

Written response of KPN N.V.



to the public consultation

on a draft

**Recommendation on regulated access to
Next Generation Access Networks**

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14 November 2008
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1. Summary

The Draft Recommendation on regulation access to Next Generation Access Networks as proposed by the Commission is well timed. It should, however, focus on improving the debate which goes on in many member states. In order to be able to do this, the debate needs to shrug off the recent past and look into the desired evolution of electronic communications in the long run.

A Recommendation can draw on past regulatory experience, but regulation of NGA networks should take account of the simple fact that the investment needed is often much higher than current valuations of businesses would normally support. In other words, NGA networks can only thrive if they elicit much higher revenues than the revenues currently gained by the exploitation of copper networks.

All parties interested in NGA networks, be they large or small service providers or operators, need regulatory certainty in order to be able to make proper business planning. In the Dutch situation, with thriving competition on and between networks, decision making is arguably more complex than in many other member states.

KPN is committed to maintaining open access to its networks, whether fixed or wireless. As it has also shown in its positioning on other issues which have recently come up, KPN welcomes pro-competitive regulation. In this sense, a future Recommendation can be much improved: it should open up possibilities to arrive at long term certainty in regulated access arrangements. This will not be easy, as will be shown in this response. The issues are very complex indeed. It will be necessary to supplement the current approach to a Recommendation with sound economic principles and then provide the legal means to ensure long term regulatory certainty.

1. General remarks

The contribution by the Commission to the already ongoing debate to the regulation of Next Generation Access is a welcome one. KPN is considering rolling out next generation access networks and trials various technological options to do this. There are considerable commercial difficulties ahead to do this, not least because it is very uncertain that customers will pay the price premium necessary to ensure sufficient revenue to recover the investment.

As important as this is, to KPN another important aspect is that these networks are open to other operators as they contribute to the success of the new technology and help KPN in competing with cable. KPN has made clear that it will offer services at various levels in the network and we understand that new networks will have to be regulated at some point in time due to the parameters of the underlying business case for fibre to the home. The regulatory framework should support efforts to arrive at predictability. Predictability is necessary for KPN as well as for parties seeking access to next generation access networks. Thus, the Commission initiative is very well timed.

KPN would have liked the Commission to approach the debate in a more open and more fundamental way, however. Without a more general (economic) background for regulation,

the introduction of a Draft Recommendation on Next Generation Access¹ runs the risk of resulting in a discussion on points of view. Rather, we need a discussion of the economic principles with which regulators should approach the phenomenon and which should then result in predictable decisions on cost modelling, returns on investment and risk premiums, and tariff structures.

This response to the draft recommendation focuses on this and other omissions. It will not focus on more detailed issues.² The next section paints the background of the Draft Recommendation and points to the most important area for improvement, namely the necessity to develop sound economic principles to regulate NGA networks, which, after all, are not yet rolled out. Subsequently, look in more detail to some regulatory principles and key issues which are not addressed in detail and which a Recommendation should address much more fundamentally. Finally, one very important legal issue is addressed, regulatory certainty, which results in a plea for a clear legal provision to enable long term commitments on regulation between NRA's and operators in case they want to make them.

2. The NGA debate should be depoliticised through proper economic analysis

The draft recommendation still echoes the discussion about regulatory holidays that has bogged down an open debate between the stakeholders. Although the draft recommendation aims to strike a balance between encouraging investment and safe-guarding competition, 80% of the document is about access, whether to ducts, to in-house wiring, to dark fibre or to bitstream/wholesale broadband services.

The draft recommendation also seems to take the roll out of networks based on fibre access, or fibre to the home (ftth) for the residential market, for granted. However, so far, commercial success in the residential market for ftth, the focus of KPN's reaction here, is certainly not guaranteed. This holds especially for markets which are characterised by infrastructure competition, such as the Netherlands.

The roll out of a new infrastructure in an environment with substitutes has few precedents. The development of NGA cannot be taken for granted. Indeed, there are still many voices which question its immediate necessity (the Caio Report for the UK government is a disappointing example). Furthermore, it is not at all obvious for investors that the fixed business of telecom operators, which have reduced in size and valuation, merits the investment. Investors will only supply capital when the investments provide revenues. In practice, this means that customers will have to be inclined to pay an NGA premium. If this does not happen, either due to the inability by operators to communicate the power of NGA or because regulation undermines the possibility to secure this premium, NGA will not be rolled out.

It would have been much more helpful for stakeholders, regulators and market players alike, to have had a clear understanding of how regulation should take into account dynamic efficiency in communication markets. It is, for example, entirely possible that a freezing of investment in NGA due to regulatory uncertainties may help existing market players which provide competition on basic services. It may also result in impeding innovative services which use large amounts of bandwidth, such as video-intensive two way communication

¹ Including its explanatory note, hereafter: the draft recommendation.

² Such as the lack of clearly defined terms for passive and active elements; ducts and dark fibre are passive elements, but should not be treated as the same from a regulatory point of view.

services in health care, entertainment and education. Service providers offering value add services are not interested in competition with basic services only, but may provide large welfare gains for society in a different way.³ A delay in the development of these services is therefore undesirable. Having said this, market players focusing on triple play basic service offers should not be disregarded. KPN fully recognises that these parties also need certainty to continue their business and they also have a role to play. The possible trade-offs between regulating from a static efficiency approach and regulating from a dynamic efficiency approach are not described in the draft, although there is a considerable body of knowledge on these issues. This lack of analysis may cost the European public dearly in the following years.

Finally, a general remark on the issues the Commission does tackle. A puzzling difference exists between the level of detail in the Annexes and the almost cursory attention to a key issue of how regulators can provide certainty over several review periods. Again, the way the former issue is approached can be characterised as originating in static efficiency-type of thinking, whereas the latter issue needs detailing from a dynamic efficiency point of view.

3. Balancing dynamic and static efficiency in communication markets

There are at least six key aspects which need attention in a Commission recommendation on NGA if we want to further the economic aspects of the debate.

The first is that the roll out of NGA (whether fibre to the home, Docsis 3.0 over COAX networks or any other technology providing very high bandwidth to customers) is necessary in the long run and that a clear path towards development of NGA should be provided by regulators. To be sure, this is a political issue and not a regulatory issue. Nevertheless, it should be addressed by the Commission. NGA roll out is necessary from a technological point of view, because current networks will at some point reach their limits as the need for bandwidth still increases exponentially. It is necessary from an economic point of view as studies in many countries have shown. Less mentioned, but very important is also that NGA can have a considerable impact on reducing mobility and energy conservation. The Commission should take a clear position on the societal aspects and therefore the necessity of rolling out NGA networks.

Secondly, although it has been one of the cornerstones of regulation, and supported by KPN, we now see that the principle of technological neutrality is very hard to maintain as such in a general way. The publication of this recommendation itself already shows a bias towards the development of new networks which is not neutral. In the Commission documents, there are even paragraphs which implicitly encourage strategic design by operators. On page 9 of the explanatory note, it is stated that GPON networks and cable networks may constitute the same market. If point2point fibre networks would be considered as constituting different markets, this creates an incentive to roll out GPON-networks, arguably much more difficult to unbundle than point2point fibre. Regulation would thus clearly have adverse effects. Should it not be instead that technological differences may result in variation in regulatory interventions in such a way that a fair competitive playing field is constituted? And should not regulation support efficient investment from a macro-economic point of view? In short, technological neutrality should be addressed much more fundamentally than the Commission has done.

³ This may also hold for Google and Microsoft.

A third aspect is that we have to understand the temporal and local nature of NGA. The roll out of NGA will take a long time. For the next 10-15 years, roll out will be local. This is true from an investment point of view, but it may very well also be true from a marketing point of view. The investment issue concerns decision-making by operators based on local possibilities, partnerships, costs and competitive aspects. The marketing issue is about possible variability in product pricing and product bundling. Therefore, regulatory subjects such as geographic segmentation, bundling should be much more clearly linked to discussions about regulating NGA.

The fourth aspect KPN wants to raise concerns the differences in market dynamics that give rise to NGA investments or which will influence the development of competition by these investments. The recommendation spends little attention to the fact that markets are very different across Europe. Competition varies between and in countries. Technology choices vary. KPN supports the ERG point of view on the draft Recommendation in this respect: There should be room for NRA's to address these differences. Competition between cable operators and telecom operators can be an important driver for NGA investments. At the same time, competition makes those investments more risky. Different levels of infrastructure competition should lead to different regulatory outcomes.

To give an example: the recommendation seems to take it for granted that cost-based access pricing will be the standard pricing remedy. But why would this be a universal principle? In the Netherlands there are two fixed infrastructures. One will be upgraded quickly to NGA by implementing DOCSIS 3. An additional NGA (ftth) is contemplated by KPN. From a business case point of view, this will have to raise a certain level of revenue. In this situation, it may very well be that wholesale pricing, if deemed necessary at all, can be more flexible mimicking retail minus type of methodologies or offering bandwidths for access pricing. Such options reflect market dynamics which may lead to geographical differences much better, provide less cumbersome administrative burdens and ensure open access.

An overview of the various market situations may also structure the recommendation better and may make it more balanced. Duct sharing, e.g., is not something which is of interest to the Netherlands, since historically no ducts were used in the access network. This means that at least 50% of the recommendation has no relevance for OPTA. Much more attention should be given to the complicated dynamics of providing access to these networks on the one hand and providing investment incentives to roll out NGA on the other hand.

This brings us to a fifth aspect: open access. As was mentioned before, the recommendation is unbalanced in its attention to duct access and its very scant attention to access to passive optical infrastructure and active infrastructure issues. Access issues will dominate the debate ultimately. Duct sharing may very well be minor issue even countries in which it is now debated heavily.

There are two important statements on this issue, which are of vital importance, but need much more detailing: *“Where access to passive elements is mandated, the pricing should take into account any higher risk and the need for the investor to recoup its investment through its revenues on the retail markets. Where access to active elements is mandated, this should not undermine investment closer to the customer or deeper in the network”* (page 4, explanatory note). When does the Commission consider that investment may be undermined? There should be more elaboration here on the possible adverse effects of access pricing as we will do shortly below. Furthermore, the Commission needs to be clear about what it means when it

discusses passive elements here. If dark fibre is not part of this statement, this has no relevance for the Dutch situation.

The second important statement on access is on page 9: *“Under the rationale of the current framework, where access to the passive infrastructure is sufficient to create effective and sustainable competition on the downstream markets, no further remedy would be considered on the downstream market since SMP would no longer exist.”* KPN wholeheartedly supports the thrust of this statement, but notes that it is still equivocal. KPN would rather have the statement saying: access to passive infrastructure (for KPN this means dark fibre) is sufficient to create competition, and therefore regulated access to downstream elements is not needed. If NRA’s cannot guarantee that regulation of upstream services is effective, what are they there for?

Again, KPN wants to make absolutely clear that it is committed to providing open access to its network. In the Netherlands as KPN has started a joint venture with Reggefiber (a company with experience in ftth) to develop NGA (ftth) networks. The joint venture will provide the passive infrastructure. KPN will access dark fibre as an “active” operator and will be able to provide wholesale broadband access to other players. Other active operators will be able to access dark fibre provided by the joint venture on non-discriminatory terms. KPN has for some time shown its commitment to offer wholesale services. It is of prime importance to KPN to satisfy competitors like Tele2, Online and Alice as they have been instrumental in keeping customers on KPN’s network and thus have limited line loss. To KPN, in competitive terms, NGA is about competing with cable. KPN experiences line loss every month due to the marketing power of analogue television, which KPN cannot offer to its customers. KPN needs partners to sell its networks and therefore it wants these networks to be accessible on equal terms.

However, access pricing can create arbitrage opportunities which negate the possibility to ensure that the revenue is achieved that is needed to recoup the investment. The tariff structure and tariffs of access services must be tuned to this risk. This means that service providers which commit to large amounts of customers and which are instrumental in attaining penetration in a geographical area must be rewarded. This should not result in not granting access to operators which are not able to commit or to regulate access to downstream products. If, e.g., there is an operator which has access to dark fibre, it would still want to sell wholesale services as an important part of its business and not have this undermined by regulated access to active elements.

The complexity mounts as we consider risk premiums, the sixth aspect we want to address. KPN agrees that investors will demand a risk premium for investing in NGA. Incorporating risk premiums in access pricing will at the same time produce an upward movement in access pricing. In competitive situations, which KPN experiences in the Netherlands with cable, this can sooner or later produce margin squeeze for some access solutions as retail offers may have to be tuned to marketing possibilities in some markets. For service providers who want to compete on pricing only (producing static efficiency), this will not be acceptable. For service providers who deliver added value for customers (producing dynamic efficiency) this will be less of a problem. In any case, a solution could be to use bandwidths for access pricing, which would allow for flexibility as well as produce certainty. It is necessary always to strike a balance in access pricing which is, KPN wants to stress again, efficient from a dynamic point of view. Also, it is necessary that this balance be struck at the national level.

Possible regulation of access pricing based on rate of return and the possibilities of introducing risk premiums in such regulation must be completely predictable. In that respect, regulators should clearly delineate their methodologies to arrive at normative levels of rates of return. After more than a decade of regulation, one would presume that this could be arrived at. The Commission should emphasise that regulators should produce this predictability.

There are no easy answers in NGA regulation. All of the above aspects combined show the complexity of developing NGA. In view of this complexity, we arrive at the final aspect, which has an overarching meaning: the necessity for regulatory certainty. We will outline this issue in our final section.

4. Regulatory certainty as *conditio sine qua non*

The key issue in developing investment NGA is to get investment going and at the same time to maintain the level of competition that we now experience. Regulatory certainty is a key issue both for companies which are contemplating investment in new infrastructure as well as for companies who want to offer services over these new networks. The former need to have assurance that sunk investment will not have to be written off because of regulation, the latter need to have comfort that they can develop business models to satisfy their customers in the future. Right now, the draft Recommendation mostly focuses on ensuring competition.

There is only one sentence in the entire draft about guaranteeing longer term certainty: “*Since investments will be considerable and only written off over longer time frames, a consistent regulatory approach should apply over successive review periods. (p10, explanatory note)*”. From various discussions with NRA’s and governments, it has become clear that no one really knows how this can be implemented.

There is doubt whether there are provisions in the law to do this. Most regulators and governments regard the review process as inflexible. Markets will change, SMP may change and even remedies may change over time. Therefore, review periods may cause change in regulatory arrangements. However, in view of the size of the investments, investors cannot accept a vague promise to be consistent on principles. Investors who offer capital for NGA demand certainty for regulatory arrangements for some 20 years, as this is the amount of time typically used to depreciate this type of investment. The number of successive review periods considered should reflect the amount of time necessary to absorb most of the investment risks, which arise not only from possible future regulation, but also from the uncertainty of commercial success of the investment.

Therefore, European Commission, governments and NRA’s need to demonstrate that they can commit to long term regulatory certainty when operators want to commit to long term investments. Certainly, there can be no lack of legal instruments to do this. If an operator wants to offer a specific long term arrangement for an access regime, and if (some) other operators and NRA’s would be inclined to accept such a long term arrangement, the NRA should be able to commit to more than vague principles and guidelines for dispute resolution. If this is not legally possible, NGA roll out may fail for this reason alone. That would not be acceptable for anyone.