thus, if for these reasons OPTA decide against unbundling, BT Ignite consider that the solution to the biba issue lies in removing structural impediments to local interconnection services to enable proper competition at the local level.

VII.b. When replying, interested parties are also asked to comment in detail on the advantages and disadvantages put forward by the Commission in this connection.

BT Ignite understand and agree with OPTA’s summary of the advantages and disadvantages. BT Ignite re-iterates that the preferred approach is to remove barriers and impediments to competition, in addition to any measures imposed on retail tariffs.

VIII.a. Interested parties are asked for their viewpoints and insights on the Commission’s opinion that the market for local interconnection is, in principle, a competitive market.

Ignite is unclear of the precise meaning of the question. The market for local **interconnection** is dominated by KPN, since it has the majority of customer lines. Therefore the “market” for local **interconnection** services is not likely to be competitive until or unless the market power of KPN is considerably reduced. Since competing operators therefore have no alternative supplier for local interconnection services (i.e. access to the majority of end users for either call origination or call

termination), then this lack of competition means that regulation of KPN is required, so as to “substitute” for the absence of a competitive market.

In addition, the current difficulties in negotiating efficient local interconnect, and certain other elements of KPNs wholesale pricing, indicate that improvement is required if competing operators’ needs are to be met. Further detail on this is provided in answer to question VIIIb.

However, a slightly different question is whether the market for local **retail** calls services is competitive. BT Ignite note that the market for local calls is not effectively competitive at present as KPN has 95% market share. However, BT Ignite do agree that the market for local traffic should be a competitive market. Therefore, BT Ignite fully support OPTA’s initiatives aimed at removing entrance barriers to the local interconnection service which should help to make the local calls retail market more competitive.

Such initiatives should include the establishment of a In Span Interconnect product which is comparable with existing offerings found in other countries around Europe. The apparent inequities in the pricing of access gateway services at the local (as compared to the regional or national) level should also be addressed, together with a continued effort to ensure KPN’s wholesale prices are efficient and cost-oriented.

VIII.b. Interested parties are asked to state whether they intend to roll out their network to a local level, and if so, the timeframe and conditions/criteria for this rollout.

BT Ignite will review their local network build plans depending upon the outcome of this consultation.

BT Ignite’s main concern is to see that the regulation of KPN’s tariffs is based on sound economic principles, in the best interests of long-term sustainable competition. Therefore, the issue of what plans other operators have to roll out to KPN local switches should not be the primary consideration. Such plans will in any case depend on a variety of factors such as product and customer mix, not just on the interconnect arrangements for PSTN traffic.

However, it is also true that the current arrangements for local interconnect are extremely unattractive for competing operators. As an illustration of this, the table presented in **Appendix 2** compares the difference between “regional” and “local” interconnect rates.

- Section A shows that the basic interconnect tariffs are indeed lower for local than for regional (and this applies for both terminating access and originating access).
- However, this ignores the effect of the access gateway charges. These charges are far higher at Local switches than at regional or national switches.

-
- These costs can be factored in to the comparison, by converting the monthly access gateway charge to an average cents per minute charge (assuming a 2Mb gateway is capable of carrying 2 Million minutes of annual traffic – an assumption that experience shows is not unreasonable)
 - Section B shows the effect of including the per minute access gateway costs with the conveyance charges, with the result that Local conveyance charges would exceed Regional conveyance charges in most instances
 - A “break-even” call duration is shown, to illustrate at what point the more expensive conveyance charges outweigh the lower set-up charges (e.g. for call termination in the WNT period, Local exceeds Regional for call durations greater than 1.3 minutes). It is highly likely that competing operators’ call durations will be greater than these thresholds, resulting in high costs of local interconnect
 - This simplified example illustrates why KPN’s local interconnect arrangements are punitively expensive for other operators (even before including any build-out costs needed in the operator’s network)

BT Ignite believes that these differences in the access gateway charges are unlikely to reflect genuine differences in underlying costs – therefore, the current pricing structure and levels creates distortions in the market.

Aside from the concerns on the level of local interconnect tariffs, there are other economic factors which may serve to mitigate against local interconnect :

- OPTA stated (paragraph 70 of the consultation) that KPN has a relatively large number of local switches, and that “given the current technology, a smaller number of switches would be sufficient”. OPTA recognise the likelihood that it is not likely to be macro-economically sensible to force KPN’s competitors to roll out to all of these local switches. Additionally, inefficiencies in KPN’s network structure should not be recoverable in interconnect charges – otherwise the wrong investment decisions will result.
- As OPT indicate, the traffic intensity of competing operators is unlikely to justify interconnect at all but the largest KPN local switches.
- Competing operators are likely to build their networks using somewhat different network design and technology considerations. Therefore, the mirroring of KPN’s network structure would be inappropriate.

Therefore, BT Ignite urge OPTA to continue to address the issues of local interconnect arrangements and efficient pricing of all interconnect services (origination and termination, and including the access gateway services), so as to ensure that efficient economic signals are provided to operators.

Also, a measure that enabled competing operators to achieve 100% geographical coverage by interconnecting at fewer than the 600 local exchanges is necessary. Specifically, it should be possible for competing operators to achieve local interconnect where they already collocate with KPN local exchanges for the purposes

of LLU/ADSL. This should be implemented using the same fibre line plant as is used for LLU/DSLAM interconnect backhaul.

Only once these measures are taken can operators make the appropriate decisions on where to interconnect, and how to compete for biba (as well as buba and other) traffic.

IX. Interested parties are asked to submit their viewpoints and insights regarding the solution direction in which the local service would be made available to KPN's competitors.

BT Ignite considers that this represents a major strategic issue for the development of competition in the Netherlands. The question is whether the focus should remain on encouraging infrastructure competition, or whether the time is ripe to start encouraging pure resale?

BT Ignite consider that the telecommunications market in the Netherlands is not yet ready for measures intended to encourage resale and that efforts should be focussed on removing remaining barriers to the development of infrastructure competition. In any event the availability of such an offering would need to be limited to only those operators that generally qualify for interconnect terms. Otherwise, if other service providers are allowed into the market at cost-based rates (but without being infrastructure builders) then this could upset the economics of the retail market, and harm the very operators that the measure was designed to help.

BT Ignite would support the solution direction which obliges KPN to charge its competitors no more than the local interconnection tariff for handling biba traffic that KPN itself could have dealt with low in its own network. However, this will only be effective if the local interconnect prices (including the access gateway charges) are efficient and reasonable. Also, as outlined in answer to question VIIa, other measures may also be necessary to facilitate the appropriate outcome, such as relaxing or removing the price cap on biba calls.

However, BT Ignite also consider that the proposed solution direction should be an interim measure that should be deployed only so long as barriers (adequate and efficient access to local exchanges, the lack of an ISI product, price cap pressures on biba) persist. Once these issues are addressed, the need for continuing with this interim measure should be reviewed.

Further, it is essential to note that this solution is necessary only to deal with issues arising from KPN's ubiquitous network, and resulting interconnection problems with **KPN**. It would be wholly **inappropriate** to impose similar principles (i.e. only charging local rate for calls that would have been handled locally) in the charging for, say, call termination on competing operators' networks.

APPENDIX 1: Reports Required For Proving Cost-Orientation, Non-Discrimination & Transparency

1. Output of Network Costs.

This is similar to the EC recommendation that there should be a Statement showing the average cost of network components. However, the content and scope of this statement should be made more explicit, and should identify :

- All the key network components and other cost activities that are involved in providing (both internally and externally) regulated (i.e. RIO) interconnect (and special access) services and wholesale facilities (i.e. including Local Loop Unbundling and Collocation)
- The operating costs of and capital employed for those components
- The applicable regulatory allowable return on capital employed for those components
- The usage volumes (and the volume definition) for each component
- The total unit costs of each component (operating costs + cost of capital)
- This would apply to both Core Network and Local Access Network components.

Such an output would aid both the objectives of cost-orientation and transparency, and would also facilitate comparison, validation, and evaluation of costs against other SMP operators in other member states.

2. Output of Unit Charges for Network Services.

This is closely related to the EC guidelines, which state that operators need to submit data showing no undue discrimination. However, BT Ignite believes that the more explicit data should be provided.

Such an output should include:

- Identification of all the key network components (elements, or activities), their unit charges, and how the unit *charges* compare with the unit *costs* (as calculated in (i))
- A clear statement of how the unit Network charges for each of the interconnect / wholesale services (as offered in the Reference Interconnect Offer) are derived from the underlying network components – showing clearly the component usage factors (such as route factors) for each service, the component unit charges, and the calculation of total unit charges
- A clear statement of how the unit Network charges for each of KPN's Retail Business activities / services are derived from the underlying network components – showing clearly the component usage factors (such as route factors) for each activity, the component unit charges, and the calculation of total unit charges;

The above would achieve three key objectives :

- Demonstration of cost-orientation of network charges;
- Transparency in the way that Network Charges have been calculated, and how these relate to the costs of various network components;
- There would be a clear demonstration of non-discrimination (since the same network unit charges would be applied to both interconnection / wholesale services and retail services).

3. Output of total transfer charges between Network Business and the Retail Business and Activities.

The Unit Charges for Network Services (ii) presents the derivation of network *unit* charges for interconnect and retail activities. An additional statement is required showing the full derivation of the *total* transfer charges between network and retail business.

This output should show:

- The various retail activities into which the Retail Business is sub-analysed;
- The relevant volume measures of those activities, for the relevant accounting period (e.g. total call minutes, or total calls, or total lines, etc.)
- The network unit charges that were calculated in (ii), above;
- The product of the unit charges and the volumes, in order to identify the total network charge for the activity – this would reconcile with the Network Charges presented in the Profit and Loss account of the retail activities.

Thus, for each activity reported within the “Retail” business, it would be possible to see how the total network transfer charge has been derived from the “Unit Charges of Network Services” (see (ii)) and the service volumes.

Such an output would further reinforce the demonstration of **non-discrimination**, since users of the accounts can see that the total network charges for each retail service have been derived from the unit network charges, which were themselves calculated in a non-discriminatory way.

It would also aid transparency, since it would facilitate reconciliation between the detail of the unit network charges, and the summary information contained in the P&L accounts. The total network charges (i.e. total revenue of the Network business) would thus be derived either from other operators or from the Retail Business. It would be clear that the revenues in the Network business would be matched by costs in the Retail business.

Such an output would go beyond the current EC guidelines, which only stated that there should be a matrix summarising the inter-business transfer charges. We would insist that a summary of inter-business transfer charges would be insufficient, since it might not consist of a fully detailed calculation of the

transfers. Without this, it is impossible to see if non-discrimination has been properly applied.

In addition, the other reports that were outlined in the EC Guidance should continue to be reported, namely:

- Profit and loss and balance sheet for the Businesses, and, in the case of Retail business, the key activities within that business;
- Matrix summarising the inter-business transfer charges;
- A clear statement of reconciliation to published Statutory Accounts. This may need to show the movement between incremental costs, fully allocated costs, current and historic cost accounting etc. to move from the regulatory accounts to published company's accounts.

The statements should also make clear the extent to which costs are adjusted for regulatory reasons, such as :

- Cost Exclusions, perhaps because they have been disallowed for regulatory reasons;
- Other adjustments (e.g. on the basis of efficiency assessments, or valuation changes, or allocation methodology changes)
- Where significant, “exceptional items” should be identified separately from normal costs.

APPENDIX 2: Comparison of costs of Local interconnect versus costs of Regional Interconnect

(All figures in Euro Cents)	Set-up	Conveyance		
		Peak	Off-peak	WNT
A. Basic Interconnect Charge				
TERMINATING Access				
Regional	0.78	0.76	0.38	0.28
Local	0.59	0.57	0.29	0.21
Difference	-0.19	-0.19	-0.09	-0.07
% difference (Vs Regional)	-24%	-25%	-24%	-25%
ORIGINATING Access				
Regional	1.05	1.03	0.51	0.38
Local	0.82	0.79	0.40	0.30
Difference	-0.23	-0.24	-0.11	-0.08
% difference (Vs Regional)	-22%	-23%	-22%	-21%
B. Cost Including Cost of Access Gateways				
TERMINATING Access				
Regional	0.78	0.81	0.43	0.33
Local	0.59	0.83	0.55	0.47
Difference	-0.19	0.02	0.12	0.14
% difference (Vs Regional)	-24%	3%	29%	44%
"Break-even" Call Duration		8.1	1.5	1.3
ORIGINATING Access				
Regional	1.05	1.14	0.62	0.49
Local	0.82	1.10	0.71	0.61
Difference	-0.23	-0.05	0.08	0.11
% difference (Vs Regional)	-22%	-4%	14%	23%
"Break-even" Call Duration		NA	2.7	2.0
C. Cost of Access Gateways (per 2Mb and converted to per minute)				
	Euros Per Month	Euros Per Annum	Minutes per 2Mb p.a.	Euro cents / minute
<u>Terminating Access Gateways :</u>				
National / Regional	75	900	2,000,000	0.05
Local	431	5172	2,000,000	0.26
<u>Terminating Access Gateways :</u>				
National / Regional	188	2256	2,000,000	0.11
Local	512	6144	2,000,000	0.31
<i>It is assumed that the pence per minute costs are uniform by time of day</i>				
<i>2 Million Minutes per 2Mb p.a. is assumed to be reasonable estimate of usage</i>				