

Protecting consumers by promoting competition

Consultation on Oftel's review of the fixed
telephony market

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Summary

S1 This document sets out Oftel's proposals to replace the current retail price controls on BT with a package of measures better designed to encourage competition, while still protecting the most vulnerable consumers in a changing marketplace.

The case for change

S2 Oftel first imposed retail price controls on BT in 1984. Since then price controls have provided consumers with protection in markets in which BT has had a monopoly and continues to have market power.

S3 But today's market place is radically different from that of 1984. Cable operators and suppliers of indirect access (IA) and now carrier pre-selection (CPS) provide greater choice than ever before. In this rapidly changing market, it is no longer self-evident that the traditional model of retail price control is the most effective or proportionate way to develop competition further and to protect residential consumers.

S4 Against this background, Oftel has looked at the markets for calls – the provision of voice and data services – and the market for access – the provision of the exchange line which is paid for through the consumer's line rental. Oftel's conclusions are that:

- competition is now increasing in all fixed telephony markets but is not yet effective;
- BT will remain dominant in the provision of access for the foreseeable future;
- the current terms of access to BT's network may not prevent but certainly deter entry from service providers and hence restrict innovation in pricing and products in the calls market; and
- in particular, the imbalance between BT's large return on capital employed in relation to calls and low return on access means that rigorous competition in calls markets could put BT into a position where it was unable to recover its costs. The current form of price control does not address this fundamental issue.

S5 In short, Oftel believes that the conclusions of the review show that a new approach is necessary.

S6 The case for regulatory intervention remains powerful. There is an overriding case for action to ensure BT does not exploit its market position unfairly in the calls or access markets. Because of the importance of telephone services for social inclusion, it is also vital that the lowest spending groups of consumers are able to access services at an affordable price. Proportionate regulation is the best policy instrument to achieve these outcomes. Competition, rather than price

control, is the best long term protector of the consumer interest, because it offers the customer greater options in terms of price and service. The proposals in this paper are therefore designed both to stimulate competition and to protect consumers where this is needed.

The main proposals

S7 The main proposals are:

- To encourage greater market entry by mandating a 'wholesale line rental' product. What this essentially means is that existing operators, telecommunications service providers and new entrants from other sectors wanting to enter the fixed telephony market will be able to buy the wholesale line rental product from BT Network on non-discriminatory terms;
- To give service providers and operators using BT's network the ability to offer a 'one bill' service. This means that the bill from the alternative supplier would cover the cost of both the line rental and the calls made, rather than there being a separate BT line rental bill. A single bill gives operators the ability to charge in wholly different ways – for example, virtually free calls but a high subscription or no explicit line rental at all and all costs recovered from the costs of calls;
- To remove RPI-X control, but only when call prices have fallen sufficiently to signal clearly that competition was now the main determinant of these prices. The removal would be automatic when the trigger was reached, rather than following a further period of regulatory review; and
- To protect low spending customers by maintaining the present Low User Scheme and maintaining a safeguard cap, preventing bills from rising in real terms, after the trigger had been pulled.

S8 Each of these main elements is explained further below.

Improving access

S9 Any withdrawal of retail price regulation only makes sense as a response to competition in the calls market. In turn, this can only happen if the terms of access are reasonable. Oftel therefore proposes to require BT to provide wholesale line rental products, which anyone wishing to offer publicly available telephony services would be able to purchase. The starting price of this product, which will be set by Oftel, will be based on BT's costs. This would give both existing resellers and potential new entrants from other sectors the opportunity to buy access on the same terms as any other operator. Oftel believes that BT should be subject to a requirement for no unfair discrimination regarding the pricing, product design and quality of service parameters of this new product available to third parties.

'One bill'

S10 At present, many consumers who have switched to another supplier for making calls continue to pay a line rental charge to BT and thus receive two bills. There is evidence that the existence of two bills deters consumer switching and so reduces competitive pressure on BT. The access product will address this problem and increase the range of choice available. For example, a single bill gives telephone companies the ability to charge in wholly different ways – virtually free calls with a high subscription or, perhaps, no explicit line rental and all costs recovered from call charges. Such products would increase competition and thus place pressure on BT to reduce its call prices and increase the range of choices it offers to customers.

S11 However, some consumers positively welcome separate calls bills and the products which reach that group (IA and CPS) will remain in place

S12 Oftel believes that there are lessons to be learned from experience in the energy industry and from past telephony experience in relation to Calls and Access in particular. Oftel will therefore be looking to work with industry and consumer bodies to deal with issues around the marketing and delivery of new products and the production of transparent, accurate, comprehensive and comprehensible price information for consumers.

Removing the price cap

S13 Oftel proposes to remove the RPI-X control. It has worked well in protecting consumers, but is increasingly inappropriate in a multi-player market place and arguably hinders the resolution of the structural imbalances between the calls and access markets. But this cannot happen immediately. The timing of the removal of the retail price cap is a crucial judgement. If it is done too early – before increased competition has appeared in the calls market – BT might be able to maintain higher call prices than would be expected in a competitive market, whilst also having the ability to increase line rental. If it is left too late, however, after the other elements of the package have had an effect, BT might not be able to recover its costs.

S14 Oftel believes that a mechanism is therefore needed to allow the price control to be removed as competition reduces BT's calls profits. This is a more appropriate approach than attempting to predict now a precise date at which the calls market will become effectively competitive and proposing that the retail price control should be removed at that time. It also provides more certainty than building in a further lengthy process of regulatory scrutiny to establish whether the calls market had become competitive.

S15 Oftel proposes that a safeguard cap, which prevents nominal price increases, should apply to the bottom 80% of residential customers by expenditure. This cap should be removed automatically once call prices have fallen significantly by a pre-set amount.

Protecting low users

S16 Oftel believes that action continues to be essential to protect, in particular, those customers that would not otherwise be able to afford telephony service. Oftel's statement *Universal Service Obligation* in August 2001 made clear that the present Light User Scheme (LUS) would be maintained and reviewed again in 2003. This scheme provides protection in the form of lower line rental to the most vulnerable 20% of telecommunications users. In addition to the LUS itself, Oftel proposes to maintain a safeguard cap to prevent the bills of this most vulnerable group of consumers from rising in real terms overall, after the automatic trigger mechanism set out above has been pulled.

S17 If Oftel's proposals bring about effective competition in the calls market, it would propose to review the means of financing the retail elements of the Universal Service Obligation (USO) when it next reviews the USO as a whole in 2003.

Conclusion

S18 Delivery of this package will require close working between Oftel, all sections of the telecommunications industry and consumer representatives. Oftel considers that the benefits to consumers of this approach make the investment of effort by regulator and industry worthwhile.

S19 Given the scale of change proposed by the document, Oftel is seeking views not just on the issues of principle and overall strategy, but also looking to the consultation to highlight more detailed issues that need to be addressed in implementation, and the best mechanisms and appropriate timescales for doing so.

S20 Oftel will issue its final decisions on the way ahead in the light of consultation in June 2002. That statement will also include the statutory consultation on changes to BT's licence to implement the final decision.

Chapter 1

Introduction

Best deal for consumers

1.1 Oftel's goal is the best deal for consumers in terms of quality, choice and value for money. To ensure that consumers have been getting value for money, Oftel has needed to control BT's ability to increase prices to prevent it from taking advantage of its dominant position in UK telecommunications. However, price controls were always intended to be a transitional measure, because competition was expected to place the longer-term constraints on BT's pricing freedom. Oftel has therefore been considering whether competition will by 1 August 2002 provide protection for all customers from possible exploitative pricing. If the answer is yes, price controls are not warranted. If it is no, then price controls are required until consumers are protected.

Price controls

1.2 BT has been subject to price controls since it was privatised in 1984. The most recent controls, which were implemented on 1 August 1997, were set for four years and were then extended from 1 August 2001 for one further year. This control required an annual reduction in prices of inflation less 4.5% (RPI-4.5%). This price control has applied to a group of services known as the price control 'basket'. The services within this basket are as follows:

- connection (of a new service);
- take-over (of a service already installed);
- line rental;
- local calls;
- national calls;
- international calls; and
- operator assisted calls.

1.3 The basket control is focused on the expenditure patterns of the lowest 80% of residential customers because when the controls were implemented Oftel believed that it was this group of customers that needed protection. Other customer groups – high spending residential customers and most businesses – were more likely to be able to benefit from greater competition for their custom, which Oftel believed meant that even if they remained customers of BT their prices would fall because of the effects of competition.

1.4 Oftel has also controlled BT's retention for calls to BTCellnet and Vodafone since 1 April 1998. These controls were introduced because competition in calls to mobiles was not strong enough to protect consumers. They were set at RPI-7% for three years and were extended for four months to align them with the controls for

the other retail services referred to in paragraph 1.2. Oftel has been reviewing separately competition in the provision of mobile call termination to decide whether controls on mobile termination will be needed after the expiry of the current controls. Oftel has referred this issue to the Competition Commission after the mobile operators rejected its proposals. BT's retention for calls to mobiles is a separate issue from that referred to the Competition Commission. The need for further control of the retention is related to the extent of competition in the retail market for calls to mobiles and is considered in this document.

Market review

1.5 In February 2001 Oftel completed a review of competition in basic telephony markets with the publication of *Proposals for Network Charge and Retail Price Controls from 2001*. Oftel noted that competition was developing, but it was not clear that competition was fully protecting all consumers. Oftel chose to extend the price controls for one further year while it monitored the development of competition. In June 2001 Oftel began a further review of competition in the fixed retail markets with the publication of a consultative document *Competition in the provision of fixed telephony services*.

1.6 Oftel has considered carefully the data and representations it has received from all parties in response to the document and subsequently. These are referred to throughout the document and in detail in Annex A. In chapter 2, Oftel defines the relevant markets and outlines the extent of competition within those markets. In chapter 3 Oftel sets out its preliminary conclusions and proposals. Issues related to the implementation of the proposals are set out in chapter 4.

European legislation

1.7 In setting out the proposals outlined in this consultation document, Oftel has taken into account the draft proposals stemming from the European Commission's review of communications regulation: "Towards a new framework for electronic communications infrastructure and associated services – The 1999 Communications Review". In particular, the draft Framework Directive requires National Regulatory Authorities (NRAs – in the UK this is Oftel) to "define relevant markets appropriate to national circumstances in accordance with the principles of competition law" (Article 14). Article 15 requires the NRAs to assess whether relevant markets are effectively competitive and, if they are not, identify those undertakings that have significant market power before imposing "appropriate specific regulatory obligations" on those undertakings with significant market power.

1.8 Oftel has carried out its market assessment along these lines. It has identified and defined the relevant markets appropriate to the UK telecommunications market. Oftel will review whether further action is appropriate following adoption of the Framework Directive and the publication of any relevant guidelines by the European Commission.

Timetable

1.9 Oftel intends to publish its final conclusions for the future of price control arrangements in June 2002. This statement will include the necessary licence modifications to give effect to the new arrangements.

Consultation

1.10 Oftel is seeking views on the proposed arrangements set out in the document to increase competition and provide protection for consumers. Oftel requires comments on these proposals by 30 April 2002.

Chapter 2

Market definition and assessment of competition

2.1 In *Competition in the provision of fixed telephony services*, July 2001, Oftel described its approach to market definition and set out its initial views on the definition of the relevant markets (see www.oftel.gov.uk/publications/pricing/pcr0701.htm). Oftel also outlined its initial assessment of competition in markets for basic telephony services. This was based on the key indicators of effective competition set out in *Implementing Oftel's Strategy: Effective Competition Review Guidelines*, August 2000.

Market definition

2.2 The approach to market definition is based on identifying constraints on the price-setting behaviour of firms. These constraints may arise from customers substituting other services for those in question (demand-side substitution), or from suppliers switching production to supply the relevant products (supply-side substitution) following a price increase. This approach is widely used by competition authorities.

2.3 Oftel proposed the following as separate markets:

- fixed access;
- local calls;
- national calls;
- international calls by country pair;
- calls from fixed to mobile; and
- operator assisted calls.

Responses to *Competition in the provision of fixed telephony services* on market definition issues

2.4 The responses to *Competition in the provision of fixed telephony services* are summarised in Annex A of this document and are available in full on Oftel's website (www.oftel.gov.uk/publications/responses/2001/pcr_0701/index.htm). Not all respondents commented on market definition issues. However, of those who did, most broadly agreed with Oftel's proposals for market definitions including general agreement that calls markets were separate from access and that markets were national in scope.

2.5 Most respondents who commented on the issue also agreed that mobile and fixed markets were currently separate. BT, however, argued in its response that fixed-mobile substitution has now developed to such an extent that fixed and mobile telephony are now part of a single market and that Oftel, by regarding them as separate markets, underestimates the extent of competitive pressure on BT. BT

submitted a study by .econ suggesting that consumers would switch between fixed and mobiles in response to price changes. This is discussed further in Annex D.

Conclusions on market definition

2.6 In the light of the above, Oftel intends to use the market definitions proposed in *Competition in the provision of fixed telephony services*, with the exception of IDD calls where the definition used in the recent review of competition in international markets will be adopted (see paragraph 2.32 below). The following separate retail markets will therefore be defined for the purposes of the price control review:

- fixed access;
- local calls;
- national calls;
- international calls in two categories as in the international direct dial (IDD) review;
- calls from fixed to mobile; and
- operator assisted calls.

2.7 Oftel proposes to define separate markets for each of the above for business and residential customers. Some respondents suggested that a further subdivision of residential markets by spend should be considered and this is discussed in paragraphs 2.35 - 2.42 below.

2.8 These markets are national in scope.

Assessment of competition

2.9 In the light of the evidence available in July 2001, Oftel concluded that competition to BT in calls markets was increasing but was not yet effective and was likely to be stronger for some services and for some customer groups than others.

Responses to Competition in the provision of fixed telephony services

2.10 Most respondents agreed that competition is increasing but not fully effective and not yet sufficient, by itself, to adequately protect consumers. However, many felt that lack of effective competition would best be addressed by tackling barriers to competition directly. Several operators identified their inability to offer a total service to the customer, with a single bill, as a factor currently preventing calls markets from being effectively competitive.

Competition indicators

2.11 A number of other sources of data relating to the competitiveness of markets have become available since July 2001. These include results from Oftel's August/September and November surveys, updated (but unpublished and unaudited) financial information from BT and updated market share data. They are summarised in the following paragraphs.

Customer satisfaction

2.12 The August/September survey found that, among small and medium-sized businesses, customer satisfaction remained high. In particular, 95% of small businesses and 84% of medium-sized businesses were satisfied with their fixed telecommunications services overall. This was not significantly different from the results of the May survey. An apparent fall in satisfaction amongst small businesses to 88% in November may be an anomaly; amongst medium-sized businesses satisfaction increased slightly.

2.13 Similarly, both the August and November surveys of residential customers found that 97% of those respondents for whom the home fixed phone was the main method of telephony were satisfied with it. This compares to 95% in May.

Profitability

2.14 Oftel has used financial information for 2000/01 prepared by BT on a fully allocated current cost basis in its competition assessment. This information is not directly extracted from BT's published financial statements and differs from the published data for two main reasons. Firstly, the regulatory businesses and activities contain activities which are not price controlled, such as calls to some non-geographic numbers and ISDN calls and lines. By excluding these services, the latest data reflect the composition of the price control basket but are not directly comparable to the Financial Statement data or the figures published in July 2001 as these included ISDN and some non-geographic calls. Secondly, these figures are calculated on an end-to-end basis and thus include profits earned in BT Network as well as in BT Retail.

2.15 Data on BT's profitability for 2000/01 are shown in Table 2.1. The figures shown below include Oftel's estimates of profits and capital employed in incoming international calls (which accrue to Concert) which were excluded from BT's figures. Comparable figures for 1999/2000 are also shown (for comparison purposes the 2000/01 access figures have been adjusted to reflect a consistent treatment of dropwire costs. The unadjusted 2000/01 ROCE for access would be 1.7%).

Table 2.1: BT's Return on Capital Employed (ROCE)

		1999/2000	2000/2001
Access		-0.3%	-0.1%
Calls			
	Local	88.6%	99.1%
	National	87.9%	97.3%
	International	89.7%	122.3%
	Operator Ass.	80.8%	87.5%
Total		20.5%	17.4%
	Calls to Mobiles	42.0%	25.0%
Total		20.9%	17.6%

Source: BT. The full methods of attribution, accounting and valuation have not been disclosed to Of tel. Of tel. believes that BT's stated methodology for removing NTS calls, based on call minutes, may underestimate the returns earned on geographic calls.

2.16 There seems to be no tendency for BT's rates of return on calls, with the exception of calls to mobiles where BT's retention is capped, to decline. They remain extremely high. The fall in the overall ROCE seems to be due to declining call volumes relative to access lines. (These returns are expressed in terms of fully allocated cost (FAC). However, in assessing BT's line rental in relation to cost to establish if BT makes or loses money on the provision of lines, a different assessment, based on incremental cost, is more relevant. In such an approach, the question is not so much whether BT makes or loses money on PSTN lines, but rather how different services contribute to the recovery of BT's common costs, both costs within the access business – intra access costs – and costs common between access network common costs. For the purposes of simplicity, the discussion here concerns returns on a current cost accounting (CCA) FAC basis.)

2.17 The impact of loss of market share and falling prices is also reflected in a decline over time in the absolute values of BT's profits on calls.

Table 2.2 BT end-to-end profits at current prices £M

	Including ISDN, some NTS, and incoming IDD calls		Excluding ISDN, NTS and incoming IDD calls	
	1998/99	1999/2000	1999/2000	2000/1
Local	1257	1081	997	762
National	955	731	612	498
IDD	493	502*	295	211
Calls to mobiles	154	77	76	47
Total	2859	2391	1980	1518

Source: BT. The basis of the figures changes in 1999/2000, (see headings) hence there are two sets of figures for that year. The discontinuity reflects the transfer of customers and assets to Concert in January 2000 (the figure marked * includes an Oftel estimate of full year profits on incoming calls). The full methods of attribution, accounting and valuation have not been disclosed to Oftel. Oftel believes that BT's stated methodology for removing NTS calls, based on call minutes, may underestimate the returns earned on geographic calls. Profits are shown before subtracting cost of capital

Awareness of information sources

2.18 Awareness of the 'Phonebills' and comparable performance indicators websites has increased over the last year. Oftel's November 2001 residential survey found that 11% of respondents were aware of each of these sites compared to 7% and 5% respectively in March 2001.

Awareness and take-up of indirect access

2.19 Oftel's August surveys yield updated information on consumers' awareness and use of IA. BT also provided some survey evidence of customer awareness in its response. Table 2.3 compares the results of BT's survey with evidence from Oftel's August/September and November surveys.

Table 2.3: Survey data

	BT	Oftel/residential		Oftel/business	
	June/July 2001	Aug. 2001	Nov.	Aug./Sept. 2001	Nov.
Customers aware of the availability of indirect access	70%	53%	56%	85% (small) 92% (medium)	85% 92%
Customers using indirect access	12%	12%	13%	25% (small) 39% (medium)	26% 44%

2.20 BT's assertion that customer awareness of IA is rising appears to be based on a comparison of its own surveys for June and July 2001 with earlier Oftel surveys (from February and May 2001). This comparison may not be valid as the higher level of awareness found in BT's surveys may reflect differences in the sample or in the form of the questions rather than a change over time. Indeed, the form of the question on awareness in Oftel's survey changed in May 2001. Oftel's August 2001 residential customer survey found no change in awareness compared with the previous quarter and the November survey found only a small

increase. Evidence from the November survey suggests that, on a comparable (ie pre-May) basis, the figure for customer awareness would now be 40%, compared to 33% in February 2001.

2.21 Similarly, there appears to have been no significant change since May in the proportion of residential customers using IA. However, there is evidence of a decline in the proportion using IA for all of their calls. Use of IA by business customers seems to be increasing.

2.22 The November survey confirmed that billing issues are a barrier to using IA for about 10% of residential customers. Some 6% quoted the "hassle of two bills" as a reason for not using IA whilst 5% mentioned complicated billing. This is comparable to numbers referring to the need to dial extra digits (6%). In addition, 7% of businesses in the November survey said that billing issues were a reason for not using an IA operator.

Customer switching

2.23 The August survey found that 8% of residential fixed telephone users had switched supplier in the last year compared to 9% in the February survey (the question was not asked in May). There appears to have been little change in rates of switching since March 2000 (the November survey in fact suggests a slight fall but this may be anomalous and will be checked in future surveys). Of those that switched, 92% found the process easy and use of number portability appears to be increasing: 58% of customers who switched in the last year kept their number compared to 35% of those who switched more than a year ago.

2.24 In August/September, 10% of small and medium-sized businesses had switched operator in the last year, of which 90% had ported all their numbers. In the November survey, 7% of businesses had switched in the last year. In both surveys, about 90% of switchers had found the process easy.

Market shares - retail access

2.25 Table 2.4 shows trends in BT's market shares to June 2001.

Table 2.4: Market shares (number of lines)

		Operator share (no. of lines)	Operator share (no. of lines)	Operator share (no. of lines)
Market segment		September 1999	September 2000	June 2001
Residential Customers	BT	83.0%	80.3%	81.5%
	Cable	16.3%	19.0%	17.9%
	Kingston	0.7%	0.7%	0.6%
Business Customers	BT	90.1%	88.5%	88.2%
	Cable	8.2%	9.2%	9.0%
	Kingston	0.5%	0.6%	0.7%
	Others	1.2%	1.7%	2.0%

Source: Oftel Market Information

2.26 BT's share of residential lines increased between September 2000 and June 2001 at the expense of cable operators. There appears to have been a small fall in its share of business lines but this remains around 90%.

Market shares - retail calls

2.27 Table 2.5 shows trends in BT's shares of calls markets to June 2001. BT's shares are declining at a faster rate than in access. There have been particularly significant reductions in BT's share of residential national and international calls since September 2000. Combined with the data on share of lines, this suggests that IA may be having increasing impact. However, BT's revenue shares are still over 50% in all markets except international calls for business customers, which suggests that it is likely to be dominant in most calls markets.

Table 2.5: Market shares (calls)

	% Market Share July - Sept 1999		% Market Share July - Sept 2000		% Market Share April - June 2001	
	Volumes	Revenues	Volumes	Revenues	Volumes	Revenues
Residential customers						
Local calls	77.6%	79.8%	75.0%	74.9%	77.6%	73.5%
National calls	78.3%	80.6%	74.5%	75.3%	66.1%	67.5%
International calls	60.0%	69.8%	53.8%	66.6%	48.3%	58.6%
Calls to mobiles	72.2%	74.3%	71.5 %	72.0%	71.9%	69.6%
Business customers						
Local calls	64.4%	70.8%	60.5%	68.3%	55.5%	66.1%
National calls	54.4%	60.6%	46.6%	60.7%	43.0%	57.5%
International calls	23.9%	39.4%	22.3%	42.2%	23.2%	40.0%
Calls to mobiles	60.7%	59.4%	55.1%	55.6%	52.5%	50.8%

Source: Oftel Market Information. Market shares have been adjusted to allow for the fact that some operators do not provide separate data for business and residential customers. In addition, Worldcom's submitted national minutes and revenues have been apportioned among local calls, national calls and calls to mobile. BT includes Concert for these purposes.

Entry by broadband and other operators

2.28 There has been significant growth in take-up of broadband service using ADSL and cable modems but from a low base. Demand for LLU has continued to be much lower than originally expected. In total, even allowing for the rapid pace of growth in the last two quarters, fewer than 1% of homes and businesses are thought to be using broadband Internet access.

2.29 Fixed Wireless Access is still only available in limited areas. Moreover, Atlantic, which provided a narrowband service mainly to customers in Scotland, has recently entered into administration.

Complaints and quality of service

2.30 At the time of the publication of *Competition in the Provision of Fixed Telephony Services*, there appeared to be a decline in some aspects of BT's quality of service. This trend was reflected in the number of complaints to Oftel concerning faults and the time taken to repair them.

2.31 More recent data suggest that this decline may have been temporary and performance in April - June 2001 (the latest period for which data are available) appears to have been restored to early 2000 levels. This has similarly been reflected in a fall in the number of complaints to Oftel. The number of complaints to Oftel about BT per 1000 BT customers is slightly below the average figure for all providers of fixed telephony (see *Consumer complaints to Oftel* www.oftel.gov.uk/publications/consumer/comp1101.htm). Generally, comparable performance indicators also suggest that BT's quality of service compares favourably with that of other operators.

Competition in international markets: International direct dial (IDD) review

2.32 In November 2001, Oftel published the results of its review of competition in IDD markets at both the wholesale and retail levels. The main conclusions regarding market definition and competition at the retail level are summarised below. These will be adopted for the price control review.

2.33 Oftel defined a single retail market for all those routes where competition at the wholesale level was effective. On routes which were not effectively competitive at the wholesale level, retail markets were defined on a route by route basis. Oftel also defined separate markets for calls by business and residential customers on the grounds that widespread price discrimination suggested that competitive conditions differed between them.

2.34 Oftel found residential retail IDD markets to be increasingly competitive, rather than effectively competitive, on all routes. Oftel also concluded that, on routes which are effectively competitive at the wholesale level, the business retail IDD market is effectively competitive. On routes where the corresponding wholesale route is not effectively competitive, the business retail IDD market is increasingly, but not yet effectively, competitive.

Customer segmentation

2.35 Several respondents to *Competition in the Provision of Fixed Telephony Services* commented that Oftel should, in its competition analysis, differentiate to a greater extent among residential customers on the basis of usage. In response to this, Oftel examined a number of indicators from its surveys of residential customers in which separate customer groups are identified according to the level of expenditure on telecommunications services.

2.36 The survey results suggest that, as might be expected, awareness of IA is higher amongst higher spenders and there is a tendency towards higher use of IA amongst higher spenders.

2.37 Similarly, higher spenders tend to be more likely to have switched supplier within the last 12 months, although the relationship between switching and spend in general is by no means clear cut, with relatively high rates of switching more than twelve months ago found amongst the lowest spenders. The reasons given for not switching supplier do not vary markedly by spend. Satisfaction with the fixed phone as the main method of calling is consistently slightly lower amongst heavier spenders.

2.38 It is perhaps slightly surprising that the survey data do not show a stronger decline in awareness and use of IA as spend declines. IA might be expected to appeal mainly to high spenders, with almost no use amongst lower spenders, but this expectation is not borne out by the survey data. Even amongst those spending less than £30 per quarter, 7% in the November survey and 10% in the August survey said that they were using IA. It is not readily possible to identify a spend level below which IA has little or no impact.

2.39 It may therefore be that low-spenders' use of IA is simply very infrequent, as might be expected given that those low spenders who benefit from the LUS are not entitled to use IA. The survey does not indicate how often respondents use their IA operator, although it excludes former users who no longer use IA.

2.40 Differences in prices and profitability may also indicate differences in market competitiveness for different groups of customers. It would generally be expected that prices and profits would be highest where competition is least effective. However, as noted above, business and higher spending residential customers are likely to be BT's most profitable, whilst the revenue from the lowest spenders does not cover (fully allocated) costs. This reflects the fact that the line rental does not cover the (fully allocated) costs of providing the line and is a much greater proportion of the bill of lower spenders. High spenders are profitable because of the high profitability of calls. This is shown in Table 2.6. Note that in this document, the term 'line rental' or 'rental charge' is used for convenience even though at present BT's quarterly fixed charge also includes an allowance of free calls (ie an inclusive call allowance).

Table 2.6: Profitability of BT residential customers by spending deciles

Customer decile	00/01 ROCE
1	-9.2
2	-1.2
3	3.1
4	5.2
5	7.4
6	9.9
7	13.0
8	17.7
1-8	5.8
9-10	35.0
Total	11.7

Source: BT The full methods of attribution, accounting and valuation have not been disclosed to Of tel.

2.41 A more relevant question might be whether call prices differ depending on call spend. BT has provided information to Of tel on how the value of inclusive call allowances (ICAs) and discounts, as a proportion of customer bills, varies by spend level (although this has not been reconciled to the Financial Statements and Of tel has previously noted some concerns about the methods used by BT to

calculate and attribute discounts). BT's ICAs offer proportionately greater savings for lower spenders. On the other hand, BT offers discount packages which allow the user to benefit from reduced call charges in return for payment of a fixed fee, some of which also feature enhanced ICAs. These are therefore most attractive to higher users. Taking into account both ICAs and discounts, the differences between average prices paid by low spending and high spending residential customers appear likely to be relatively small.

2.42 It is difficult to draw firm conclusions from this because the design of BT's ICAs and discount packages reflects not just the impact of competition but also regulation, in particular the retail price control. However, the profile of average call prices by spend, taking account of discounts and free calls provided in the form of ICAs, appears broadly consistent with the survey results outlined above. Both suggest that competitive pressure tends to increase with spend but that there is no obvious threshold of spend at which calls markets become competitive.

Price of operator assisted calls ('OA' calls)

2.43 A number of respondents felt that the market for OA calls was at least potentially competitive. They argued that OA could feasibly be provided by operators other than the access line provider but that at present the costs of billing made such competition uneconomic. Until competition becomes fully effective, Oftel believes that OA prices should continue to be subject to price control. It does not however propose a separate control for OA services.

Price of calls to mobiles

2.44 BT is currently subject to a separate control on its retail retention on calls to BTCCellnet and Vodafone. The retention is subject to a cap set at RPI-7% per annum.

2.45 Competitive conditions in the provision of retail calls to mobile are broadly similar to those for other call types. The calling party is able to respond to increases in the retail price of calls to mobiles by switching his (originating) network. Whilst returns on calls to mobiles are lower than on other call types and this may have discouraged some IA operators from offering them, BT's share of calls to mobile minutes is similar to its shares of local calls and national calls. IA allows BT's customers to choose to have their outgoing calls routed by alternative operators through the use of short access codes. In addition, calls to mobiles are available from Carrier Pre-Selection ('CPS') operators under the all calls option. CPS allows BT's customers to choose to have their outgoing calls routed by alternative operators without the need for the customer to dial additional initial digits directly or via an auto-dialler as is the case with IA. Oftel therefore proposes to include the retail retention on calls to all four mobile networks in the new retail basket, rather than make it subject to a separate control.

2.46 It should be noted that competitive conditions in the retail provision of calls to mobiles are intrinsically different from those in the provision of mobile call termination. The latter largely reflect the fact that, under the calling-party pays principle there is little incentive for the called party to change his or her mobile network in response to an increase in call termination charges. Oftel's proposal for the retail control on calls to mobile prices is therefore entirely consistent with its proposals for individual controls on mobile call termination charges.

Conclusions on competitiveness

2.47 In the light of responses to *Competition in the Provision of Fixed Telephony Services* and other new information, Oftel believes that access and calls markets are not effectively competitive (with the exception of the competitive business IDD markets identified in the IDD review). However, competition is increasing and there are good prospects for effective competition in retail calls markets if the remaining barriers are addressed. Existing policies address these problems to some extent, although there is currently no policy to address one of the main barriers identified: the current need for IA and CPS customers to pay two bills.

Chapter 3

Policy objectives and proposals

3.1 As set out in chapter 2, Oftel believes that BT remains dominant in the access market. In addition, despite a slow decline in its market share of residential national and local call volumes (BT's share is now 61% and 71% respectively), Oftel believes that BT retains a position of dominance in calls.

3.2 BT's market power in the calls market has resulted in call prices being above the competitive level, as can be inferred from the high returns made by BT on all types of calls.

3.3 Oftel has constrained BT's pricing behaviour since it was privatised in 1984 because of BT's market power. If Oftel had not taken such action BT would have been able to exploit its dominant market position by raising prices. So Oftel has imposed price controls limiting BT's freedom to increase prices for a group of services, notably access (connection and line rental) and calls.

3.4 Price controls and increasing competition have been successful in bringing benefits to consumers: prices are now over 50% lower in real terms than they were in 1984. However, there remains an imbalance between BT's high profits on calls and low returns on access, and this is not a sustainable pricing structure in the face of fully effective competition in calls markets. Competition in calls markets is not yet effective, but it is growing and can be expected to continue to grow. If competition in calls markets can be made fully effective, the movement towards a more balanced tariff structure will benefit most customers in terms of lower prices overall and greater choice of product and provider. Oftel therefore intends to stimulate competition in calls markets and to allow BT to increase its rental charge to the extent that this is necessary for it to be able to recover its overall costs in the face of falling call profitability.

Promoting effective competition in calls markets

3.5 The competition that has been delivered through IA is being enhanced by the full introduction of CPS from December 2001. In the case of 'all calls CPS', BT's customers can choose to have an alternative supplier route all their local, national and international calls and calls to mobiles. In these circumstances, BT would bill the customer only for the line rental.

3.6 A number of respondents to the consultation argued that these developments by themselves will not lead to effective competition as customer inertia, resistance to receiving two bills and the customer's ongoing relationship with BT will limit progress. They argued that a new product should be available which enables them effectively to lease BT's exchange line and so include the charge for BT's line rental on their bill. The provider would decide how best to route the customer's

calls and how the line rental costs should be recovered, for example through call charges or through a monthly/quarterly rental charge or both. From the customer's perspective the sole relationship for the provision of service would be with the alternative provider. Providers of IA and CPS argue that a new access product would encourage new players into the market with established and trusted brands.

3.7 BT's current Calls and Access tariff is aimed at the resale market. However, the competitive impact of resale depends to a large extent on the terms on which resellers gain access to BT's network. IA and CPS providers argue that the terms on which access to BT's exchange line has so far been provided have significantly limited the extent to which competition to BT can develop. However, since November 2001, the price of the line rental under Calls and Access has been reduced to £31.37 per quarter before VAT bringing it closer to cost (on a CCA FAC basis).

3.8 Oftel therefore believes that many of the conditions necessary for an expansion of retail competition are already largely in place, although their full effect has not yet been felt. CPS has eliminated the need to dial extra digits in order to send calls via an alternative operator. Calls and Access permits the customer to use a CPS operator without the need to pay two bills and the price of that product has moved closer to cost in recent months. Awareness of price comparison aids such as the Phonebills website is increasing.

3.9 But Oftel believes that action is needed to accelerate this welcome trend. In particular, what remains to be done is to formalise the requirement to provide a suitable cost-based access product by making its provision a requirement of BT's licence, ensuring that adequate and non-discriminatory prices and quality are maintained and making its price subject to an appropriate level of control, if a control is necessary. The charge for the wholesale access product will be geographically uniform.

3.10 Oftel believes that the introduction of a new wholesale line rental product could provide an additional stimulus to competition and encourage new players into the market. In addition, by allowing providers to offer both calls and access, innovative approaches to tariffing could develop changing the 'balance' between the line rental and call charges. It may lead to similar packages to those now available in the mobile market, for example to a greater availability of 'free' calls within line rental charges or the replacement of or reduction in rental charges with some part of rental costs being recovered through call tariffs.

3.11 Oftel's research *The Importance of Brands in the Telecoms Market: Qualitative Report* published in November 2001 confirms the importance that telecoms customers place on well established brands (www.oftel.gov.uk/publications/research/2001/bran1101.htm). It also suggests that customers' views differed on the benefits of having one bill rather than separate bills for rental and calls. Some favoured a single bill for convenience; others preferred separate bills so that expenditure could be monitored more

closely. The new access product would allow competitors to provide single bills. Both existing and potential competitors to BT would be able to offer a choice to their customers of single billing or of separate bills with either IA or CPS.

3.12 Oftel proposes that BT should be required to provide the wholesale line rental product (and related products such as connection and takeover) and this allows competitors to offer single bills to end-users for all telecommunications services. These products would enable the purchaser to take on the retail relationship with the customer so that all interactions would be with the reseller and not BT. This would be in contrast to IA under which the retail customer retains a contractual relationship with BT through the provision of the line. Oftel proposes to modify BT's licence specifically to require it to provide this product and other related products such as connection and take over. The modification would be made in a way that required BT to provide the product to anyone wishing to offer telecommunications services to end-users. Oftel's initial view is that this would not be an interconnection product as it would in large part be an enhanced replacement for the current Calls and Access product with a firmer regulatory base, rather than an interconnection product as commonly understood. This product would be subject to the same provisions as Standard Services.

3.13 Oftel believes that the price of this product should be based on BT's costs in providing the service, including the contribution to common costs deemed to be recovered from the access service in the setting of interconnection charges under the Network Charge Control. At present BT's residential PSTN line rental is set below this level, and the common costs deemed to be recovered from access are in fact recovered through profits on calls. As calls markets become more competitive, it will be increasingly difficult for BT to recover costs in this way. In addition, in respect of customers taking calls and access from a reseller, BT would receive no retail revenue. A wholesale charge based on BT's retail line rental could therefore be unsustainable against a background of increasing competition in calls markets, unless BT were to raise the line rental at an unacceptably rapid rate.

3.14 Oftel therefore proposes that the charge for this service should be based on BT's costs rather than its retail price. To ensure competitive neutrality, Oftel believes that the pricing, product and quality of service parameters of this new product should be available on non-discriminatory terms. A consequence of the provision of this service is that Oftel might need to change the definition of certain of BT's Businesses. There would therefore be a case for separating BT Access into network and retail Businesses for accounting purposes in order to monitor this.

3.15 In relation to conveyance services, Oftel proposes to leave the current position unchanged in line with its initial view that the new product is not an interconnection service. Condition 69 conveyance will therefore remain available only to those telecommunications providers that interconnect with BT. Those that do not interconnect can purchase conveyance services from other suppliers.

3.16 It is recognised that the introduction of a wholesale line rental product could lead to reseller marketing activities (such as doorstep selling) similar to those experienced in the energy markets. These issues are explored further in chapter 4.

3.17 Oftel proposes that these requirements shall take effect as soon as possible. chapter 4 discusses the development of the new product in more detail.

Oftel invites views on:

- **the introduction of a wholesale line rental product; and**
- **the extent to which service delivery procedures agreed for Call & Access are appropriate for the new product, the extent to which they need to be extended and improved and how far this improvement could and should be achieved through formal regulatory action as opposed to a co-regulatory route**

Protecting customers as call prices fall

3.18 Oftel believes that another retail price control similar to the current one is not appropriate in the current circumstances, with the expectation of increasing competitive pressures in calls markets. The current cap relies on the continuation of excess profits from business and high-spending residential customers to finance losses (measured on a consistent basis) on lower spending customers (see table 2.6). This would not be sustainable in a world where increased competition is expected to eliminate persistent excess profits.

3.19 However, the impact on the market of IA, CPS and a new wholesale access product is difficult to predict with any certainty. Competitors to BT may take time to emerge and may seek to compete on tariff structure and quality as much as price. Given this uncertainty, Oftel believes that consumers would not be protected adequately if all price controls were removed immediately.

3.20 As explained above, Oftel believes it would be appropriate to allow BT to cover the costs of the provision of a line and to raise the line rental to some extent to offset call price reductions provided that those reductions were driven by competition. However, Oftel does not wish BT to be able to raise the line rental unless and until competition brings down call prices. Oftel believes that it is appropriate for changes in rentals and call prices to be linked within a price control basket. If such a basket were 'broad', containing all services supplied to all customers, there would be a danger that BT would have an incentive to raise rentals and cut call prices in the absence of competitive pressures. Oftel therefore

prefers a 'narrow' basket including services supplied only to some groups of lower spending customers. Because of the high weight of the line rental in such a basket, BT would have to cut call prices very substantially to offset rental increases, and so would not wish to change the structure of its prices unless competitive pressures forced it to do so.

3.21 As noted above in 3.18, with competition becoming increasingly effective, especially in respect of services to higher spending customers, a cap set on the same basis as the current control would not be sustainable. Nevertheless BT remains dominant in the provision of access and, for the time being, calls. It continues to be necessary to prevent BT from exploiting its market power to the detriment of consumers. Given the modest level of profitability of the lowest spending 80% of residential customers, Oftel believes that a safeguard control which would allow no nominal price increases (ie it would be set at RPI-RPI) would provide the appropriate level of protection for customers, while allowing BT to respond to increased competitive pressure in calls markets. Thus Oftel proposes a control under which the overall level of prices in the basket would be held constant in nominal terms, but BT would be free to adjust the balance of charges within the control. Oftel proposes that the safeguard controls should be:

- applied to the spending patterns of the lowest 80% of residential customers; and
- based on the same basket of services – access, local, national and IDD calls and calls to operator assistance – but with the addition of BT's retention for calls to mobiles.

3.22 A control set at RPI-RPI has the potential to become unduly onerous for BT if inflation turns out to be unexpectedly high. In order to avoid this, the control will be limited to RPI-5% if inflation is greater than 5% per year.

Oftel invites views on the introduction of a RPI-RPI safeguard control to maintain a linkage between line rental and call prices until competition becomes the determinant of call prices.

Trigger to remove controls

3.23 Oftel has to consider the implications for this new price RPI-RPI price control if and when competition develops as intended. The further competition develops, the greater the risk that such a control could prevent BT from recovering its costs. The returns from the lowest spending 80% of residential customers are below the cost of capital, as shown in Table 2.6. Profits from other higher spending customers allow BT to recover its costs overall. If competition develops as intended, the profits that BT makes outside the basket on calls will be competed away and the control may eventually not be sustainable for BT.

3.24 Therefore, it is necessary to introduce an arrangement to remove the RPI-RPI control as competition reduces BT's call profits. Oftel proposes that there should be a trigger that would remove the control. The trigger could be expressed in terms of market share, return on capital employed or prices. Using return on capital employed or market shares as the point when triggers would be activated would give BT perverse incentives. If return on capital employed were used, BT would have an incentive to become less efficient and thus reduce profitability. If market shares were used, there would be an incentive for BT to lose customers which would be in complete contrast to the desirable incentive properties of competitive markets where companies strive to retain and gain customers. Oftel therefore believes that basing the trigger on prices would be preferable since it would have the correct incentives and be more meaningful to consumers.

3.25 It is proposed that removal of the price control would be triggered once call prices had fallen by a significant amount. The level of the trigger would be set taking into account the impact of reduced call prices (for business and residential customers from an agreed date) on BT's returns. For example, a 50% reduction in BT's call prices would reduce BT's end-to-end rates of return on calls to around 25%. To provide certainty to BT, Oftel believes that the trigger should be measurable and automatic, ie not subject to discretionary checks by Oftel. There would nevertheless be provisions for the reinstatement of controls if prices rose significantly again above the trigger level. If the trigger had not been activated within two years of the introduction of the control, the continuation of the control would be reviewed as part of the regular review process required under EC Directives.

3.26 It is important to emphasise that the activation of the trigger would not be equivalent to a judgement that the market was effectively competitive. That assessment will be made through regular market reviews required by the Framework Directive. It would, however, reflect a judgement that competition in the market had reached the level whereby an RPI-RPI control was no longer appropriate. There would still, however, be a case for some less intrusive regulatory action on the basis described below.

Oftel invites views on:

- **the principle of a non discretionary trigger to remove the control when call prices are competitively determined;**
- **the proposed use of call prices for the trigger;**
- **possible levels of a trigger.**

3.27 In addition to the price control, Oftel proposes that there should be a bill constraint of RPI+0% on the amount by which the bills of customers in deciles 3, 4 and 5 could increase. This is an important provision, because increases in the line rental, even combined with reductions in call prices, are likely to increase the bills of some of the lowest-spending residential customers in the absence of measures to prevent this.

3.28 The RPI+0% safeguard could apply either as a separate constraint on each decile 3-5 or across deciles 3-5 effectively as a 'basket'. The latter would give BT greater freedom to recover a greater share of common costs from the line rental. The former would provide a greater level of protection for lower spending customers in respect of the line rental but could restrict the rate at which BT could adjust its prices in response to greater call price competition. An alternative approach to a control on separate deciles could be to extend the Light User Scheme, which provides for reductions in the line rental for BT customers in deciles 1 and 2 who make few calls (see paragraphs 3.34), to customers in decile 3.

3.29 BT has argued that such a control is not necessary, as the RPI-RPI control could be based instead on the spending patterns of customers in the third to fifth deciles.

3.30 Oftel believes that two separate measures are required because they address two distinct objectives. The purpose of the RPI-RPI control is to prevent BT from exploiting its market power before competition is effective. It is designed to allow BT to offset reductions in call prices made in response to competition by increases in the line rental, but not to give BT an incentive to pre-empt competition by raising the line rental in advance of competition forcing call prices down. This incentive is provided by weighting the basket towards the spending patterns of the lowest spending 80% of customers.

3.31 The objective of the RPI+0% constraint, by contrast, is primarily to make sure that vulnerable customers are not made worse off. Oftel believes that this will remain necessary even after the removal of the price control has been triggered by the development of competition in order to prevent increases in the bills of the lowest-spending residential customers.

3.32 The danger, therefore, of trying to use a single measure to address both objectives is that neither is achieved. In particular, a cap focused on deciles 3, 4 and 5, collectively or individually, could be satisfied without general reductions in call prices. For example, it could be satisfied by call price reductions targeted at decile 3, 4 and 5 that might not benefit customers outside this narrow group.

Oftel invites views on whether the RPI+0% control to safeguard customers from increases in bills should be applied as a 'basket' control including deciles 3 to 5 or applied to each individual decile.

Ongoing protection for low spending customers

3.33 Existing Universal Service measures would remain in place to ensure that vulnerable customers do not experience significant increases in their bills.

3.34 Under the Light User Scheme (LUS) users receive a rebate on the rental if call charges are less than £15.95 per quarter (excluding VAT). For every 1.0p that the call charge falls below this amount, the customer receives a rebate of 1.078p (excluding VAT). The maximum rebate is £17.19 (excluding VAT), and applies where no chargeable calls have been made. LUS currently has around 2 million customers, forming most of the lowest two deciles of BT customers by spend. Oftel's Statement *Universal Service Obligation* published in August 2001 stated that Oftel would review the Scheme again in 2003. However, Oftel believes that a RPI+0% safeguard and, as discussed 3.28, an extension to include customers in the third decile may be needed.

3.35 In addition, BT's prices for basic services are currently required to be averaged geographically. This requirement will continue. This means that such services are priced at the same level throughout the UK even when there are regional differences in the cost of provision. Geographic averaging delivers the benefits of competitive price levels nationally, rather than just in geographic areas where competition is strongest. Also, it ensures that telephony is affordable in areas where the high costs of provision would otherwise disadvantage certain groups of customers.

3.36 Oftel believes that the overall limit on increases in bills (RPI+0%) on deciles 3, 4 and 5 should continue once the proposed trigger has been activated and the controls removed. The objective would be to ensure all categories of customers should be guaranteed that their bills would not increase in real terms. It is questionable however whether users of IA or CPS should be covered by bill protection since they are likely to be benefiting already from reduced call charges. In these circumstances it may not be appropriate for other BT customers effectively to subsidise their line rental.

3.37 Oftel also believes that there is a continuing need for a ceiling on the retail line rental to ensure that it does not rise above cost. Although the new cost-based access product should eventually provide sufficient competitive pressure to prevent BT from pricing line rental above cost (in practice the wholesale access charge plus an allowance for retail costs), Oftel would wish to ensure that the retail access market was competitive before removing such a control. Oftel would assess the level of BT's market power in access as part of the regular market review process.

Oftel invites views on:

- **the appropriate form of continuing protection of low spending following the removal of controls; and**
 - **the need to protect IA and CPS users**
-

Ensuring the arrangements for low spending customers are sustainable

3.38 As long as competition is not effective, the cost of measures to protect vulnerable customers can be borne by BT out of profits made from higher spending customers as an offset to the benefits that accrue to the BT brand from its position as an USO provider. Once competition is effective, this may not be sustainable and could represent an unfair burden on BT.

3.39 In these circumstances, European legislation allows for the funding of such social protection measures through public provision, cost sharing by operators or a mixture of both. In the case of joint funding by operators, Oftel would wish to ensure that providers other than BT (and Kingston Communications in the Hull area) could compete to be providers of universal service.

3.40 Oftel proposes to next review the provision of USO in 2003. In determining the way forward Oftel will take into account:

- the implementation and take-up of the new access product and the effects on competition;
- the extent to which BT is able to meet its USO obligation through high call profits; and
- any changes in the level of protection required.

Quality of service

3.41 Improving service quality has always been an important objective for Oftel. The approach adopted by Oftel has been to promote quality improvements through monitoring and publication of comparative performance statistics, combined with the pressure of competition, rather than to incorporate quality requirements into the controls or to specify quality targets. This is because making quality an explicit part of the control in a way which accurately reflected customers' valuations of quality improvements would be extremely complex. Explicit targets are also difficult to set and frequently create perverse incentives. However, Oftel has stated that it will take appropriate action to ensure service quality levels are acceptable should any major problems arise. This could include, if necessary, re-considering the level of intervention needed in the retail market.

3.42 The importance of quality of service is likely to be re-emphasised in the forthcoming National Audit Office report into the Network Charge Controls. This importance will continue under the arrangements to succeed BT's current retail price control. Indeed a new dimension is created by the proposal to require a wholesale access product to be made available to other operators. This is because there might be an incentive for BT to provide its own retail customers with a higher quality of service than it provides to customers of its competitors who use the wholesale access product. Experience with the existing Calls and Access product also suggests that quality of service issues can arise in services targetted at resellers quite as much as in relation to interconnection products. Therefore, it

will be necessary to ensure that BT maintains high quality of service, for example in relation to line fault rates and fault repair times. Moreover, BT must also provide competitors purchasing the wholesale access product with service quality that is at least as good as that enjoyed by its own retail arm. There will therefore be a non-discrimination requirement relating to the quality of the wholesale access product. Without this, the other aspects of Oftel's proposals would not be a proportionate response to BT's market power. This is not however a radical departure from Oftel's past approach to retail quality of service, although it is now a more explicit part of the overall 'package'.

Other issues

3.43 There is a licence requirement on BT not to increase the rental charge for hardwired phones in real terms, ie RPI+0%. This also expires on 31 July 2002. Over 300,000 customers have hardwired phones and, given the absence of competition in the provision of hard-wired phones and the costs involved in switching to a plug and socket connection, Oftel proposes that they should continue to retain this protection.

Oftel invites views on the proposal that customers who use hardwired phones should continue to be protected by a control on the rental of the phone set at RPI+0% and views on the duration of this control.

3.44 The focus of the proposed safeguard controls is on lower spending residential customers. However, the pattern of usage of some small business customers is similar to that of a moderate spending residential customer. As part of the current price control package, BT has given a voluntary assurance - the 'Small Business Safeguard' - to offer a package to small businesses that is equivalent to that offered to residential customers. In addition BT agreed that the line rental for small businesses would not increase by more than RPI each year.

3.45 Oftel believes that BT should continue to provide an RPI+0% cap on line rental under the new arrangements because BT will remain dominant in the provision of access. However, increased call price competition may reduce the need for an undertaking to provide an overall package equivalent to that offered to residential customers. Alternatively, because the pattern of usage of small business and moderate residential users is expected to remain similar, it may be appropriate to maintain this undertaking until the safeguard price controls are removed.

Oftel invites views on:

- **the proposal that the line rental protection for small businesses should continue;and**
 - **whether the undertaking to offer a package equivalent to residential users should continue to be provided.**
-

3.46 In summary, Oftel's proposals are:

- to seek to increase competition in the calls market by requiring BT to provide all providers of telecommunications services on request with cost based wholesale line rental;
- to ensure BT does not raise line rentals in the absence of call price reductions;
- to establish a mechanism by which price controls would be removed once call prices are reduced to a pre-set level; and
- to ensure that vulnerable customers continue to be protected and ensure that these arrangements are sustainable in an effectively competitive market.

The policy proposals				
1	2	3	4	5
New wholesale line rental product to stimulate competition	Safeguard controls RPI-RPI basket & RPI+0% on deciles 3-5	Automatic removal of RPI-RPI control	Ongoing protection RPI+0% on deciles 3-5 and cost based ceiling on line rental	Alternative methods of funding social measures
From August 2002		When call prices fall by x%		When competition effective

Chapter 4

Implementation issues

4.1 In chapter 3, Oftel set out proposals to encourage competition in calls markets by requiring BT to provide wholesale line rental to anyone wishing to offer publicly available telecommunications services. This measure could bring significant changes in the way services are marketed and delivered to customers and would require the industry to reach contractual terms on which it is available. In addition, Oftel needs to consider whether the safeguard price controls need to be stipulated within BT's licence. These issues are considered within this chapter.

Consumer protection: wholesale line rental

4.2 In chapter 3, Oftel explained that competitive pressure in calls markets could be increased with the advent of wholesale line rental. Oftel believes that BT should be required to provide wholesale line rental to anyone wishing to offer publicly available telecommunications services and that this product should be based on BT's costs in providing the ongoing service including maintenance of the line.

4.3 It is possible that the availability of the wholesale line could bring significant changes in the way services are marketed and delivered to customers. There are issues that will need to be established in the service level agreement before wholesale line rental is made available, such as fault reporting.

4.4 Other issues that Oftel believes need to be considered include:

- door step selling;
- transfer of service;
- debt blocking (the level at which a customer's outstanding debt could prevent a transfer);
- 'winback' activities during the transfer process;
- need for independent information for customers; and
- handling of customer complaints and network problems.

4.5 Some of these issues have been considered in the context of the implementation processes for number portability, Call & Access and CPS. However, Oftel is currently consulting on improving the provision of accurate information to customers by development of an accreditation scheme for price comparison websites. There is also much relevant experience to be gained from the energy sector. Oftel proposes to lead a working group with appropriate consumer and industry representation to consider how best to tackle these

practical implementation issues. Oftel hopes that this group would be able to begin work during the consultation period, so that its initial work can help to inform details in the final decision. The working group would be expected to recommend how and by when any measures that it proposed should be implemented, for example by formal regulation or voluntary codes of practice.

Pricing of wholesale line rental

4.6 In Annex E to *Price Control Review: Proposals for Future Retail Price Controls*, October 2000, Oftel stated that, if introduced, the price of wholesale line rental should be consistent with the price for unbundled local loops. The price for unbundled local loops is based on long-run incremental costs and includes a mark-up for common costs. A major difference in the prices of the two products would be that wholesale line rental would not include charges for services specific to unbundling the local loop. The charge for LLU, however, does not include costs of components that are provided by the operator buying the 'loop' or which were charged for separately, notably the costs of the line card and of exchange accommodation. As with LLU, the charge for wholesale line rental will exclude the costs of retail activities that BT does not incur when providing the wholesale product.

4.7 Oftel has not accepted arguments that the charge should be based on BT's present retail price less retail costs. This could potentially be unsustainable if BT's supernormal call profits were eroded ie BT might not be able to cover its costs.

4.8 Oftel has not yet reached a firm view on the appropriate charge for wholesale line rental. However, Oftel notes that, the November 2001 change to the charge for the access element of Calls and Access reduced the rental to £31.37 per quarter before VAT. This charge is within the current range of estimates of cost on a CCA FAC basis. On the basis of information provided by BT, the charge for wholesale line rental is likely to lie within the range £29 and £31 before VAT per quarter. Oftel will pursue further the question of the appropriate cost of this service with BT in the course of the consultation and make definitive price proposals based on this work in due course.

4.9 As noted earlier, Oftel proposes that this service should be provided subject to a requirement that BT does not discriminate unduly in favour of its own retail customers. BT would therefore be subject to similar requirements in terms of accounting provisions as it is for Standard Services. This does not mean that BT will be forced to raise the retail line rental above the wholesale rental charge, since the availability of this product means that other operators would have the same ability as BT to finance losses on access from profits on calls given the availability of interconnection services from BT or its competitors at cost-based rates.

Connection and ancillary services (eg directories and network services)

4.10 Oftel has not examined the appropriate costs for services other than the wholesale line rental. However, anyone offering wholesale line rental would be permitted to attract new customers and therefore they need to purchase wholesale products equivalent to BT's retail connection and take over charges. BT would therefore charge the competitor for connection, if a new installation, or take over if a pre-existing connection. In addition, competitors might wish to offer directories and network services, such as Call Waiting, to their customers. Oftel intends to set charges for all these services consistent with those it proposes to set for wholesale line rental. However, Oftel does not intend to delay setting a charge for the wholesale line. Therefore, until Oftel has set charges for these additional services, competitors would need to pay for these services at the Calls and Access rates set out in Section 3, Part 3 of BT's Retail Price List.

Conveyance

4.11 Conveyance can be bought from BT in three ways: retail customers can purchase calls priced at retail prices only; service providers can purchase calls priced below the retail price by virtue of BT's product, Calls and Access; and interconnecting operators can purchase conveyance services based on incremental costs. Oftel does not currently propose to change this regime.

4.12 Under the proposals set out in this document, interconnecting operators could purchase cost-based wholesale line rental and interconnection conveyance services. BT would bill the interconnecting operator for wholesale line rental and any calls not delivered by 'all calls' CPS. The retail customer would not have a relationship with BT.

Obligation to supply

4.13 Oftel proposes to introduce a new condition to BT's licence that will set the charge for wholesale line rental (and the ancillary services referred to in paragraph 4.10) and set any such controls that Oftel believes will be required to ensure that the price remains based on costs.

Timetable

4.14 The major difference between wholesale line rental and Calls and Access rental is that Oftel proposes to modify BT's licence so that it is formally required to offer wholesale line rental. Oftel believes that the wholesale line rental product could be offered promptly. Oftel believes that the processes and staffing used to establish Calls and Access relationships could be a reasonable initial building block for the provision of wholesale line rental. Oftel believes that it would not be unreasonable to expect BT to provide the wholesale line as early as possible and certainly by no later than the end of 2002.

Price controls: voluntary or licence condition

4.15 Oftel needs to decide on the means by which the price controls are implemented and monitored. BT suggested that price control measures and safeguard restrictions on bills could be introduced on a voluntary basis through a contractual 'customer bill guarantee'. Consumer groups have expressed concern about the correct level of such a guarantee, its legal enforceability and arrangements for its regular monitoring and periodic review.

4.16 The circumstances in which using a voluntary approach is practical are likely to depend on the type of measure proposed. In the case of the proposed RPI-RPI control and trigger, BT might offer to introduce the RPI-RPI safeguard through a guarantee and to maintain it until an assessment established that the trigger should be activated and the safeguard removed. Oftel would need to satisfy itself that a voluntary commitment was the most appropriate way of ensuring that the policy was delivered. For instance, in the example above, Oftel would need to be able to establish that the RPI-RPI guarantee was being met and that the trigger was activated at the appropriate time. Oftel would also need to be in a position to take **immediate** action if BT did not meet the terms of the guarantee or sought to remove a guarantee unilaterally. Under current arrangements, Oftel could re-impose conditions only through a licence modification process following a market review. This process could take up to a year. If BT refused the licence modification and Oftel referred the issue to the Competition Commission, the process could add another year to the process. During this period, customers would not have the protection that they would have enjoyed if the requirements on BT had been established in its licence. Given the importance of the RPI-RPI control it may not be prudent to adopt the voluntary approach.

4.17 However, in the case of the proposed ongoing protection – the RPI+0% bill constraint and the cost-based ceiling on line rental – competition could be expected to provide protection to most consumers. Additionally, in relation to these protections, it would be possible to identify and compensate the particular customers disadvantaged by any failure on BT's part to abide by the voluntary assurances. In these circumstances, a voluntary approach may be preferable to long-term regulatory intervention.

Oftel invites views on the extent to which the measures set out in chapter 3 could be introduced on a voluntary basis.

Chapter 5

How to make comments on the questions raised in this consultation document

1. Oftel is publishing this consultation document so that interested parties may comment on the issues which it addresses. The closing date for submitting comments is 30 April 2002.

2. Where possible, comments should be made in writing and sent by e-mail to mike.galvin@oftel.gov.uk. However, copies may also be posted or faxed to the address below. If any interested parties are unable to respond in one of these ways, they should discuss alternatives with the Oftel manager named below:

Mike Galvin
Oftel
50 Ludgate Hill
London
EC4M 7JJ
Tel: 020 7634 8869
Fax: 020 7634 8924
e-mail: mike.galvin@oftel.gov.uk

Further copies of this document

3. This document can be viewed in the *Publications* section of Oftel's website at www.oftel.gov.uk, under classification *Pricing and price control*. Paper copies and alternative formats such as large print, Braille, disc and audio cassette can be made available on request. Please contact Oftel's Research and Information Unit by phoning 020 7634 8761 or by sending an e-mail to infocent@oftel.gov.uk.

Publication of comments made by stakeholders

4. On this occasion, Oftel is not programming a formal period during which interested parties may comment on the responses made by others. Nevertheless, in the interests of transparency, comments will be published, except where respondents indicate that a response, or part of it, is confidential. Respondents are therefore asked to separate out any confidential material into **a confidential annex which is clearly identified** as containing confidential material. Oftel will take steps to protect the confidentiality of all such material from the moment that it is received at Oftel's offices. However, in the interests of transparency, respondents should avoid applying confidential markings wherever possible.

5. Non confidential responses can be viewed on Oftel's website in the *Publications* section under *Responses to Oftel consultations*. Comments can also be viewed at Oftel's Research and Information Unit. Appointments must be made in advance (see contact details in paragraph three).

e-mail notifications

6. Oftel has a free e-mail based mailing list to help people stay informed about the work that Oftel is doing. Each time an Oftel document is published and placed on Oftel's website at www.oftel.gov.uk, subscribers to the list receive an e-mail alert. To register, please go to the *What's New* section of the website and access the electronic form.

The consultation criteria

Oftel considers that this document meets the Cabinet Office code of practice on written consultation documents. The code is reproduced below for convenience. If you have any comments or complaints about this consultation **process** please contact:

Oftel co-ordinator for the code of practice:

Robert Jex
Oftel
50 Ludgate Hill
London EC4M 7JJ.

e-mail: rob.jex@oftel.gov.uk

Tel: 020 7634 5350

Fax: 020 7634 8940

1. Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.

2. It should be clear who is being consulted, about what questions, in what timescale and for what purpose.

3. A consultation document should be as simple and concise as possible. It should include a summary, in two main pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.

4. Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.

5. Sufficient time should be allowed for considered responses from all groups with an interest. 12 weeks should be the standard minimum period for consultation.
 6. Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and reasons for decisions finally taken.
 7. Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure that all the lessons are disseminated.
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Annex A

Responses to consultation

A.1 In July 2001, Oftel published the consultation document *Competition in the provision of fixed telephony services*. This document kicked-off Oftel's review of competition in fixed telephony markets and thus the need for price controls. In competitive markets price controls are not required, as competition provides the competitive constraint on prices.

A.2 *Competition in the provision of fixed telephony services* set out Oftel's view on the relevant markets in which it would consider the extent of competition and it also set out the indicators that it would use to consider whether markets were competitive. As well as these, Oftel set out its preliminary views on the competitiveness of the relevant markets based on the indicators. Oftel sought views on its definition of the relevant markets, the competitive indicators set out and requested data on the extent of competition based on the indicators.

Responses, industry workshop and other meetings

A.3 Oftel received sixteen responses (representing the views of a cross-section of operators, service providers and consumer representatives) to *Competition in the provision of fixed telephony services* (one of which was confidential) and two comments on responses to the first stage of consultation. The respondents were (in alphabetical order):

1. BT;
2. Cable & Wireless;
3. Centrica;
4. Consumer Communications for England;
5. Energis;
6. National Consumer Council;
7. Northern Ireland Advisory Committee on Telecommunications;
8. Operators Group¹;
9. Powergen;
10. Public Utilities Access Forum;
11. Scottish Advisory Committee on Telecommunications;
12. Telewest;
13. TXU;
14. Virgin Energy; and
15. Welsh Advisory Committee on Telecommunications

Comments-on-comments were received from BT and Powergen.

¹ Cable & Wireless; Colt; Equant; Fibrenet; Kingston; ntl; Tiscali; and Thus

A.4 Oftel also hosted a workshop on 20 November 2001 to which public telecommunications operators and systemless resellers were invited. Twenty people attended this workshop representing eighteen companies. In addition, Oftel met all requests for meetings from operators, systemless resellers and consumer representatives, as well as seeking expert advice from external economic and consumer consultants.

Responses

A.5 The competition analysis set out in chapter 2 is based on responses and other data that Oftel has collected eg through its consumer surveys. There were generally three broad themes that either in part or in whole were reflected throughout responses. These were that:

- a) Competition was indeed increasing in all relevant markets or had increased to the extent that the price controls were no longer needed;
- b) Competition was indeed increasing in all relevant markets but would not be effective unless Oftel required BT to provide a wholesale 'access' product at a lower price than the access price for Calls and Access; or
- c) Competition was increasing but would not protect all consumers in which case social measures needed to be maintained or further price controls introduced until such time as competition was effective.

A.6 BT was not alone in believing that the time had come for price controls to be withdrawn. It pointed out that consumers in the bottom two deciles of spend and those in rural areas are protected by universal service measures under which it offers low price telephony services and prices that are geographically averaged. It also was not alone in believing that the market structure, as it is, was such that even if Oftel believed that competition was not effective now it soon would be. Above cost call prices were measured against below cost access. The sum of the two, BT argued, did not suggest that the market had failed but actually suggested that competition was vigorous and likely to increase still further what with the introduction of 'all calls' CPS and the availability of local loop unbundling.

A.7 Others were more sceptical about the level of competition or the likelihood that the present structure of the market was such that effective competition was imminent or was even possible.

Access

A.8 BT's dominance in access and its ability to leverage its dominance in this market through tariffs such as the inclusive call allowance was believed by some respondents to be an inherent weakness in the structure of the market. It was that the availability of an access product based on retail-minus pricing principles – and by retail-minus they meant a charge that was below BT's retail price rather than a

cost-based charge that would be higher than BT's retail price – could remove a major barrier to competition in telecommunications markets. Competitors would then be able to compete with BT on what they believed would be an even keel.

A.9 BT did not agree that it would be reasonable to require it to provide an access product that was below the price of its retail product. Its argument was that its retail rental price is below its actual costs in providing access and it would not therefore cover its costs if it did not receive any calls from the retail customer or a rebalanced rental from a competitor.

Calls

A.10 In general, competition in calls markets was believed to be or was expected to become more competitive. 'All calls' CPS addressed one of the remaining barriers to entry to this market. However, some respondents believed that the inability of BT's competitors to offer a 'like for like' service in terms of calls and access precluded competition even in calls markets from being competitive.

Price controls

A.11 There were mixed views on the need for price controls. Respondents that did not believe that competition was competitive in either access or calls markets were not automatically of the opinion that price controls were the answer. Many respondents believed that price controls were no longer necessary with increased competition or were otherwise relevant in today's market. However, others remained of the view that price controls – at least for lower deciles – should not be removed until such time as competition was shown to be effective and that the removal of such controls should not be considered on the basis that markets were likely to become competitive.

Workshop

A.12 On 20 November 2001, OfTel hosted a workshop for public telecommunications operators and systemless resellers. This workshop was designed to obtain the views of providers of services on the extent of competition on a forward-looking basis; and the measures that would be needed to achieve an effectively competitive market whilst retaining protection for vulnerable customers. OfTel specifically set four questions for BT, Cable and Wireless and a systemless reseller² to answer in separate presentations to the workshop. The questions asked were:

² In actual fact, no one from the systemless reseller community made a presentation. However, they were well represented at the workshop and, it seemed (following discussions that followed the presentations), their views were not far removed from those of Cable & Wireless

- a) What is your vision for the retail market in two years' time?
- b) What are your proposals for the regulatory measures to get us there?
- c) What do your proposals mean for the lower spending customers (bottom 3-4 deciles)?
- d) How would uneconomic customers and areas be funded under your vision?

Cable & Wireless

A.13 Cable & Wireless' presentation focussed on what it believed were fundamental flaws in the structure of the telecommunications market that were limiting competitors' (to BT) impact in the market for calls. It was argued that defects in the competitive environment had helped BT to maintain supernormal profits in calls markets and – without remedies designed to combat the structural problems in the market – would see BT retain market power in the provision of calls.

A.14 Cable & Wireless believed that – to encourage competition in retail calls markets – Oftel should require BT Network to provide a regulated wholesale access product to BT Retail's competitors. The provision of such a product would allow competitors to compete with BT Retail and would limit BT Retail's ability to leverage its dominance in the access market into the potentially competitive calls markets.

A.15 This wholesale product would allow Oftel to withdraw from price control regulation, as competitors and BT Retail would be competing on equal terms as BT Retail (under this regime) would be required to purchase the wholesale access product from BT Network on the same terms and conditions as its competitors. Under this new regime, customers benefiting from social policies (for instance, BT's light user scheme) would continue to do so, others would benefit from competition.

BT

A.16 BT viewed the competitive structure of the market somewhat differently. Enough regulatory action had already been taken at the wholesale level to allow BT's competitors to provide an effective alternative to BT Retail. Further retail regulation should therefore focus on the provision of services to uneconomic customers and BT should not be expected to be the sole contributor for the costs of such provision, as this would become increasingly unsustainable.

Other meetings

A.17 Oftel met various interested parties throughout the consultation period and thereafter. These meetings generally covered similar ground to that referred to elsewhere in this annex. Even so, these meetings helped to develop Oftel's thinking further.

A.18 In addition, Oftel held meetings with external economic experts – Professor Mark Armstrong and Simon Carne – and consumer consultants – Ann Foster and Professor Jonathan Michie. These meetings were used to provide Oftel with independent analysis of competition in retail markets, possible solutions and outcomes that might result. Oftel also received advice from Chairmen of the four national advisory committees: Moira Black of CCE; Courtenay Thompson of NIACT; Jeremy Mitchell of SACOT; and Mike Tedd of WACT.

Annex B

General price control issues

B1 This annex covers a number of general issues relating to the operation of the retail price control. In most cases, Oftel's view on the appropriate approach has not changed and the new control will continue to operate in the same way as the current control. Therefore, this Annex gives just a brief summary of the issues. A fuller discussion may be found in *Pricing of Telecommunications Services from 1997*, Statement (June 1996) and the consultation document of the same title published in March 1996,

www.oftel.gov.uk/publications/1995_98/pricing/pri1997b and www.oftel.gov.uk/publications/1995_98/pricing/pri1997a respectively.

Reference prices

B2 Under the current rules, BT is free to nominate 'reference' prices for the residential line rental and call prices. The RPI-X price cap is applied directly only to these reference prices. This approach was intended to facilitate the provision by BT of a wide range of customer price packages.

B3 Two drawbacks of this approach have emerged during the current control. Firstly the number of customers on the current reference tariff is now small. This reduces the relevance of the price control for most customers whose tariffs are not directly affected by the control. This problem has been made worse by the introduction of bundled packages. As these have completely separate tariff structure, there is no clear mechanism, direct or indirect, by which the changes required by the control are transferred to these customers. Secondly, the current arrangements permit BT to redefine the reference package during the control period. Oftel believes that this may allow BT to 'game' the cap to its advantage. Oftel therefore proposes that the next control should not apply to a reference tariff and invites comments on possible successor mechanisms.

Discounts

B4 Under the current control, price reductions given in the form of discounts or packages do not count towards meeting the price cap requirement. This is in order to avoid giving BT too much flexibility to target cuts on higher spending customers. BT is however required to maintain a minimum value of discounts to residential customers called the 'Score'. The total value of discounts each year, relative to the reference tariff, is called the Discount Yield.

B5 Oftel believes that this restriction is no longer necessary. Given the narrow scope of the current basket, BT's freedom to target price cuts at the more competitive parts of the market is much less than it would be in a broader basket, particularly if the latter included business customers. The range of discount

packages has been increased and has broader appeal than before, with the majority of customers now benefiting from some form of package. The value of discounts is well in excess of the Score which as a result is no longer a binding constraint. Calculation of the Score and Discount Yield is also complex. Therefore, consistent with its proposal to replace the reference tariff approach, Oftel proposes that (with one important exception discussed below) price reductions in the form of discounts should count towards meeting the new control and the Score and Discount Yield should no longer be calculated.

B6 Oftel proposes that inclusive call allowances (ICAs), including those given as part of optional tariff packages and 'all you can eat' tariffs, should, as an exception to this approach, not count towards meeting the requirements of the price control. This is because the price control is intended to allow the line rental to increase in response to competition forcing the generality of call prices down. If ICAs counted towards meeting the cap, BT would have an incentive to anticipate competitive pressure by raising the line rental, offsetting it by an increase in the ICA. This could then be a 'cheap' way of satisfying the control compared to reductions in per minute call prices which benefit higher spenders proportionately more.

Price cap timing constraint

B7 BT's licence currently contains a provision preventing it from delaying required price reductions to the end of each price control year. Under this provision BT is required to time the implementation of its price changes in such a way that the combined effect is equivalent to it having made all the price changes half-way through the price control year. Oftel proposes to maintain this requirement in the new control.

The appropriate index for price control

B8 The current control on BT's prices is based on the all-items RPI. This has the advantages of public familiarity and certainty. In previous consultations, many respondents have given great weight to the need for the index to be understood by the public. Oftel therefore proposes that the new price control should be based on the all-items RPI.

Duration

B9 The current retail price cap was originally set for four years in order to balance the incentive on BT to reduce costs with the need to pass the benefits of cost reductions to customers in a reasonable time. Oftel has proposed that the new control should not necessarily last for four years, but should be removed automatically when call prices have fallen sufficiently. However, Oftel intends to set the cap as if it were expected to apply for a full four years. This allows a reasonable time for competition to develop sufficiently to trigger removal of the cap whilst maintaining incentives on BT to improve its efficiency during this period.

Rollover

B10 The current retail price control was extended for one year in order that the assessment of the need for new controls could take account of emerging new developments in competition. BT's licence now contains a rollover provision so that, if a subsequent control is needed and it proves impossible to agree this with BT before the existing control expires, the existing price control continues in force in the interim until a new control is agreed. This has the advantage that reviews can be carried out later with better information. Although it is not expected that a subsequent control will be required, Oftel proposes that the new control should also contain a rollover provision.

Price control mechanics

B11 In the current control, the basket weights for BT's price controls have been set equal to the proportions of basket revenue accruing to the relevant services in the prior year to that in which the price change takes place. Oftel intends to continue with the prior year revenue weighting system for the price control basket.

Provision for carry-over

B12 If BT reduces its prices by more than is required in a particular price control year then it is allowed to count the excess price reductions towards its obligations in the following year. The current controls limit BT's ability to carry over price reductions into the fourth year of a price control, depending on the extent to which BT has used this facility in previous years. Oftel intends to continue these arrangements.

Annex C

Fixed-mobile substitution

C1 BT argued in its response that fixed-mobile substitution has now developed to such an extent that fixed and mobile telephony are now part of a single market and that Oftel, by regarding them as separate markets, underestimates the extent of competitive pressure on BT. BT submitted a study by .econ suggesting that consumers would switch between fixed and mobiles in response to hypothetical price changes. This is discussed further below.

C2 BT argues that the large increase in quarterly fixed bills which Oftel survey evidence suggested would be necessary to induce customers, on average, to switch to mobiles, is not relevant, as switching by a few marginal customers may be sufficient to establish a common pricing constraint. Whilst it may be true that not all customers have to respond to price changes for a common price constraint to exist, the extent of switching in response to small price changes needs to be material. The magnitude of the average price increase required suggests that most customers do not consider mobile and fixed access to be close substitutes and therefore it seems unlikely that the extent of switching will be sufficient for there to be a single market. For example, Oftel survey evidence suggests that more than three quarters of those who have started using BTTalk Together had not changed their mobile usage as a result. There would need to be clear evidence of a single pricing constraint operating for the single market hypothesis to be accepted.

C3 The .econ study is based on the application of econometric techniques and is therefore vulnerable to the problems of such studies discussed in Competition in the provision of fixed telephony services (paragraphs 2.59 - 2.64). In particular, by being based on current price levels it is vulnerable to the 'Cellophane fallacy', that is, although substitution may take place at current price levels, which are well-above costs (as shown by BT's rates of return on fixed calls), it would not do so if prices were at competitive levels. In addition, survey evidence on switching is derived from questions postulating very large price changes - 25% or more. The value usually regarded as relevant to the SSNIP test of market definition is 5%. Even so, .econ's figure 41 shows that over 60% of respondents would not change their fixed line usage if mobile prices fell by one quarter and nearly 50% would not change their fixed usage if mobile prices fell by half. Similarly, "amongst single fixed users willing to acquire a second fixed line almost 90% have not considered a mobile instead". In addition, some of the results appear counter-intuitive. The econometric analysis of fixed and mobile take-up across countries is also likely to suffer from data problems.

C4 .econ argued that Oftel should also have considered other potential substitutes for voice calls, notably short messaging services (SMS). The possibility that SMS could be an effective substitute for voice calls was in fact considered and rejected in Oftel's September 2001 statement *Effective Competition Review: Mobile* (paragraphs A1.37 - A1.39).

Survey data

C5 *Competition in the provision of fixed telephony services* drew on the results of Oftel's regular surveys of business and residential customers up to May 2001. The results of Oftel's August and November 2001 surveys are now available and this enables the analysis to be updated (note however that not all questions are necessarily repeated in every survey). These are particularly relevant to the issue of fixed-mobile substitution.

C6 The August and November surveys of residential consumers found that 78% of respondents still considered the home fixed telephone as their main method of making and receiving calls (compared to 79% in the May survey as reported in *Competition in the provision of fixed telephony services*). Some 17% regard the mobile as their main telephone (15% in May). These findings are therefore similar to those of the May (and indeed February) 2001 surveys, suggesting that there has been little recent change in the proportion of customers regarding their mobile as their main telephone.

C7 BT quotes some survey results in its main response and these are compared to the latest Oftel data below. These results are derived from Oftel's August survey as the questions on impact of mobiles on fixed usage were not included in the November survey for reasons of space.

	BT	Oftel residential survey August 2001
Consumers with both fixed and mobile services sometimes using mobile at home	40%+	66%
Reasons for using a mobile from home (<i>more than one answer possible</i>)		
More convenient	33%	23%
Fixed line in use for voice	30%	22%
Calls are cheaper	26%	16% on same network 13% certain times of day
To use of up free minutes	22%	15%
Fixed line in use for Internet	16%	14%

C8 The percentages reporting some substitution are generally higher in BT's survey results and this may reflect differences in the way the results are

calculated, the sample, or the way the questions were asked. However, the ranking of reasons appears broadly similar.

C9 According to the Oftel surveys, there has been little change in the proportion using their mobiles at home since August 2000. At that time 31% of respondents with both fixed and mobile phones never used the mobile at home whilst in February 2001 this proportion had risen to 32% (as reported in *Competition in the provision of fixed telephony services*). In August 2001, the figure was 34%. Slightly surprisingly perhaps, this proportion has, if anything, been rising, which does not support the hypothesis of increasing substitution. In addition 20% of all respondents have only a fixed phone.

C10 The .econ survey contains a higher, though still low, proportion of mobile-only households (8.4%). Previous .econ surveys in 1999 and 2000 show mobile only households at around 6% of the total. Oftel surveys suggest the share of mobile-only households was roughly constant between May 2000 and November 2001 at 5% - 6%. The proportion of households with both a fixed and a mobile phone has continued to rise (from 72% to 75%) since May 2001 at the expense of the proportion with a fixed phone only. There does not seem to have been a significant increase in the proportion of mobile-only households.

C11 It is also notable that 60% of .econ's sample regard the fact that mobile calls are sometimes cheaper than fixed as not at all or not very important as reasons for purchasing a mobile, and only "image" is ranked as less important.

C12 According to .econ's survey, the main reason for using the mobile at home is that calls are sometimes cheaper. This contrasts, not only with Oftel's surveys, but with BT's survey results quoted in its main response, which rank convenience and fixed line in use as more important. Even .econ's survey found that "the majority (actually 69.2%) of respondents believe having a mobile has caused no change in their usage of their fixed line".

C13 Oftel also concluded in its review of competition in international markets that an international call from a mobile is not in the same market as an international call from a fixed line.

Annex D

Framework for cost-benefit analysis of price control proposals

D1 This Annex sets out a framework in which a cost-benefit analysis (cba) of the proposals for measures to replace BT's retail price cap can be conducted. It draws on the analyses in *National Leased Lines: Effective Competition Review and Policy Options* (August 2000) and *Review of the Charge Control on Calls to Mobiles* (September 2001).

Principles of CBA

D2 The principle underlying the cba is that regulation is justified only where, as far as can be judged, the benefits exceed the costs. However, it is not possible to quantify all costs and benefits, for example those associated with wider policy objectives, in a cba. The purpose of the cba is to inform but not dictate the choice among policy options.

Options for appraisal

D3 The first stage in any cost-benefit analysis is to set out the options for appraisal, including a 'base case' or 'do-nothing' option against which the costs and benefits of the other options can be assessed. The preferred option is a cost-based wholesale access product combined with a new cap similar to the current one which will be removed once competition has developed to a pre-announced degree. Protection for low users is also a feature of the proposal. This is assessed against a base case in which the retail price control is removed but no additional action is taken to stimulate competition or protect consumers.

Benefits

Reduced prices

D4 Relative to the base case, the proposal set out above is likely to lead to lower call prices to consumers whether or not competition develops sufficiently to trigger removal of the cap. The price cap will place downward pressure on call prices directly, whilst wholesale access will do so by increasing competition, particularly from resellers. Lower call prices stimulate demand for calls and this increase in output is the traditional source of welfare gains from lower prices (sometimes referred to as the welfare triangle).

D5 If successful, the above proposal should result in BT just earning its cost of capital (when costs are measured appropriately) on basket services across business and residential customers combined by the end of the price control period.

D6 At present, BT earns very high rates of return on calls (when costs are assumed to equal LRIC plus an equal proportionate mark-up for common costs) but a negative return on access (measured on the same basis). Effective competition is likely to lead to call prices approximating to cost which will mean that the line rental will also have to rise to cover access costs and make a greater contribution to the recovery of common costs. However, BT is likely to wish to increase the line rental even if there is no control or increased competition and its market power in access means it is likely to be able to do so. Therefore it has been assumed that the line rental is also increased to cover fully allocated costs in the base case and so does not enter into the cost-benefit calculation.

D7 The size of the welfare gain from reduced call prices depends on the elasticity of demand for calls and the rate of growth of the market over the period of the analysis. It is therefore necessary to make assumptions about the size of demand elasticities in order to carry out the cba.

D8 In addition, prices might fall to a greater extent if competition is increased, compared to a price cap, because the information asymmetries between the regulator and the regulated firm make it difficult for the former to know the firm's actual costs. It may therefore be appropriate to assume that average prices (including call prices and the line rental) are higher if a traditional retail price cap is imposed than if competition is stimulated. This has not been allowed for explicitly. However, it suggests that measures to reduce prices purely by regulatory means would have lower benefits than Oftel's preferred option.

Network externality

D9 In theory, account could also be taken of the 'network externality' which arises because an additional person joining the network benefits existing subscribers who can now make calls to and receive calls from him or her. As the line rental is by assumption the same in both the base case and under Oftel's preferred option, it is not necessary to estimate the network externality arising from changes in the number of subscribers connected to the network due to line rental increases. However, call prices are lower under Oftel's preferred option than in the base case and this could encourage more subscribers to join the network. As the size of such cross-elasticity effects is uncertain, no explicit allowance has been made for the network externality in this analysis, though it would clearly increase the net benefits of Oftel's proposal.

Cost efficiency

D10 Increased competition will increase the pressure on BT to make efficiency savings in its retail business (the measures considered here do not directly increase competitive pressure on BT's network costs).

D11 The value of 'X' in any price control would reflect an expectation that BT would be able to reduce its costs over the price control period and eliminate inefficiencies existing at the start of the period. A price control would also give BT an incentive to further increase its efficiency because it will benefit to the extent that it is able to reduce its costs by more than the amount implicit in the cap. However, if the regulator is not able to anticipate the gains which the firm can potentially make, this incentive may be attenuated to some extent, particularly in the last years of the cap, because BT will expect the next control to pass any gains made to customers. It may therefore be appropriate to allow for greater cost reductions at the retail level if competition is increased.

Other benefits

Avoidance of inefficient entry

D12 To the extent that current price levels are above costs, inefficient entry may be encouraged which will have the effect of raising aggregate costs. It may be, for example, that some IA operators who are able to operate profitably given current call prices are in fact inefficient and will have to reduce their costs or exit the market if prices fall. On the other hand, a rise in the line rental towards an economic cost level may encourage some efficient entry in access (although entrants into network access are also likely to have taken the prospect of call profits into account).

Increased choice

D13 Measures to stimulate competition should lead to customers having a greater choice of service providers than price capping. Apart from the effect of increased competition on price and quality, increased choice may result in non-price benefits to consumers such as being able to select a supplier which more closely meets their needs. In addition, some customers who currently incur extra costs in order to use a competitor to BT (such as IA customers who have to pay two bills) may be able to save these.

Innovation

D14 Increased competition at the retail level may lead to increased innovation in the supply of retail products, although this will be constrained by the nature of the wholesale product supplied by BT. In addition, the scope for innovation in the provision of purely basic telephony services may anyway be limited. As new services are not capped, the incentive to introduce totally new services is unlikely to be directly affected by the choice between price capping and increased retail competition. However, to the extent that new competitors enter to provide basic services and subsequently introduce, or stimulate others to introduce, innovative ones, there could be some additional benefit arising from measures to stimulate retail competition.

Costs

Compliance costs

D15 Relative to the base case of no controls or other regulatory action to increase competition, both retail price capping and measures to increase competition are likely to involve increased compliance costs.

D16 In the long-term, measures to increase retail competition should have lower compliance costs than price capping. There would be cost-savings for both BT and Oftel arising from the fact that it would no longer be necessary to monitor BT's compliance with the price control. There would also be significant savings from avoidance of the need for periodic retail price control reviews.

D17 However, it is necessary to take into account the initial one-off costs associated with designing and costing the new wholesale access product. In addition, there would be ongoing costs associated with the need to monitor or control the wholesale access price. There could also be some ongoing additional costs if retail price competition is increased insofar as a greater number of allegations of anti-competitive behaviour or unfair discrimination result.

Loss of economies of scale

D18 Both BT's network and retail operations are subject to economies of scale, that is, the average cost of output declines as the volume of output increases. Thus if measures to increase competition lead to reductions in BT's output, its average costs could rise.

D19 However, this would be offset by a number of factors. Firstly, although measures to stimulate retail competition might reduce the volume of BT's output at the retail level, its impact at the network level is less clear cut. Reductions in prices are likely to stimulate the output of all operators. In addition, service providers using BT's wholesale access product will use BT's network for at least part of the transmission of a call. Secondly, to the extent that BT loses retail and wholesale traffic to other operators, they are likely to benefit from cost reductions due to economies of scale. In the leased lines case, it was concluded that it was not possible to judge whether the overall effect was a net gain or loss and no cost or benefit was included in the cba in respect of this item.

Data sources

D20 The main data requirements of the cba have been sourced as follows:

- data on the percentage price reductions and rental increases needed to bring call prices and the line rental into line with cost, or which would be consistent with a particular price cap, have been derived from Oftel's price control model;
- data on volumes of calls and lines have been derived from the same source;
- estimates of price elasticities have been derived from the literature; and
- estimates of compliance costs have been based on internal Oftel estimates.

D21 Some additional assumptions need to be made in order to carry out the cba. These include the relevant time period over which to assess the costs and benefits and the discount rate to apply. A period of ten years has been used and the Government's test discount rate of 6% is applied. This is preferred as the present value of the costs and benefits of the policy options is evaluated from a national perspective rather than that of BT.

Estimates of benefits of costs

D22 The net annual benefit of reducing call prices to cost is estimated at some £430m per annum at 2001/02 prices. This would imply a net benefit of about £2.4bn in present value terms over a ten period from 2006/2007. In addition there would be smaller annual benefits in the years up to 2006/2007 before the measures have their full effect.

D23 It is not possible readily to quantify the additional efficiency savings which are likely to result from increasing retail competition. However they are potentially significant. A saving of just 1% in the costs of access and retail calls could amount to more than £50m per annum.

D24 Other benefits, including the avoidance of inefficient entry, the benefits of increased choice, and increased innovation, have not been quantified.

D25 Against these, the compliance costs, relative to the base case of no controls, are likely to be relatively small. Estimates suggest that the cost of carrying out a price control review is no more than a few million pounds and it is clear that these costs are orders of magnitude smaller than the benefits to be expected from lower prices resulting from Oftel's proposals.
