Oftel Office of Telecommunications

Protecting consumers by promoting competition: Oftel's conclusions

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Summary

S.1 This statement sets out Oftel's conclusions on its review of the fixed telephony market. The review was necessary because the current price control arrangements on BT are due to expire in July 2002. Oftel has carried out an assessment of the level of competition in the residential market and decided on the measures that are now needed to promote competition and protect consumers.

S.2 This statement sets out a radical package of measures to give consumers a greater choice of service providers while maintaining controls on BT's prices as competition develops and continuing to protect the most vulnerable consumers from excessive charges.

Regulation in a changing market

S.3 Oftel has imposed controls on BT's retail prices since 1984 to protect consumers from excessive prices. Price controls have been used to require BT to lower prices because there has been insufficient competition in the retail market to exert downward pressure on prices.

S.4 Since price controls were introduced, BT's residential calls prices have fallen by over 50 per cent in real terms. The current control of RPI-4.5 per cent was introduced in 1997 for four years and extended for one year in 2001.

S.5 Oftel's review of the fixed telephony market has found that the level of competition in the provision of fixed calls has steadily increased. Consumers in many areas now have a wide range of choice from other suppliers – cable operators, indirect access, calls and access and carrier pre-selection service providers. BT's market share for calls is gradually being eroded, and BT's call profits are falling (in absolute terms) over time.

S.6 Oftel welcomes both the increase in competition and the continued reduction in BT's prices. However, the market is not yet effectively competitive. In particular, BT continues to have a large share of both lines and calls markets, and makes very high returns on calls, although these are offset to a significant degree by low returns on access (ie the basic provision of the exchange line, paid for by the telephone rental charge).

(Note that in this statement, the terms 'line rental' or 'rental charge' are used for convenience even though at present BT's standard quarterly fixed charge also includes an allowance of 'free calls' (ie an inclusive call allowance)).

S.7 BT's continuing strong market position means that immediate withdrawal from regulation would put consumers at risk. Oftel believes that, as well as some continued price regulation, new measures are needed to promote additional competition from different service providers that will lead to a greater range of

choice for consumers. And as the additional competition increases commercial pressures on BT to reduce its prices, the price control regime both can and should be relaxed.

S.8 The current price control is focussed on the lowest spending 80 per cent of residential customers, for whom the rental charge makes up a large proportion of their bills. Because BT's calls are much more profitable than lines, BT makes much higher returns from higher spending customers than from lower spending customers. Under the current price control, the significant profits made by BT on its highest spending consumers from calls have been used to offset the required price reductions on lower spending customers.

S.9 As BT's profits on calls are increasingly eroded through competition, the price control regime also needs to be modified. In particular, change is needed because, profits from high spenders might not be available in future to continue to support the level of price reductions to low spenders required by current price controls.

Promoting competition

S.10 The main element of Oftel's package of measures to promote competition is to require BT to provide a new wholesale line rental (WLR) product.

S.11 The review identified that a significant inhibitor of competition and innovation was the inability of alternative service providers to provide a single bill to their customers. For example, consumers who use indirect access or carrier pre-selection services receive two bills – one from BT for the line rental and one from the service provider for calls. However, both indirect access and carrier pre-selection have helped to increase competition in calls markets. But WLR might encourage larger numbers of customers to consider whether they are receiving the best deal available to them for their expenditure.

S.12 Oftel is to require BT to introduce a new line rental product to enable alternative suppliers to provide a single bill that covers both line rental and telephone calls. A single bill will give suppliers the opportunity to develop innovative tariffs such as no or low line rental with all costs recovered from calls or virtually unlimited calls paid through a monthly subscription.

S.13 The new line rental product will be available to other network operators and service providers on cost-based and non-discriminatory terms. It will be available from BT in a basic form within four months. Oftel intends to set the following prices for the following products:

- wholesale line rental (residential quality of service) – £28 per line, per quarter;
- wholesale line rental (business quality of service) – £29.87 per line, per quarter;
- transfer of service from BT to a service provider – £1.41 per line or multiples thereof; and

- connection of a new line for a service provider – £92.89 per line.

S.14 WLR will need to be developed to operate efficiently at large volumes and seamlessly with other products such as carrier pre-selection. In July, Oftel will set up industry groups comprising operators, service providers and consumer representatives to develop a product specification.

S.15 The specification will cover issues such as how orders are processed, how WLR suppliers forecast demand, how BT provides for that demand in its systems a service level agreement and will consider operational penalties for over-forecasting. It will also include a code of practice on marketing for WLR suppliers to ensure that selling practices are fair and that consumers are protected.

S.16 Developing the WLR product will require commitment and participation from all stakeholders. Oftel will lead the groups where appropriate and resolve issues that develop. With this commitment, Oftel believes it will be possible to consult on and publish a specification in autumn 2002. BT will then be in a position to develop its systems and implement an enhanced product.

Controlling prices as competition develops

S.17 As competition develops, Oftel will ensure that customers continue to be protected through a price control. This will be an 'RPI-RPI' control focussed on the expenditure patterns of the bottom 80 per cent of residential customers by expenditure. This means that the lower spending 80 per cent of residential customers will face no increase in their phone bills. The price control will ensure BT does not exploit its market power in the residential telephony market.

S.18 Full introduction of the wholesale line rental product, however, will lead to a significant increase in competitive pressures on BT. This could make the RPI-RPI control on the lowest spending 80 per cent of residential customers unduly tight, as the return BT makes on this group of customers is fairly small.

S.19 In the light of this concern, and in order to give an additional incentive for BT to introduce the WLR product as quickly and efficiently as possible, Oftel is ready to modify the RPI-RPI control to RPI+0 per cent. This will happen once a commercially viable WLR product has been fully implemented by BT in line with the determined product specification and is being taken up by service providers.

Protecting low users

S.20 In parallel, with the further opening of the market, Oftel will introduce additional measures to protect those customers who do not make many calls and for whom the line rental makes up a significant proportion of their bill. BT's Light User Scheme, which currently provides protection for the most vulnerable 20 per cent of customers in the form of a rebate on the line rental and there are provisions to extend it to cover the lowest 30 per cent of customers by spend.

S.21 There will also be a ceiling on BT’s line rental charge to ensure that it does not rise above cost for all of BT’s residential customers. The geographic averaging of BT’s prices, which ensures that basic telephony charges are the same throughout the country, will continue.

Review process

S.22 The price controls set out in this statement will be set for four years. Oftel will review the retail market in 2004. The review will consider the effectiveness of competition at that time, including the operation of WLR, and the appropriateness of the continuing controls and consumer protection measures. The approach set out in this statement may then be modified as a result of this review.

Consultation

S.23 This statement includes draft modifications to BT’s licence that will implement those measures. Comments on these are required by 19 July 2002. Unless BT objects to the proposed modifications, they will take effect from 1 August 2002. However, should BT object to the proposed modifications, Oftel will refer the issue to the Competition Commission and the existing controls on BT's retail prices, including the controls on BT's retention for calls to mobiles, will continue for another year while the Competition Commission considers the case.

Chapter 1

Introduction

Price control and market power

1.1 Oftel's aim is to obtain the best possible deal for consumers in terms of quality, choice and value for money. Competition is most likely to provide consumers with the best deal. The need to compete in terms of price, quality and otherwise meeting customers' needs provide the best incentives for companies to strive to be efficient and provide customers with the most attractive all-round communications package. However, in markets in which competition is not effective or there is a monopoly supplier, the incentives to increase efficiency and provide customers with the best deal are diminished. This is because there is little or no threat to the profitability of the supplier.

1.2 In telecommunications, BT has market power in the provision of access and calls. Approximately half of the UK has little choice but to get access to telecommunications networks through BT. In calls markets, BT is faced with a greater threat but continues to have high market shares whilst maintaining prices that are well in excess of the level necessary to maintain a sustainable business.

1.3 Price controls have been used to restrict BT from excessive pricing that its dominance would otherwise allow, and they have also been used to encourage BT to increase its efficiency. BT is given incentives to increase its efficiency because it is allowed to keep the benefits of cost reductions until the end of the price control period if these cost reductions are higher than those that had been anticipated when the controls were set. These controls have generally been set for four years.

The current price control and market review

1.4 BT has been subject to the current price controls since 1 August 1997. These controls were set at RPI-4.5 per cent and limited BT's ability to increase prices for a basket of services provided to the bottom 80 per cent of residential customers. The services controlled have been as follows:

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

1.5 The controls were focussed on the bottom eight deciles of residential customers because Oftel believed that competition would deliver a better deal to the highest spending residential customers and business customers than would be delivered by the price controls.

1.6 Oftel has also controlled BT's retention for calls to BTCellnet and Vodafone since 1 April 1999. These controls were introduced because competition in calls to mobiles was not strong enough to protect consumers. They were set at RPI-7 per cent for three years and were extended for four months to align them with the controls for the other retail services referred to in paragraph 1.4.

1.7 Originally, the main price controls set out in paragraph 1.4 were set to last for four years, but Oftel extended them for a further year to 31 July 2002 following Oftel's 2001 review of competition in the provision of the price-controlled services.

1.8 Oftel extended the controls in order further to assess the growing impact of indirect access and the early impact of carrier pre-selection and local loop unbundling. In addition, Oftel noted that the extension to the control would also enable it to assess later financial data that would show whether the trends of decreases in overall profitability of the controlled services were continuing.

1.9 Oftel has considered the growing competitive threat that BT is faced with and in January 2002 published a consultation document, *Protecting consumers by promoting competition: consultation on Oftel's review of the fixed telephony market*. That document set out Oftel's market analysis and sought comments on a set of proposals to promote competition and protect consumers. The responses to that consultation document are summarised throughout this statement and are available on Oftel's website (www.oftel.gov.uk/publications/responses/2002/pcr0102/index.htm).

1.10 This statement sets out the outcome of the review and sets out Oftel's final proposals for the future.

European legislation

1.11 Although Oftel's review of competition in fixed markets commenced before the publication of the new Directives resulting from the European Commission's review of communications regulation, Oftel's market assessment is consistent with the Framework Directive (Directive 2002/21/EC). The Framework Directive stated that:

"National regulatory authorities shall…….define relevant markets appropriate to national circumstances" (Article 15(3)).

Additionally, national regulatory authorities:

"shall determine on the basis of its market analysis……whether a relevant market is effectively competitive" (Article 16(2)).

1.12 As part of the implementation of the new Directives, operators' licence conditions will be replaced by general conditions of entitlement and, where considered necessary, individual significant market power conditions by 25 July 2003. Unless Oftel carries out a review of the retail market, beginning later in 2002, the provisions in the licence conditions that result from this statement will cease after 24 July 2003. Oftel therefore intends to conduct a review of this market later in 2002.

1.13 Oftel intends to conduct a further review of the retail market in 2004.

Consultation

1.14 At annex B, Oftel has set out the proposed modifications to BT's licence that are required to give effect to Oftel's proposals. Oftel has set out these proposed modifications for statutory consultation. Interested parties are given until **19 July 2002** to comment on the proposed modifications. These modifications are intended to give effect to the policies outlined in chapters 2, 3 and 4.

Chapter 2

Market assessment

Market definition and assessment of competition

2.1 In the consultation document *Protecting consumers by promoting competition*, 31 January 2002, Oftel set out its views on the definition of the relevant markets (see www.oftel.gov.uk/publications/pricing/2002/pcr0102.htm) in the light of responses to its July 2001 consultation document *Competition in the provision of fixed telephony services*. Oftel also outlined its assessment of competition in markets for basic telephony services.

Market definition

2.2 Oftel's 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 has proposed the following as separate markets:

- fixed access;
- local calls;
- national calls;
- international calls in two categories, which is consistent with its review of competition in international markets;
- calls from fixed to mobile; and
- operator assisted calls.

2.4 This is identical to the list proposed in *Competition in the provision of fixed telephony services*, with the exception of international direct dial (IDD) calls where the definition used in the November 2001 review of competition in international markets was adopted. Oftel has also stated that it considers that these markets are national in scope and that separate markets can be defined for each of the above for business and residential customers. Oftel has also considered whether a further subdivision of residential markets by spend could be made. However, although Oftel found evidence that competitive pressure tends to increase with spend, it found no firm basis for, and does not intend to define, separate markets for lower and higher spending residential customers.

Responses to *Protecting consumers by promoting competition*, on market definition issues

2.5 Most respondents, who commented on the market definitions, broadly agreed with Oftel's proposals and there was general agreement that calls markets were separate from access and that all markets were national in scope.

2.6 In the previous round of consultation, most respondents who commented on the issue agreed that mobile and fixed markets were currently separate. BT, however, argued in its response that fixed mobile substitution had developed to such an extent that fixed and mobile telephony were now part of a single market and that Oftel, by regarding them as separate markets, had underestimated the extent of competitive pressure on BT. BT submitted a study by the consultants **.**econ suggesting that consumers would switch between fixed and mobiles in response to price changes. This was discussed further in annex C to *Protecting consumers by promoting competition*.

2.7 Some respondents to *Protecting consumers by promoting competition*, commented that fixed mobile substitution was increasing, but had not reached the point where fixed and mobile services could be regarded as being in the same market. Price differentials between fixed and mobile services, together with limitations on mobile coverage and quality of service, were mentioned as possible reasons for fixed and mobile services remaining separate markets. One respondent with particular requirements for confidentiality, privacy and reliability commented that mobiles were unsuitable for its purposes.

2.8 BT has again argued that mobile services should be regarded as part of the same market as fixed services. In support of this view, BT submitted a response by **.**econ to the points made by Oftel in Annex C to *Competition in the provision of fixed telephony services*. However, this seeks to defend **.**econ's earlier analysis rather than presenting new evidence. It is perhaps worth stating that Oftel, in its earlier response, did not take issue with the econometric techniques used by **.**econ on the grounds that different or better techniques should have been used. Rather it argued that the results of the econometric analysis did not demonstrate that fixed and mobile services now constitute a single market, still less that competition from mobiles is sufficient for measures to control or increase competitive pressure on BT's prices to be unnecessary. Oftel has noted the points made by **.**econ but continues to believe that fixed and mobile services should be regarded as being in separate markets.

Conclusions on market definition

2.9 In the light of the above, Oftel believes that the market definitions proposed in *Protecting consumers by promoting competition* are appropriate. The following separate retail markets will therefore be defined for the purposes of the price control review:

- fixed access;
- local geographic calls;
- national geographic calls;
- international calls in two categories as in the review of competition in international markets;
- calls from fixed to mobile; and
- operator assisted calls.

2.10 Oftel also confirms its proposal to define separate markets for each of the above for business and residential customers but not to make any formal subdivision of residential markets by spend and that it regards these markets as national in scope.

Assessment of competition

2.11 In *Protecting consumers by promoting competition*, Oftel set out its belief that access and calls markets are not effectively competitive (with the exception of the competitive business IDD markets identified in the review of competition in international markets). However, it appeared to Oftel on the basis of responses and other information that competition was increasing and that there were good prospects for effective competition in retail calls markets if the remaining barriers were addressed. Existing policies addressed these problems to some extent, although there was no policy in place to address one of the main barriers identified: the current need for indirect access (IA) and carrier pre-selection (CPS) customers to pay two bills.

Responses to *Protecting consumers by promoting competition* on competitiveness

2.12 Most respondents agreed that competition, at least in calls markets, is increasing but not fully effective and not yet sufficient, by itself, adequately to protect consumers. BT's dominance in access markets was felt to be rather more intractable, particularly in remote areas, as significant expansion of cable networks was considered unlikely. In addition, some argued that competition for low users was likely to remain weak because such customers had little to gain from switching and were least attractive to competing operators.

2.13 Some drew attention to price cuts and reductions in BT's market share as evidence that competition is already well developed, particularly in business markets. However, others noted that the level of BT's market share remains above the threshold for a presumption of dominance in most calls markets, and that the profitability of calls is also very high despite the availability of indirect access.

2.14 CPS was felt to be a potential source of increased competition in calls markets in future and BT pointed out that the CPS customer base is growing at some 60 per cent a month. However, some felt that progress could still be hampered by low awareness of the availability of CPS and by the need for CPS customers to pay two bills. On the other hand, use of BT's existing calls and access product, which allows service provider customers to receive only a single bill, has fallen dramatically since 2000. Nevertheless, there was support for Oftel's proposal to require BT to provide a new wholesale line rental product so that operators could offer a total service to the customer, with a single bill. Some argued that this would also help drive growth in CPS take-up.

2.15 One respondent pointed out that the widespread use of direct debit by retail customers could also reduce the inconvenience of paying two bills. However, others referred to experience in energy markets and research supporting the view that the inability to offer a total service to the customer, with a single bill, is a factor currently preventing calls markets from being effectively competitive.

2.16 BT argued that competition was now sufficiently well established for price controls to be removed without the need for additional measures to stimulate competition. In addition to arguing that substantial competition was provided by mobile operators (see above), it also presented in support of its case an empirical analysis commissioned from OXERA which suggested that customers respond to price differentials by switching operator. The rates of switching (nine per cent of customers in cabled areas have switched fixed-line access provider in two years) and use of IA (13 per cent) found by OXERA appear, in fact, to be broadly consistent with those from Oftel's surveys (four per cent switched in the last year and 11 per cent using IA in February 2002). In an econometric analysis, OXERA found that price differentials are a significant determinant of switching. However, it does not follow from OXERA's empirical findings that switching is sufficient to constrain prices to the competitive level.

Competition indicators

2.17 A number of other sources of data relating to the competitiveness of markets have become available since January. These include results from Oftel's February 2002 international benchmarking study, Oftel's February 2002 survey of residential customers and updated market share data. BT has published its group financial results for 2001-02, but its regulatory financial statements are not available for this period (as a result, BT has been unable to extract and reanalyse the necessary data in order to update the financial information outlined in *Protecting consumers by promoting competition*). The new data are summarised in the following paragraphs. Where possible, Oftel has differentiated between business and residential customers.

International benchmarking

2.18 If UK fixed telephony markets are competitive, one would expect UK consumers to be getting a deal which is as good as or better than that available to customers in similar economies overseas. In order to assess whether this is the case, Oftel has undertaken a series of surveys to compare UK prices and trends with those in other comparable countries. The latest survey was conducted in February 2002.

2.19 The survey found that UK prices for residential PSTN services generally compare favourably with prices elsewhere, with only Sweden and California among the sample having lower prices. UK residential prices were lower than equivalent prices in France and Germany for all usage patterns considered, while for the US the results varied according to usage. UK prices for business PSTN services were slightly above average: roughly five to eight per cent higher than in France, California and Germany, significantly higher than in Sweden but 10 per cent lower than those in Ohio.

2.20 Prices paid by residential consumers in the UK fell by around four per cent between February 2001 and February 2002. This is similar to price falls seen in most other countries (prices in Sweden have remained stable). Prices for business consumers in the UK fell by about five per cent. This is similar to the price falls seen in Germany and Sweden while larger price falls have been seen in France and the US.

2.21 The UK's relative position is generally little changed since the 2000 and 2001 surveys. As before, the existence of a significant price gap between the UK and Sweden is consistent with the proposition that UK fixed telecommunications markets may not yet be effectively competitive. However, it is not possible to draw firm inferences in the absence of an analysis of the reasons for the good performance of the Swedish operators. Given the relatively short history of competition in France and Germany, it is perhaps to be expected that UK operators would fare better when compared with counterparts in these countries.

Customer satisfaction

2.22 Oftel's February 2002 UK survey found that, among residential customers, satisfaction remained high. Some 96 per cent of those respondents for whom the home fixed phone was the main method of telephony were satisfied with it. This compares to 97 per cent in the August and November 2001 surveys.

2.23 Oftel's first international consumer and business survey was conducted in February 2002 in UK, France, Germany, Italy, Sweden, Canada, Japan and the US states of Ohio and California. The UK was found to have significantly above average residential customer satisfaction with price and reliability of fixed service, price and reliability. Amongst UK businesses, however, overall satisfaction was about average although satisfaction with value for money was slightly below average.

Awareness and take-up of indirect access

2.24 Oftel's February 2002 survey yields updated information on consumers' awareness and use of IA. BT also provided some survey evidence of customer awareness in the note by OXERA included in its response. Table 2.1 compares the results of BT's survey with evidence from Oftel's August and November 2001 and February 2002 surveys.

Table 2.1: Survey data

	BT/OXERA	Oftel residential		
	Q4 2001	Aug 2001	Nov 2001	Feb 2002
Customers aware of the availability of indirect access		53%	56%	52%
Customers using indirect access	13.2%	12%	13%	11%

2.25 Oftel's surveys suggest that there has been little change in either awareness or use of indirect access by residential customers since August 2001. OXERA's estimate of the proportion of customers using IA in Q4 2001 is very similar to Oftel's. However, there is evidence of a continuing decline in the proportion of customers using IA for all of their calls which in November 2002 was about half the level of a year ago. The survey results do not conclusively identify the cause of this.

2.26 In Oftel's February 2002 international survey, the UK was found to be significantly above average on awareness of alternatives for residential customers and about average for business customers.

Customer switching

2.27 The February 2002 survey found that four per cent of residential fixed telephone users had switched supplier in the last year. This appears to confirm the fall in switching rates identified in the November survey which was thought possibly to have been anomalous. These figures compare to eight per cent in the August survey, a figure which had changed little since March 2000.

2.28 As noted above, the rates of switching found by OXERA's study for BT appear to be broadly consistent with those from Oftel's surveys. But the headline figure quoted in the main BT response document refers to switching by customers in cabled areas only. Overall, OXERA find rates of switching to be *lower* than in Oftel's surveys (seven per cent in two years, 15.5 per cent ever, compared to four per cent in the last year and 22 per cent ever in Oftel's February 2002 survey, figures which have not changed significantly in recent quarters). However, OXERA has found similar reasons for switching.

2.29 In Oftel's February 2002 international survey, the UK was found to be about average on rates and ease of switching for residential customers and ease of switching for business customers, although rates of switching by business customers were below average.

Market shares – retail access

2.30 Table 2.2 shows trends in BT's market shares to December 2001. BT's share of residential lines has fallen slightly since September 2000. There appears to have been a small fall in its share of business lines but this remains nearly 90 per cent.

Table 2.2: Market shares (number of lines)

		Operator share (no. of lines)	**Operator share (no. of lines)**	**Operator share (no. of lines)**	**Operator share (no. of lines)**
Market segment		September 1999	September 2000	September 2001	December 2001
Residential Customers	BT Cable Kingston	83.0% 16.3% 0.7%	81.0% 18.3% 0.7%	80.5% 18.9% 0.6%	80.2% 19.2% 0.6%
Business Customers	BT Cable Kingston Others	89.9% 8.4% 0.5% 1.2%	87.2% 10.1% 0.6% 2.1%	87.3% 9.6% 0.7% 2.4%	87.4% 9.5% 0.7% 2.4%

Source: Oftel Market Information

Market shares – retail calls

2.31 Table 2.3 shows trends in BT's shares of calls markets to December 2001. BT's shares in volume terms are declining at a faster rate than its share of lines. There have been significant reductions in BT's shares of residential national and international calls since September 2000 although recent data revisions suggest that this decline may have been less marked than suggested in the January document. However, BT's revenue shares are still over 50 per cent in all markets except international calls for business customers, which suggests that it is likely to be dominant in most calls markets. It should be noted that, although data are only presented here for international calls as a whole, Oftel's view is that it is appropriate to regard individual country-pair routes as separate markets, at least where these are not competitive at the wholesale level. BT's share on some routes is likely to be significantly higher than on others, and this may be part of the cause of the difference between BT's shares by volume and by revenue.

Table 2.3: Market shares (calls)

	% Market share July – Sept '99		% Market share July – Sept '00		% Market share July – Sept '01		% Market share Oct – Dec '01	
Residential customers	volume	revenue	volume	revenue	volume	revenue	volume	revenue
Local calls	75.7%	74.4%	77.2%	76.4%	77.6%	74.2%	78.4%	73.0%
National calls	72.4%	74.0%	68.2%	70.5%	63.6%	67.3%	64.6%	64.4%
International calls	53.8%	64.0%	52.5%	61.6%	45.6%	58.9%	46.9%	56.8%
Calls to mobiles	72.4%	71.2%	72.9 %	71.7%	72.6%	69.6%	73.3%	65.6%
Business customers								
Local calls	58.2%	66.0%	58.5%	66.2%	54.1%	64.9%	53.4%	63.9%
National calls	44.2%	57.4%	42.4%	57.0%	40.9%	55.5%	40.4%	54.4%
International calls	20.2%	38.1%	20.3%	41.4%	19.8%	40.1%	19.3%	38.3%
Calls to mobiles	53.4%	53.5%	53.8%	53.4%	50.4%	54.7%	47.3%	49.3%

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 market shares include Concert market shares for these purposes.

Profitability

2.32 In its competition assessment in *Protecting consumers by promoting competition*, Oftel reported financial information showing the end-to-end profitability of individual retail basket services for 1998-99, 1999-2000 and 2000-01. This information was an extraction and reanalysis by BT of data underlying figures disclosed in the 1998-99 and 1999-2000 CCA financial statements. Comparable data on BT's profitability for 2001-02 are not yet available. BT has however published its fourth quarter and preliminary group financial results for 2001-02 and its group statutory accounts and these enable overall trends in BT profitability to be inferred.

2.33 Turnover in BT Retail for the year 2001/02 increased by 0.2 per cent compared to the previous year. However, reductions in sales and administration costs have enabled earnings before tax, interest, depreciation and amortisation (EBITDA) to increase by some 21 per cent compared to 2000-01. Calls turnover and call volumes have fallen slightly, though the rate of decline in the latter is said to have been 'stemmed'. On the other hand, both turnover from and volumes of fixed lines have increased and this is partly attributed to the success of the BT

Together packages and to customers returning to BT. The profitability of lines has improved due, according to BT, to price changes, cost reductions and volume growth. BT estimates that its share of the market for residential fixed voice calls has been stable since June 2000. Its share of business voice calls is estimated to have fallen by 3 per cent, compared to a fall of 4.5 per cent in the previous year.

2.34 It is difficult to draw firm conclusions on trends in profitability in retail price controlled services from these data. However, there does not appear to be any reason to expect there to have been a significant decline in BT’s rates of return on calls, which are therefore likely to have remained extremely high.

Entry by broadband and other operators

2.35 Growth in take-up of broadband service using ADSL and cable modems has continued. Demand for LLU has continued to be much lower than originally expected. In total, there are still only just over 500,000 end users of broadband Internet access, mainly ADSL and cable modem customers. However, demand for ADSL is likely to grow as a result of recent price reductions and the introduction of self-install products.

Price of operator assisted calls (‘OA’ calls)

2.36 In *Protecting consumers by promoting competition*, Oftel proposed that, until competition becomes fully effective, OA prices should continue to be subject to price control. It did not however propose a separate control for OA services. In the light of responses received, Oftel confirms its intention to subject prices for OA services to the same controls as other prices.

Price of calls to mobiles

2.37 BT is currently subject to a separate control on its retail retention on calls to BTCellnet and Vodafone. The retention is subject to a cap set at RPI-7 per cent per annum. In *Protecting consumers by promoting competition*, Oftel proposed that, in future, BT’s retail retention would be included in the retail price control basket rather than be subject to a separate control.

2.38 Oftel received a number of responses from mobile operators on this issue. Few other respondents mentioned it. Those mobile operators who responded argued that BT’s retention on calls to mobiles should be subject to a separate cap as now, although those fixed line operators who commented did not share this view. The former argued that, without this, reductions in mobile termination rates would not be passed on to end users. Oftel believes, however, that it is not necessary for BT’s retention on calls to mobiles to be subject to a separate cap in order for customers to benefit from reductions in termination rates. If BT’s retention on calls to mobiles increases, it will need to make offsetting reductions in the prices of other services within the basket.

2.39 Oftel believes that competitive conditions in calls to mobiles are broadly similar to those for other call types. Mobile operators tended to disagree, arguing that fixed operators did not appear to be actively competing on calls to mobile prices. Oftel noted in *Protecting consumers by promoting competition*, that returns on calls to mobiles are lower than on other call types and that this may have discouraged some operators from offering them. However, BT’s current level of returns should be sufficient to attract entry unless operators have a significant cost disadvantage to BT. BT’s share of calls to mobile minutes is similar to its shares of local calls and national calls. In addition, calls to mobiles are available from CPS operators under the ‘all calls’ option. These factors suggest a similarity of competitive conditions between calls to mobiles and other call types and this is reflected in Oftel's proposals set out later in this document.

2.40 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

2.41 In the light of responses to *Protecting consumers by promoting competition*, 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 review of competition in international markets). Responses suggest that Oftel's proposal for a wholesale line rental as set out in *Protecting consumers by promoting competition*, would address one of the main remaining barriers to competition identified: the current need for IA and CPS customers to pay two bills.

Chapter 3

Wholesale line rental

3.1 In the January 2002 consultation document, Oftel set out its view that competition in the provision of fixed services was not effective and that BT remained dominant in the provision of access and calls.

3.2 In calls markets, BT is faced with increasing competition on a national basis from indirect access operators using short dial codes or carrier pre-selection. However, in access markets, the competition is in the main provided by the cable operators whose geographic reach extends to approximately 50 per cent of the country. Competition in access is therefore limited in its geographic scope.

3.3 One consequence of BT's dominance in access – over 80 per cent of residential and business customers are connected to BT's network – has been its ability to maintain call prices that are well in excess of its cost of capital (Oftel estimates that BT's cost of capital is 13.5 per cent – see Oftel's website at www.oftel.gov.uk/publications/pricing/pcr0101.htm). BT continues to maintain extremely high shares in most calls markets and its extremely high profitability in these markets has still to be eroded.

3.4 To increase competition in the fixed telephony market, Oftel proposed that BT should be required to provide wholesale line rental (WLR) to other operators and service providers on cost-based and non-discriminatory terms. This would allow competitors to take on the retail relationship with the customer. All interactions would be with the reseller and who could offer a 'single bill' to end users for all telecommunications services. This would be in contrast to IA under which the retail customer retains a contractual relationship with BT for the provision of the line.

3.5 The introduction of WLR would also provide customers in areas not served by cable operators with a choice of access providers. In addition, Oftel believes that service providers might introduce innovative tariffs that might change the 'balance' between line rental and call charges. It might lead to similar packages to those now available in the mobile market, such as a fixed fee charge including line rental and call charges. Alternatively service providers might choose to offer packages that include a lower fixed rental charge and higher prices for calls.

Responses to the consultation

3.6 Respondents broadly welcomed Oftel's proposal to introduce WLR. However, opinions differed on the extent to which the supply of BT's existing calls and access product were adequate to support WLR. Several service providers and operators argued that Oftel would have to take a proactive role in industry groups that Oftel stated that it would set up to define the product and oversee the development of appropriate supply processes.

3.7 Consumer groups in particular believed that it was essential that adequate consumer protection arrangements were established to counter possible mis-selling. Other respondents urged Oftel to consider ways in which BT could be incentivised to deliver WLR as early as possible.

Oftel's conclusions

3.8 Oftel intends to require BT to provide WLR on cost based and non-discriminatory terms to anyone wishing to offer access to BT's public telephone system or publicly available telephone services. Oftel is therefore consulting on modifications to BT's licence to introduce a new condition requiring BT to provide 'access services'. Oftel is also determining the amount BT can charge other providers for key access services. The proposed licence modifications and the charges for certain access services are described later in this chapter and in annex B (licence modifications) and E (setting the charges).

3.9 Initially, Oftel expects that WLR will be made available in a form similar to the access element of BT's existing calls and access product, as soon as practical after 1 September 2002. However, Oftel is not simply resetting the price of the access element of calls and access. Oftel is setting prices for new products that will need to inter-work with current interconnection products, such as CPS, in order to give competitors an offering that will enable them to compete with BT Retail. In this chapter and in annex D, Oftel has set out key elements of the fully operational second stage product.

3.10 The fully operational second stage product should be made available at the earliest possible date. Oftel therefore proposes to take a lead role in designing the specification of this product. It intends to establish industry groups – comprising operators, service providers and consumer representatives – to develop a product specification for the enhanced WLR. The product specification will include:

- a product functional description;
- a process definition and manual;
- ordering handling and maintenance processes;
- a service level agreement;
- marketing guidelines;
- consumer protection measures;
- consumer guide;
- contract terms; and
- a cost determination for any enhancements if necessary.

3.11 Although Oftel proposes to lead on the design of the product specification, it intends to consult interested parties. Oftel aims to complete and publish the product specification by October 2002.

WLR: provision of access services

3.12 In Condition 69B.1 of the proposed licence modifications Oftel has described access services as follows:

> "….any and all Public Switched Network services ('Access Services') that the Service Provider so reasonably requests for the purposes of providing to his own customers access to the Fixed Public Telephone Systems run by the Licensee or Fixed Publicly Available Telephone Services provided by the Licensee to his own customers, or both."

3.13 In effect, Oftel believes that by virtue of Condition 69B.1 service providers should be able to offer a basic telephony service that is equivalent to the service that BT Retail offers to its customers in terms of the technical offering. In terms of the WLR product, this means that the service provider could provide its retail customer with a line for the provision of incoming call services. It also guarantees that the line would be repaired in the event of failure and that the customer would receive phone books on a non-discriminatory basis. In addition, WLR would allow the service provider to offer outgoing calls services to its customers, although these would have to be bought separately from BT or another operator offering calls services eg a supplier of service using CPS.

3.14 The terms and conditions under which the access services are commercially made available would need to be established within BT's contract with the service provider and within its service level agreement. However, the proposed licence modification would underpin both the contract and the service level agreement, as it includes provisions that are intended to prevent discriminatory behaviour. But the contract and service level agreements are bilateral agreements. Service providers would therefore be expected to honour their obligations. BT would not be expected to maintain service for a service provider in breach of contract.

The proposed licence modifications

3.15 The main provisions of the proposed modifications to BT's licence are as follows:

- *Condition 69B.1 requires BT to provide access services.*

  This is a broad undertaking requiring BT to provide all reasonably requested access services to anyone wishing to offer access to BT's public telephone system or publicly available telephone services.

- *Conditions 69B.3 to 69B.5 empower the Director General to resolve disputes.*

  This would allow the Director General to resolve disputes about charges or other terms and conditions relating to access services.

- *Conditions 69B.6 to 69B.8 requiring BT not to act in a discriminatory manner.*

This is a broad provision requiring BT not to act in a discriminatory manner. The Director General would need to decide on a case-by-case basis whether BT had acted in a discriminatory or otherwise in an anti-competitive manner. However, in general, Oftel would not expect service providers' customers to experience longer lead times in the provision of service or experience more faults or slower repair of such faults than BT Retail customers' experience.

- *Condition 69B.9 establishes publication requirements.*

Oftel believes that BT should publish a notification (the 'Access Charge Change Notice') before changing the price for any access service. Oftel believes that notification requirements should match those in Condition 69. It is therefore proposing that BT should issue a notice ninety days before changing a price for services for which Oftel is setting price controls – in effect, these are regarded as non-competitive services. For other services, Oftel believes that BT should provide twenty eight days' notice.

- *Condition 69B.10 sets starting charges for certain access services.*

Oftel proposes to set starting charges for the following services:

- wholesale line rental (residential quality of service);
- wholesale line rental (business quality of service);
- transfer of a single line or multiples thereof; and
- installation charge per line.

Oftel proposes that these will take effect on 1 September 2002.

- *Condition 69B.11 to Condition 69B.21 set the price controls.*

Oftel proposes to control the charges for the services for which it is setting starting charges. This would be through the introduction of price controls that would apply to the basket of services. However, within the basket the transfer charge would be subject to a sub-cap. Oftel proposes to set the charges for the basket control and the sub-cap at RPI-2 per cent.

3.16 At Annex B, Oftel has set out the proposed new Condition 69B to give effect to the requirement to provide WLR. Oftel has set out this proposed modification to BT's licence for statutory consultation and is therefore seeking comments on these proposed modifications by **19 July 2002**. Thereafter, Oftel will remind BT that it has seven days to object to the proposed licence modifications. If it does not do so, the modifications will take effect from 1 August 2002.

WLR: Costs, charges and charge controls

3.17 Oftel is setting the following starting charges for the following services:

- wholesale line rental (residential quality of service) – £28.00 per line, per quarter;
- wholesale line rental (business quality of service – £29.87 per line, per quarter;
- transfer of a single line and multiples thereof – £1.41 per transaction or multiples thereof; and
- each newly installed line – £92.89 per line.

3.18 Oftel has set these charges on the basis of BT's incremental costs in providing these services plus a contribution towards common costs. Oftel has set out its cost calculation in annex E.

3.19 In addition, Oftel proposes to subject these services to a basket control set at RPI-2 per cent and subject the transfer charges to a sub-cap within the basket, which will also be set at RPI-2 per cent. These controls would last for four years – if Oftel has introduced a specific condition of entitlement to give effect to these controls after 24 July 2003 – with each control set to commence on 1 September 2002.

3.20 At present, Oftel does not propose to set prices for ancillary services such as call waiting. However, Oftel expects BT to provide these services and expects prices for them to be reasonable. The Director General would consider any dispute brought to him on the reasonableness of any charges.

WLR residential and business quality of service

3.21 In paragraph 3.17, Oftel has stated that it proposes to set starting charges for two WLR services and the difference in the charges is due to the different levels of service quality in terms of fault repair. The residential quality of service product offers fault repair by the end of the next working day (Monday to Friday) if reported within normal working hours (8am to 5pm). Although BT only states that it offers similar repair services to its business customers, its actual aim is to restore service in faster for business customers. Oftel intends to monitor how quickly BT repairs services for its own customers in comparison to service providers' customers. Service providers need not buy residential quality of service for a residential customer and nor do they have to buy business quality of service for a business customer.

Implementing WLR

3.22 As explained in paragraph 3.10, Oftel intends to set up industry groups to develop a Product Specification for enhanced WLR. The two main groups that Oftel envisages are:

- a **steering group**, comprising senior representatives of the operators, service providers and consumers to monitor the progress of the project and to consider significant policy or process issues which cannot be resolved in other groups; and

- an **operations group**, which will co-ordinate the development of the product specification.

3.23 Oftel proposes to chair both groups. Other tasks groups will be set up on an ad hoc basis to develop particular aspects of the Product Specification eg processes, systems, service level agreements and contract terms.

3.24 The task groups will deliver their output to the operations group. Oftel may appoint consultants with specialist technical expertise to assist in the development of the product specification as appropriate. However, in the first instance, Oftel intends to build on the processes designed for carrier pre-selection and calls and access.

3.25 Oftel will hold workshops in July to discuss an outline product specification and the groups and work plan needed to deliver it. Further details of the workshops will be given on Oftel's website.

3.26 The rest of this chapter seeks to define the essential elements of the enhanced WLR product and processes to be described in the product specification.

WLR: relationship with carrier pre-selection (CPS)

3.27 WLR allows the purchaser to offer 'access' to an end user. It is likely that some service providers would wish to combine WLR with either the CPS functionality – purchased directly or indirectly depending upon their status – while others might prefer to buy wholesale conveyance purchased from BT. Operators with Annex II status can purchase cost based call origination services from BT and can mix this service with other interconnection services purchased from BT, other operators or services provided over their own networks in order to compete in the provision of end to end calls. Service providers without Annex II status could choose to purchase wholesale calls services from BT or other operators though these would not necessarily be available on cost-based terms.

3.28 In theory, it is not necessary for WLR and CPS to be provided simultaneously, provided that the customer experiences a single transfer to the WLR provider. The service provider could ask BT to provide the WLR and activate CPS as soon as possible thereafter. In between these times the end-user would use BT for calls services. However, in practice, it is likely that the service provider reselling WLR would wish to offer access and the means of making outgoing calls simultaneously or, if that is not possible, with little gap in the provision of both services.

WLR: indirect access

3.29 BT's current call and access product has a facility whereby calls and access customers can override the routing selected by their service provider and choose to route calls via an indirect access operator. This facility will be present in the basic WLR product available after 1 September 2002. Indeed, some customers might prefer the ability to select other call service providers and this might make the retail offering giving such freedom an attractive proposition. However, Oftel is aware that some service providers would prefer not to allow their customers to have a choice to route calls via anyone other than themselves. They argue that they need to guarantee that they will receive the customer's call income if they are going to be able to offer innovative tariffs, such as lower fixed elements being subsidised by higher price variable elements.

3.30 Oftel believes that the requirement to provide call origination services should be applied only to operators that have SMP in the relevant market. In the national markets for access and calls, this is BT. This principle would suggest that service providers using the WLR should not be obliged to allow their retail customers to choose to route their calls via an alternative IA or CPS operator. However, to enable service providers to bar their customers from using IA operators could require alterations to BT's network, which might involve costs.

3.31 Oftel therefore proposes to consult on whether service providers taking WLR should be able to bar access to indirect access (including CPS) operators' services on WLR lines. This consultation will include discussions on the relevant costs and who should pay them taking account of Oftel's six principles of cost recovery, namely:

- **cost causation** – costs should be recovered from those whose actions cause the costs to be incurred at the margin;

- **cost minimisation** – the mechanism for cost recovery should ensure that there are strong incentives to minimise costs;

- **distribution of benefits** – costs should be recovered from the beneficiaries especially where there are externalities;

- **effect on competition** – the mechanism for cost recovery should not undermine or weaken the pressures for effective competition;

- **reciprocity** – where services are provided reciprocally, charges should also be reciprocal; and

- **practicability** – the mechanism for cost recovery needs to be practicable and relatively easy to implement.

Notification requirements

3.32 Oftel is requiring BT to provide WLR and related services because of its dominance in the provision of access. It therefore follows that competitors will need prior notification before BT is permitted to change a price for any access service. Oftel believes that it is reasonable to require BT to provide advance notification that is consistent with BT's interconnection requirements. BT will therefore be required to give ninety days' notification before changing the price or the structure of the price for the services subject to price controls. For other services, BT will be required to give twenty eight days' notice.

3.33 These notification periods are intended to give competitors an opportunity to change the prices for their retail services in line with changes at the wholesale level.

Other issues

3.34 Respondents to the January 2002 consultation raised several other issues about the WLR product and processes. These are set out in annex D. Oftel's views on these issues, also set out in that annex, will inform the content and development of the product specification. Oftel's broad views on the essential features of the fully operational WLR product are summarised in Table 3.1.

Table 3.1: WLR – essential features

Customer/WLR supplier relationship	• WLR customer can receive just one bill covering access and calls. • WLR provider will handle customer enquiries.
BT/WLR supplier relationship	• BT to provide residential and business products. • number portability available. • BT Retail sales and marketing functions not to have access to details of WLR customers.
Relationship between WLR suppliers	• transfer of service between WLR suppliers available. • number portability available subject to industry agreement to the process.
Volume capability	• needs to handle significant volumes. • appropriate forecasting requirements.
Transfer process	• highly automated with little manual intervention except where a manual method is more cost effective. • appropriate level of 'winback' activity. • no blocking of transfers because of outstanding customer debt. • BT to be able to demonstrate that its retail business incurs similar costs when customers transfer back as is charged to SPs in outgoing transfers.
Consumer protection	• appropriate consumer protection measures. • Marketing Code of Practice to be established.
Interaction with CPS	• inter-working with CPS seamless from customer's perspective. • where practical, a single process for transferring lines and calls. • minimal delay between the transfer of a line and CPS routing.
Developments after launch	• standard processes for notification of price or other service level changes. • formal modification process for the development of product. • on-going monitoring of WLR performance measures.

Chapter 4

Retail price controls

4.1 Oftel believes that the main constraint on BT's call prices in future should be provided by competition. As explained in chapter 2, competition is increasing (but not yet effective) and Oftel believes it should be stimulated further by the availability of the wholesale line rental product. Some control on line rentals may continue to be necessary, although competitive pressure could be brought to bear on these charges by suppliers using the wholesale line rental product. However, despite the current and prospective growth in competition, Oftel believes that protection continues to be needed to prevent BT from exploiting its market power as competition develops. Oftel also recognises that longer term protection will be needed for the lowest spending customers.

4.2 The main elements of Oftel's price control proposals in the January 2002 consultative document to address these issues were:

- an RPI-RPI safeguard control to control customers' bills while allowing BT to respond to increasing competitive pressure in calls markets,
- a method of removing the RPI-RPI control as competition becomes effective, and
- ongoing consumer protection measures for lowest spending customers.

Safeguard control

4.3 In *Protecting consumers by promoting competition*, Oftel explained its view 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. This would not be sustainable in a world where increased competition is expected to eliminate persistent excess profits.

4.4 Oftel also considered the imposition of broader price controls covering all residential and business customers. This would target price controls on the areas where BT continues to make excessive profits. However, it would supplant the forces of competition rather than using them. Oftel believes that this would not be appropriate as the primary means of reducing BT's call prices unless there were little or no prospect of competition emerging in the foreseeable future. Oftel believed that this is not the case and so considered that such a broadening of price controls would not be appropriate.

4.5 Oftel also took the view that it would be undesirable for the cap to be too narrowly focused. A cap based on the spending patterns of too small a group of customers could invite BT to target price reductions precisely on this group, with little benefit to customers outside it who might also not yet be benefiting from effective competition. This could also undermine the intention not to give BT an incentive to raise the line rental ahead of competitive pressure described above.

4.6 Oftel considered whether it could identify a level of spend above which competitive conditions were clearly different to those below it. It considered the profile of average call prices by spend, taking account of discounts and calls provided in the form of Inclusive Call Allowances, together with survey results on customer awareness and use of alternative operators. Both types of indicator suggested that competitive pressure tends to increase with spend, but Oftel has found that there is no obvious threshold of spend at which calls markets become competitive.

4.7 Oftel explained that as competition develops BT is likely to want to rebalance, that is increase the residential line rental to the point where it covers its costs, including a standard contribution to the recovery of common costs. Indeed, this is likely to be necessary if competition develops in the way Oftel hopes. Oftel does not believe that it would be consistent with the emergence of increased competition in calls markets to assume that BT will continue to make sufficient supernormal profits from higher spending customers to fund lower spending customers. Oftel also noted that most customers would be better off than they are today if prices for lines and calls properly reflected costs. Thus, rebalancing within a vigorously competitive environment for calls would be to the benefit of most customers, as well as providing a more economically sensible structure of prices.

4.8 In the light of these concerns, Oftel proposed in the consultative document that there should be a safeguard control – RPI-RPI – over retail prices, at least as a short-term measure. This would be based on the spending patterns of the lowest 80 per cent of residential customers. This would allow BT to rebalance as call prices are forced down by competition, but would not give BT an incentive to raise rentals and reduce call prices in the absence of vigorous competition in calls markets. The control has this effect because of the high weight of access in the spending of the bottom 80 per cent of residential customers means that increases in the line rental have to be offset by relatively large reductions in call prices (which also benefit higher spenders). The required call price reductions can be such that increases in the line rental are overall unprofitable for BT, unless it would have to reduce call prices anyway as a result of competitive pressure. The design of the cap therefore discourages BT from rebalancing unless competition is forcing call prices down. In the absence of competitive pressure on call prices, BT is likely to wish to increase the residential line rental only relatively slowly.

Responses

4.9 BT argued that the RPI-RPI control was excessively tight if focused on the lowest 80 per cent of customers, a group from which BT earns less than its cost of capital. Other providers recognised that, in the absence of effective competition at the wholesale level, there was potential for BT to exploit its position through excessive pricing. Because of this they accepted the need for the safeguard control but argued that Oftel's emphasis should be on establishing the wholesale line rental product. Some consumer groups preferred a control similar to the current RPI-X cap aimed at driving out BT's excess profits or targeted at call price reductions.

Oftel's conclusions

4.10 On balance, Oftel believes that a RPI-RPI control weighted towards the spending patterns of the bottom 80 per cent of residential customers provides the most appropriate degree of customer protection, as well as having desirable incentive properties.

4.11 The control would not be expected to act as the ultimate determinant of prices, but would give consumers confidence that some level of price constraint would remain if competition developed less rapidly than expected. It would also allow BT to raise the line rental to recover a greater proportion of common costs from its access business as competition develops, without giving it a regulatory incentive to do so in advance of competitive pressure.

4.12 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 Director General is empowered under the proposed new Condition 70 to limit the control to RPI-4 per cent if inflation is greater than 4 per cent per year.

4.13 The proposed licence modification to introduce this control – Condition 70 – is set out in Annex B. The control is intended to last for four years – if Oftel has introduced a specific Condition of Entitlement to give effect to these controls after 24 July 2003 – although Oftel is able to modify or remove the control during that period.

Treatment of calls to mobiles

4.14 As explained in chapter 2, BT continues to have high market shares and makes high returns in all calls markets. However, in calls originating on BT's network bound for any of the five mobile operators (BTCellnet, Hutchison 3G, Orange, T-Mobile and Vodafone), its returns are lower than for other major call types. This reflects the controls that have capped BT's retention for calls to BTCellnet and Vodafone that have been in place since 1 April 1999. BT's market share for calls to mobiles and other major call types are broadly similar.

4.15 As the competitive conditions for calls to mobiles and other calls types were (and remain) broadly similar, Oftel proposed in the consultation document to include BT's retention for calls to mobiles within the general price control basket. This remains Oftel's proposal. In its 1998 report on the Prices of Calls to Mobiles, the then Monopolies and Mergers Commission (now the Competition Commission) stated that it believed that BT's retention for calls to different mobile networks should be the same at all times of day, so that BT's retention could not distort any competitive pressures brought about by different termination rates charged by different mobile operators. The current licence condition dealing with BT's retention for calls to BTCellnet and Vodafone reflects this, and BT's retention for calls to different mobile networks is allowed to differ in any time of day period by no more than 0.1 pence per minute. Oftel intends that the price control basket and this non-discrimination requirement (the 0.1 pence per minute differential) will continue and, although Oftel did not refer to calls to Hutchison 3G in *Protecting consumers by promoting competition*, Oftel believes it should also apply to calls to Hutchison when it starts offering retail services.

Removing controls as competition develops

4.16 The speed of the development of competition has implications for the sustainability of the proposed price RPI-RPI price control. As competition develops there is a risk that the RPI-RPI control could prevent BT from recovering its costs. The returns from the lowest spending 80 per cent of residential customers, measured on a fully-allocated cost basis, are below the cost of capital. Profits from other higher spending customers allow BT to recover its costs overall. If competition develops as expected, the profits that BT makes outside the basket on calls will be competed away and the control may eventually not be sustainable for BT.

4.17 To address these issues, Oftel proposed in *Protecting consumers by promoting competition* that there should be a trigger to remove the control once competition reduced BT's call profits. Oftel suggested that it would automatically remove the control once call prices had fallen by 50 per cent (reflecting a rate of return on calls of around 25 per cent).

Responses

4.18 The automatic trigger raised widespread concerns. BT argued that a level of 50 per cent was much too high and rendered the proposal meaningless. Other providers were concerned that the proposal would give BT an incentive to reduce call prices ahead of competitive pressures and make competitors' market position unsustainable. Consumer groups argued that the automatic nature of the trigger, focussing on one indicator of competition, was not appropriate and proposed instead for a review taking account of all relevant factors.

Oftel's conclusion on the process for relaxing the control

4.19 Oftel does not intend to proceed with the trigger to remove price controls automatically. As explained above, Oftel proposes to carry out a full review of the retail market in 2004 in line with the requirement in the new European Directives to hold regular reviews. This would enable Oftel to take account of all indicators of competition in assessing which controls were appropriate.

4.21 In the meantime, Oftel believes that concerns about the possible excessive tightness of the proposed control, particularly if the introduction of the WLR generates additional competitive pressure on BT, can be addressed in an alternative way.

4.22 As explained in paragraph 4.16, it is conceivable that the RPI-RPI control focussed the bottom 80 per cent of residential customers could be too tight, as the return that BT makes on this group of customers is lower than its cost of capital. The likelihood of this control being too tight is increased with the introduction of WLR, as BT could lose higher spending customers that currently allow BT to earn more than its cost of capital overall.

4.23 In view of this concern, and in order to provide BT with an incentive to introduce WLR as quickly and efficiently as possible, Oftel proposes to modify the price control from RPI-RPI to RPI+0 per cent. But this modification will take place only when Oftel is convinced that a fit-for-purpose product is available and being actively used by competitors.

4.24 Additionally, Oftel does not anticipate carrying out an assessment of the functionality of WLR until it has been available for three months, as this would allow for any significant operational issues to be identified. Oftel would make use of external expert advice if appropriate. If Oftel concluded that that BT had implemented a fit-for-purpose WLR product in line with the determined Product Specification, as far as reasonably practical, it would issue a draft Determination proposing to modify the control. The modified control would be monitored on the same basis as the RPI-RPI control. Table 4.1 shows the sequence of events that might lead to an easing of the price controls.

Table 4.1: Implementation of WLR and easing of retail price controls

Implementation work	Timing
Oftel-led development of WLR Product Specification	July to September 2002
Consultation on draft Product Specification	October 2002
Publication of final Product Specification	November 2002
BT development, testing and implementation	August 2002 to Date ‘X’
BT notifies Oftel of implementation	Date ‘X’
Oftel carries out fit-for-purpose assessment	Date ‘X’ plus three months
Oftel issues draft Determination proposing to relax the price control[1]	Date ‘X’ plus four months
Oftel issues final Determination relaxing price control	Date ‘X’ plus five months

[1] This assumes that the ‘fit-for-purpose’ assessment has been satisfactorily met.

Ongoing protection

Light User Scheme

4.25 In *Protecting consumers by promoting competition*, Oftel proposed additional measures to protect the lowest-spending residential customers. Because the line rental forms a significant proportion of these customers' bills, reductions in call prices are unlikely to compensate fully for rental increases, as competition pressures force BT to change the relative prices within the price control basket. Oftel therefore proposed to protect these customers in one of two ways:

> a) the application of a bill constraint of RPI+0 per cent on the amount by which the bills of customers in deciles 3, 4 and 5 could increase; or
>
> b) by extending the Light User Scheme (LUS), which currently provides rebates to the line rental for qualifying BT customers in deciles 1 and 2, to include qualifying customers in decile 3.

4.26 Oftel stated that these measures would remain in place even if the RPI-RPI control were modified or removed.

Responses

4.27 BT argued against RPI+0 per cent controls on the grounds that they would be unnecessarily restrictive and prevent BT from addressing the structural imbalances in tariffs between access and calls. BT favoured instead an extension of the LUS to customers in decile 3, which would take effect if and when BT raised line rental by an amount that would otherwise increase the average decile 3 bill by more than inflation. Other providers also preferred the LUS extension seeing it as the option least likely to distort the market. Consumer groups tended to favour the RPI+0 per cent control but were concerned that the interaction of the RPI-RPI and RPI+0 per cent controls and LUS made the package of measures overly complex.

Oftel's conclusions

4.28 Oftel believes that the protection should be targeted at those customers whose overall bills might increase as rental charges increase. Customers in deciles 4 and 5 should be no worse off and in most cases should benefit if line rental and call charges reflected costs. Oftel therefore favours the targeted protection provided by an extension of LUS to the 3rd decile. The main feature of the new arrangements is to protect LUS customers in decile 3 from line rental increases, after allowing for inflation. This approach is consistent with Oftel's strategy of regulating only where necessary. It also has the advantage of simplifying the main price control measures to a single control of RPI-RPI with ongoing protection provided by LUS.

4.29 There is a risk of the call spend deciles could be distorted over time by ‘all calls’ CPS customers (who make no calls via BT and therefore would appear in the lowest call spend deciles). To prevent LUS having a decreasing populace, BT has indicated that it would be willing to ‘freeze’ the maximum number of minutes enabling customers to qualify for the existing and extended LUS schemes at an amount determined by the current levels and patterns of usage of customers at the 21^{st} percentile and 31^{st} percentile respectively. This would protect the value of LUS over time. BT has also indicated that it would be willing to modify its current blanket exclusion of mobile users from LUS to address the issue that some customers now have a mobile for emergency purposes only.

4.30 Oftel is scheduled to review all Universal Service schemes in 2003. This review will examine the operation of the revised LUS scheme and ensure it is providing adequate protection. In particular, Oftel will consider the treatment of consumers who also have mobile phones (and who are thereby excluded by BT from LUS, although BT has agreed to modify its treatment of such customers – see previous paragraph).

Rental ceiling

4.31 In *Protecting consumer by promoting competition*, Oftel argued that, because of BT’s dominance in access, there was a need for a ceiling on the retail line rental to ensure that would not rise above cost.

Responses

4.32 BT argued that a ceiling would be increasing regulation and unnecessary because of developing retail competition.

Oftel’s conclusions

4.33 Oftel continues to believe that there should be a cost-based ceiling (ie the costs of provision of WLR and a contribution its retail costs in providing service) on BT’s retail line rental because of BT’s dominance in access. Oftel will require BT to demonstrate that increases in the line rental do not make it rise above a ceiling. However, Oftel recognises that the WLR product may eventually provide sufficient competitive pressure to prevent BT from pricing line rental above cost. Oftel would assess the level of BT’s market power in access as part of the 2004 market review and consider the ongoing need for a regulatory ceiling.

Hardwired phones

4.34 Around 200,000 customers rent hardwired phones from BT. There is currently a licence requirement on BT not to increase the rental charge for hardwired phones in real terms (ie RPI+0 per cent) and this expires on 31 July 2002. BT currently charges £25 to convert the connection from hard-wired to a plug and socket connection. In the January 2002 consultative document Oftel proposed that this protection should continue, given the absence of competition in the provision of hard-wired phones and the costs involved in switching to the plug and socket connection.

Responses to the consultation

4.35 BT recognised that elderly and vulnerable customers use hardwired phones but argued that, because numbers of such customers are currently falling by 20 per cent each year, the control should continue only for a defined period of time or until numbers fall to an agreed level (for example, 100,000). Consumer groups argued that the control should continue until BT removes its charge for converting the socket.

Oftel's conclusions

4.36 Oftel believes that the charge for socket conversion may prevent customers from upgrading and may provide BT with an opportunity to raise rental charges above what would be the competitive level. Oftel therefore believes that the RPI+0 per cent control should remain. However, if BT were to offer free socket conversions on a permanent basis, Oftel would propose to waive the control.

Small business safeguard

4.37 As part of the current price control package, BT has given voluntary assurances: (i) to offer a package to small businesses that is equivalent to that offered to residential customers; and (ii) not to increase the line rental for small businesses by more than RPI each year.

Responses

4.38 BT argued that high awareness and increasing use of IA, together with low take-up of the safeguard tariff (less than 1 per cent of BT's business customers) meant that the controls were no longer needed. Consumer groups responding on the issue felt that the safeguard should continue to protect in particular very small businesses and business without a choice of access provider.

Oftel's conclusions

4.39 Because of BT's continuing dominance in the access market, Oftel believes that the RPI+0 per cent rental safeguard should continue. Oftel will seek BT's voluntary assurance to this. In calls markets, Oftel recognises that businesses are able to choose a range of alternative suppliers. This should be further enhanced by the introduction of the WLR product. Oftel therefore does not intend to seek BT's commitment to provide a business calls safeguard. Oftel will continue to monitor the business market and will include this area in the 2004 market reviews.

Chapter 5

Consultation details

How to make representations and objections to the proposed changes

5.1 Parties likely to be affected by the proposed changes to BT's licence have until 19 July 2002 to make representations or objections to the proposed changes. Any representations or objections must be made in writing and, where possible, sent by e-mail to mike.galvin@oftel.gov.uk. However, copies may also be posted or faxed to the address below. If any affected 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

5.2 In accordance with Section 12(6D) of the Telecommunications Act 1984, representations made against the proposed modifications shall be taken to constitute an objection only if a written statement that they are to be so taken accompanies them. The Director is required by Section 12(2) of the Act to consider any representations or objections on the proposed modifications duly made and not withdrawn. Subject to such consideration, and to the consent of BT for the respective modifications, the Director proposes to make the modifications as soon as practicable after the statutory consultation is completed.

Further copies of this document

5.3 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 the Oftel Research and Information Unit on 020 7634 8761 or by e-mail at infocent@oftel.gov.uk for more information.

Publication of representations and objections

5.4 Representations and objections 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.

5.5 Non confidential representations and objections can be viewed in the Publications section of Oftel's website under classification Responses to Oftel consultations. They may also be viewed in Oftel's Research and Information Unit. Appointments must be made in advance (see contact details in paragraph three).

Annex A

Respondents to consultation

A.1 On 31 January 2002, Oftel published the consultation document entitled *Protecting consumers by promoting competition*. That document set out Oftel's initial proposals for future price control arrangements, having considered the competitiveness of basic retail telephony markets, with the focus especially on competition in the provision of access and calls. Oftel had set out its initial views on competitiveness in the consultation document entitled *Competition in the provision of fixed telephony services*, 31 July 2001. Responses to that document had been taken into account in reaching the initial proposals set out in *Protecting consumers by promoting competition*.

Responses, industry workshop and other meetings

A.2 Oftel received twenty-seven responses (one of which was confidential) to *Protecting consumers by promoting competition*. Responses were received from established telecommunications operators and others that have recently entered the market, as well as from all major consumer representatives. The respondents were (in alphabetical order):

1. Ashley, Pauline;
2. Association of Communications Service Providers;
3. BT;
4. Cable & Wireless;
5. Calls and Access Interest Group (CAIG);
6. Centrica;
7. Communication Workers Union;
8. Consumer Communications for England and Communications for Business;
9. Advisory Committee for Disabled and Elderly people (DIEL);
10. Energis;
11. LE Group/Virgin HomePhone Ltd;
12. National Consumer Council;
13. NCS Pearson;
14. Northern Ireland Advisory Committee on Telecommunications;
15. OneBill Telecom Ltd;
16. Operators Group[2];
17. Orange;
18. Powergen;
19. Public Utilities Access Forum;
20. The Royal Society for Mentally Handicapped Children and Adults (Mencap);
21. Scottish Advisory Committee on Telecommunications;
22. Telephone Helplines Association;

[2] Cable & Wireless; Colt Telecommunications; Energis; Fibernet Group plc; Global Crossing; Kingston Communications; Redstone Communications; Telia International Carrier; Thus; WorldCom; and Your Communications.

23. Telewest;
24. TXU;
25. Welsh Advisory Committee on Telecommunications; and
26. Wendon, Dave

Annex B

Proposed Modifications to BT's Licence

(DEFINITIONS)

In paragraph 1 of Part 1 of Schedule 1 to BT's Licence under the sub-heading entitled 'ADDITIONAL DEFINITIONS RELATING TO SCHEDULE 1 TO THIS LICENCE'', the following definitions shall be inserted in the appropriate places in alphabetical order or substitute the existing definitions (as the case may be), as described below:

1. the following new term **"Access Services"** shall be inserted—

'"Access Service" has, for the purposes of Condition 69B, the meaning given to it in Condition 69B.1;'

2. the following new term **"Access Services Charges"** shall be inserted—
'"Access Services Charges" for the purposes of Condition 69B mean charges (being in all cases the amounts offered or charged by the Licensee) to Service Providers for Access Services described in paragraphs 69B.11(a) to 69B.11(h), as the case may be, of Condition 69B;'

3. the following new term **"Calls to Mobiles"** shall be inserted—

'"Calls to Mobiles" mean, for the purposes of Condition 70, a circuit switched conveyance of a Message originating in a telecommunication system which is not an Applicable System but which is connected to any of the Applicable Systems, and intended to terminate on a handset connected to the mobile public telecommunication system of any Specified Mobile Operator, other than:

(a) any call by which there is conveyed a voice telephony Message in relation to any services provided by means of any of the Applicable Systems which form part of its Supplemental Service Business;

(b) any call, however paid for, from a Public Call Box, any call from a Private Call Box where the charge to the renter is based on charges for calls from Public Call Boxes published by the Licensee in accordance with Condition 7 and transferred charges in respect of calls from Calls from Call Boxes;

(c) any call connected with the assistance of a human operator;

(d) any call billed by means of the Licensee's Chargecard service or any successor service;'

4. for **sub-paragraphs (ii) and (iii) of the definition of “Controlling Percentage”** there shall be substituted the following, respectively—

‘**(ii)** for the purposes of Condition 69B, has the meaning given to it in Condition 69B.13;
(iii) for the purposes of Condition 70, has the meaning given to it in Condition 70.6;’

5. the following new term “**Existing Line Transfer**” shall be inserted—

‘“Existing Line Transfer” means the combination of transactions consisting of a customer (including a customer who is a service provider) of the Licensee for an Exchange Line terminating his contract (‘the customer contract’) with the Licensee for the Exchange Line, and the Licensee entering into a contract for that Exchange Line with a Service Provider (‘the Service Provider contract’), except where the Service Provider contract is entered into after the Licensee has ceased the Exchange Line (in which case the Service Provider contract shall be deemed to be a New Line Installation).”

6. for the definition of **“General Prices”** there shall be substituted the following—

‘“General Prices” mean:

(i)

(A) charges for the use and Ordinary Maintenance of a residential Exchange Line;

(B) charges for the connection or taking over of a residential Exchange Line;

(C) charges for the conveyance by means of such Exchange Lines of voice telephony Messages from a place within the Licensed Area to any other place (whether or not within the Licensed Area);

(D) charges for the facility of transferring, with assistance from a human operator, voice telephony Messages referred to in sub-paragraph (i)(C) above;

(E) the Retention for Calls to Mobiles; and

(F) charges (or groups of charges) including the fee, (if any) for services offered in combination with charges (or groups of charges) for other services (or groups of services) or with a periodic or non-periodic fee and which, if the Value Added Service (or group of services) was charged for separately or a fee was not payable, would be General Prices, other than:

(AA) charges payable by Operators;

(BB) charges for Private Leased Circuits or International Simple Bearer Circuits;

(CC) charges for special, emergency or priority Fault Repair Services;

(DD) charges for the conveyance of voice telephony Messages in relation to any services provided by means of the Licensee's Applicable Systems which formed part of its Supplemental Services Business;

(EE) charges for the conveyance of voice telephony Messages which are to be conveyed to customers of an Operator which is not a Fixed Link Operator;

(FF) charges for Specially Tariffed Voice Services;

(GG) charges for Directory Information Services;

(HH) charges, whether paid in cash or by credit card or debit card or token or otherwise, in respect of calls from Public Call Boxes, and calls from Private Call Boxes where the charge to the renter is based on charges for calls from Public Call Boxes published by the Licensee in accordance with Condition 7, and transferred charges in respect of calls from Call Boxes;

(II) charges for any Maritime Services;

and each discrete charge of any such description shall be treated as a separate General Price;

(ii) for the purposes of Condition 71, the meaning given to it in sub-paragraph (i) above, except that it shall not include those General Prices agreed between the Director and the Licensee on or before the date on which that Condition came into force and, subject to that exception, shall include charges for services which, if offered to residential customers, would be General Prices;'

7. the following new term **"New Line Installation"** shall be inserted—

'"New Line Installation" means a service provided under Condition 69B for the installation of an Exchange Line, where some or all external (or internal) wiring has to be provided, or brought into use for the first time, by the Licensee. For purposes of this definition, “external wiring” means wiring from the distribution point to the protection box (or where one would be fitted) at the premises at which the Network Termination and Testing Apparatus is located and “internal wiring” means wiring from the protection box up to and including the first main socket, block terminal or other Network Termination Point;’

8. for sub-paragraph (ii) of the definition of **“Percentage Change”** there shall be substituted the following—

‘**(ii)** for the purposes of Condition 70, has the meaning given to it in paragraph 70.2;’

9. the following new **sub-paragraphs (iii) and (iv) of the definition of “Percentage Change”** shall be inserted immediately after paragraph (ii) of that definition:

‘**(iii)** for the purposes of Condition 69B, in relation to the aggregate of charges for the Access Services specified in paragraphs 69B.11(a) to 69B.11(d), has the meaning given to it in paragraph 69B.12;’

‘**(iv)** for the purposes of Condition 69B, in relation to the charge for Existing Line Transfer, has the meaning given to it in paragraph 69B.14;’

10. for sub-paragraph (i) of the definition of **“Relevant Year”** there shall be substituted the following—

‘**(i)** except for the purposes of Conditions 69, 69B and 73, any of the four periods of 12 months beginning on 1st August starting with 1st August 2002 and ending on 31st July 2006;’

11. the following new **sub-paragraph (iv) of the definition of “Relevant Year”** shall be inserted immediately after paragraph (iii) of that definition:

‘**(iv)** for the purposes of Condition 69B only, any of the four periods of 12 months beginning on 1st September starting with 1st September 2002 and ending on 31st August 2006;’

12. the following new term **“Retention”** shall be inserted—

‘“Retention” means the retail charge made by the Licensee at its standard tariffs net of discounts for Calls to Mobiles less the payment made by the Licensee to each Specified Mobile Operator for interconnection of the Calls to Mobiles, and the term “interconnection” has the same meaning as in the Telecommunications (Interconnection) Regulations 1997;’

13. the following new term **"Specified Mobile Operator"** shall be inserted—

'"Specified Mobile Operator" means any and all of the following specified companies or their subsidiaries or branded operations, or any successor company operating the same or substantially the same mobile public telecommunication system:

(a) BT Cellnet Limited (formerly Telecom Securicor Cellular Radio Limited);
(b) Vodafone Limited;
(c) Orange Personal Communications Services Limited;
(d) T-Mobile (UK) Limited (formerly One 2 One Personal Communications Limited which was, in its turn, formerly Mercury Personal Communications Limited);
(e) Hutchison 3G UK Limited;

14. the following new term **"Value of Inclusive Calls"** shall be inserted—

'"Value of Inclusive Calls" means, for the purposes of Condition 70, the monetary value of the charges for the conveyance by means of residential Exchange Lines of voice telephony Messages from a place within the Licensed Area to any other place (whether or not within the Licensed Area) which are included in the charges for the use and Ordinary Maintenance of such Exchange Lines;"

15. the following new term **"Wholesale Line Rental"** shall be inserted—

'"Wholesale Line Rental" means a service provided to a Service Provider under Condition 69B for the use and Ordinary Maintenance of an Exchange Line.'

(CONDITION 69B)

REQUIREMENT TO PROVIDE, AND CONTROL OF CHARGES FOR, ACCESS SERVICES

Provision of Access Services

69B.1 The Licensee shall, within a reasonable period of receipt of a request from a Service Provider, provide, or offer to provide, to that Service Provider any and all Public Switched Network services (“Access Services”) that the Service Provider so reasonably requests for the purposes of providing to his own customers access to the Fixed Public Telephone Systems run by the Licensee or Fixed Publicly Available Telephone Services provided by the Licensee to his own customers, or both.

69B.2 Subject to paragraphs 69B.10 to 69B.21, the Licensee shall provide, or offer to provide, Access Services to the Service Provider on terms and conditions (including charges) which are reasonable.

Dispute Resolution

69B.3 Where any question arises out of this Condition as to the reasonableness of:

(a) any term or condition (including a charge); or
(b) any request made by a Service Provider pursuant to paragraph 69B.1,

either party may refer in writing the dispute to the Director for determination, which determination shall be binding on both parties.

69B.4 Before referring a dispute to the Director under paragraph 69B.3, the parties shall take all reasonable steps to resolve the matter (including, where appropriate, the provision of relevant evidence to support any assertions made). The Director may decline to give a determination where it appears to him that the parties have not complied with the provisions of this paragraph, including where a Service Provider is unable to demonstrate to the satisfaction of the Director that there are sufficient reasons for the Provider to assert that:

(a) any term or condition (including a charge) is not reasonable; or
(b) the Provider has reasonably requested the Access Services in question pursuant to paragraph 69B.1.

69B.5 The Licensee shall ensure that he is able to demonstrate to the Director at his request that any term or condition (including a charge) is reasonable. Where the Licensee fails to the satisfaction of the Director to demonstrate such reasonableness, the Director may take such failure into account in considering whether a term or condition (including a charge) is reasonable and may draw such inferences as he considers appropriate in the circumstances of each case in order to make his determination.

Undue Preference and Undue Discrimination

69B.6 The Licensee shall not (whether in respect of the charges or other terms or conditions applied or otherwise) show undue preference to, or exercise undue discrimination against, particular persons or persons of any class or description as respects the provision of any of the matters to which this Condition relates.

69B.7 The Licensee may be deemed to have shown such undue preference or to have exercised such undue discrimination if it unfairly favours to a material extent a business carried on by it in relation to the doing of any of the things mentioned in paragraph 69B.6 so as to place at a competitive disadvantage Service Providers competing with that business.

69B.8 Any question relating to whether any act done or course of conduct pursued by the Licensee amounts to such undue preference or such undue discrimination shall be determined by the Director, but nothing done in any manner by the Licensee shall be regarded as undue preference or undue discrimination if and to the extent that the Licensee is required to do the thing in that manner by or under any provision of this Licence, or any provision of law.

Access Charge Change Notice

69B.9 The Licensee shall send a written notice (an “Access Charge Change Notice”) to the Director and to all Service Providers with which it has entered into (or offered to enter into) an agreement pursuant to this Condition:

(a) in the case of an Access Service subject to the provisions in paragraphs 69B.10 to 69B.20, not less than 90 days before any change to a charge for such a Service is to come into effect; and

(b) in the case of all other Access Services, not less than 28 days before any change to a charge for such a Service is to come into effect,

which identifies:

(i) the current charge offered for, and the location in the Licensee’s current price list of the terms and conditions associated with, the provision of any Access Service under this Condition; and

(ii) the date on which or the period for which the proposed new charge will take effect.

Control of Charges for certain Access Services

69B.10 Without prejudice to the generality of paragraph 69B.2, the Licensee shall secure that the following starting charges for each respective Access Service specified below, to be effective from 1 September 2002, are not exceeded by more than the Controlling Percentage in the first Relevant Year and that, for any following Relevant Year, those starting charges are not exceeded except in so far as, and to the extent that, the Licensee may do so under paragraphs 69B.11 to 69B.18:

(a) for the Wholesale Line Rental (residential quality of service), £28.00 per line per quarter, or pro-rated figure for any fraction of a quarter;

(b) for the Wholesale Line Rental (business quality of service), £29.87 per line per quarter, or pro rated figure for any fraction of a quarter;

(c) for the Existing Line Transfer of a single line or multiples thereof, £1.41; and

(d) for the New Line Installation, £92.89 per line.

69B.11 The Licensee shall take all reasonable steps to secure that during any Relevant Year the Percentage Change in the aggregate of charges for the following Access Services (determined by the formula set out in paragraph 69B.12), namely:

(a) Wholesale Line Rental (residential quality of service);

(b) Wholesale Line Rental (business quality of service);

(c) Existing Line Transfer of a single line or multiples thereof;

(d) New Line Installation

is not more than the Controlling Percentage.

69B.12 The formula mentioned in paragraph 69B.11 is:

$$C = \left[\frac{\sum_{i=1}^{n} \frac{R_{ti} V_{(t-1)i}}{V_{ti}} - \sum_{i=1}^{n} R_{(t-1)i}}{\sum_{i=1}^{n} R_{(t-1)i}} \right] x100$$

where:

C is the Percentage Change in the aggregate of charges for the Access Services specified in paragraphs 69B.11(a) to 69B.11(d);

R(t-1) is the actual revenue from service *i* in the year immediately preceding the Relevant Year where service *i* is one of the specific Access Services identified in paragraph 69B.11.

V(t-1) is the actual volume of service *i* in the year immediately preceding the Relevant Year where service *i* is one of the specific Access Services identified in paragraph 69B.11.

Rt is the actual revenue from service *i* in the Relevant Year where service *i* is one of the specific Access Services identified in paragraph 69B.11.

Vt is the actual volume of service *i* in the Relevant Year where service *i* is one of the specific Access Services identified in paragraph 69B.11.

subject to that, for the first Relevant Year, the Percentage Change in the charge for each of the separate Access Services specified in paragraphs 69B.11(a) to 69B.11(d) shall be the amount of the difference between the charge for each such Service at 1st September 2002 and at 31st August 2003 expressed as a percentage of the charge as at 1st September 2002.

69B.13 The Licensee shall take all reasonable steps to secure that during any Relevant Year the Percentage Change in the charge for Existing Line Transfer (determined by the formula set out in Condition 69B.14) is not more than the Controlling Percentage.

69B.14 The formula mentioned in paragraph 69B.13 is:

$$C = \left[\frac{\frac{R_t V_{(t-1)}}{V_t} - R_{(t-1)}}{R_{(t-1)}} \right] x100$$

where:

C is the Percentage Change in the charge for Existing Line Transfer.

R(t-1) is the actual revenue from Existing Line Transfer in the year immediately preceding the Relevant Year.

V(t-1) is the actual volume of Existing Line Transfer in the year immediately preceding the Relevant Year.

R(t) is the actual revenue from Existing Line Transfer in the Relevant Year.

V(t) is the actual volume of Existing Line Transfer in the Relevant Year.

69B.15 The Controlling Percentage in relation to any Relevant Year is the amount of the change in the Retail Prices Index ("RPI") in the period of 12 months ending on 30 June immediately before the beginning of that Year expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that period, reduced by 2.

69B.16 Where, notwithstanding the obligations imposed on the Licensee by paragraphs 69B.10 to 69B.15, the Percentage Change as calculated according to the formula in 69B.12, or the Percentage Change as calculated according to the formula in 69B.14, fails in the opinion of the Director, to meet the requirements of those paragraphs, the Licensee shall make such adjustments in the charges for each of the separate Access Services specified in paragraphs 69B.11(a) to 69B.11(d) (or leave them unchanged) for the period, whether in the Relevant Year in question or the following Relevant Year as may be reasonably required to satisfy the Director that the matter has been remedied.

69B.17 Where the Licensee makes a material change (other than to an Access Service Charge) to any Access Service for which an Access Service Charge is charged or to the date on which its financial year ends or there is a material change in the basis of the Retail Prices Index, paragraphs 69B.10 to 69B.16 shall have effect subject to such reasonable adjustment to take account of the change as the Director may determine to be appropriate in the circumstances. For the purposes of this paragraph, a material change to any Access Service includes the introduction of a new Access Service wholly or substantially in substitution for an existing Access Service.

69B.18 If the Licensee imposes, during any Relevant Year, a specific charge or an increased charge in relation to any goods or service which up to the time when the charge or increased charge is first imposed had been provided without charge or at a lower charge and the Director determines that some or all of the costs properly attributable to that service had previously been attributed to Access Services and that it would be proper in the circumstances for the newly introduced or increased charge to be controlled, all revenues accruing from that service will be deemed to relate to one or more Access Service and revenues from such services will be taken into account in determining the Percentage Change calculated according to the formula in paragraph 69B.12 and, if those costs had previously been attributed to Existing Line Transfer, the Percentage Change according to the formula in paragraph 69B.14, in that Relevant Year.

69B.19 The Licensee shall no later than the time at which it notifies or should have notified the Director under paragraph 69B.9 of any change to any Access Service Charge inform the Director in writing of:

(a) the amount of revenue which the Licensee reasonably believes to have accrued in the Relevant Financial Year for each Access Service in respect of which an Access Service Charge is charged; and

(b) the amount of each Access Service Charge at the beginning of the Relevant Year.

69B.20 The Licensee shall as soon as practicable after the end of each Period in which there has been a change in an Access Service Charge inform the Director in writing of:

(a) the changes made or new charges imposed in relation to any other Access Service Charge in the same group of aggregate Access Service Charges, whether under paragraphs 69B.11(a) to 69B.11(d) during that Period specifying its nature and amount and the Access Service for which the Access Service Charge is charged; and

(b) the amount of the Percentage Change in the relevant aggregate of Access Service Charges which has taken place during the Period and whether by way of increase or reduction.

69B.21 Paragraphs 69B.9 to 69B.20 shall not apply to such extent as the Director may determine.

(CONDITION 70)

CONTROL OF GENERAL PRICES

70.1 The Licensee shall take all reasonable steps to secure that, during any Relevant Year, the amount of General Prices remains such that the Percentage Change in the aggregate of all General Prices (determined by employing the formula set out in paragraph 70.2 and, as the case may be, calculated as set out in paragraphs 70.4 and 70.10) is not more than the Controlling Percentage.

70.2 The formula mentioned in paragraph 70.1 is:

$$C = \left[\frac{\sum_{i=1}^{m} \sum_{j=1}^{n} \frac{N_{tij} V_{(t-1)ij}}{V_{tij}} - \sum_{i=1}^{m} \sum_{j=1}^{n} N_{(t-1)ij}}{\sum_{i=1}^{m} \sum_{j=1}^{n} N_{(t-1)ij}} \right] x100$$

where:

C is the Percentage Change in the aggregate of all General Prices;

$N_{(t-1)ij}$ is the actual net revenue from service *j* within package *i* in the year immediately preceding the Relevant Year where service *j* is a specific service for which a General Price is charged and package *i* is a group of services which, if offered separately, would each be a specific service for which a General Price is charged;

$V_{(t-1)ij}$ is the actual volume of service *j* within package *i* in the year immediately preceding the Relevant Year where service *j* is a specific service for which a General Price is charged and package *i* is a group of services which, if offered separately, would each be a specific service for which a General Price is charged;

N_{tij} is the actual net revenue from service *j* within package *i* in the Relevant Year where service *j* is a specific service for which a General Price is charged package *i* is a group of services which, if offered separately, would each be a specific service for which a General Price is charged;

V_{tij} is the actual volume of service *j* within package *i* in the Relevant Year where service *j* is a specific service for which a General Price is charged and package *i* is a group of services which, if offered separately, would each be a specific service for which a General Price is charged;

m is the number of packages available during the Relevant Year or a sufficient number of packages to reasonably reflect the totality of revenues

accrued by the Licensee in the Relevant Year to be agreed in writing by the Licensee and the Director; and
n is the number of General Prices or a sufficient number of services to reasonably reflect the totality of revenues accrued by the Licensee in the Relevant Year to be agreed in writing by the Licensee and the Director.

70.3 In applying the formula referred to in paragraph 70.2, references in that formula to revenues from, and volumes of, package *i* and service *j* shall mean those revenues and volumes accrued from all residential customers whose bills issued by the Licensee to them are equal to or less than the highest bill of residential customers in the eighth decile (ranked on the basis of the amount billed by the Licensee to all residential customers for the services for which General Prices are charged, the highest bill being at the top of the tenth decile) in the Relevant Financial Year.

70.4 Where the Value of Inclusive Calls:

(a) is increased during any Relevant Year beyond the Value of Inclusive Calls as at 31 July 2002, such increase shall not be taken into account in the calculation of the Percentage Change in the aggregate of General Prices (calculated in accordance with paragraph 70.2) for the Relevant Year in question or any following Relevant Year; and

(b) is decreased during any Relevant Year, such decrease shall be deemed as a corresponding increase in the charge for the use and Ordinary Maintenance of a residential Exchange Line and shall be taken into account as such in the calculation of the Percentage Change in the aggregate of General prices (calculated in accordance with paragraph 70.2) for the Relevant Year in question.

70.5 Where, notwithstanding the obligation imposed on the Licensee by paragraph 70.1 (or paragraphs 70.1 or 70.2 of Condition 70 having effect on 31 July 2002) and without prejudice to the generality of that obligation, there has taken place a change in General Prices (or General Prices as defined in that Condition 70) of a kind not permitted under paragraph 70.1 (or paragraphs 70.1(a), 70.1(b) or 70.2 of Condition 70 having effect on 31 July 2002), the Licensee shall make such adjustments in General Prices (or leave them unchanged), for such period, whether in the year in question or the following year (and whether or not that year is a Relevant Year), as may be reasonably required to satisfy the Director that the matter has been remedied. Such adjustments shall not be relevant for the purposes of establishing compliance with paragraph 70.1 in a following Relevant Year.

70.6 Subject to paragraph 70.7, the Controlling Percentage in relation to any Relevant Year is the amount of the change in the Retail Prices Index (“RPI”) in the period of 12 months ending on 30 June immediately before the beginning of that

Year, expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that period, reduced by RPI subject to the following provisions:

(a) where the Director notifies the Licensee in writing that he is satisfied in relation to the introduction and provision of services specified in paragraphs 69B.11(a) to 69B11(h) during any Relevant Year, he may determine that the Controlling Percentage in the Relevant Year in question shall be calculated according to the following formula:

$$\frac{b(RPI)}{a+b}$$

where *a* is the number of days in the Relevant Year prior to the satisfactory introduction and provision of such services and *b* is the number of days in the Relevant Year after the satisfactory introduction and provision inclusive and that the Controlling Percentage in any following Relevant Year shall be RPI; and

(b) where on 30 June, in any Relevant Year, RPI is 4 per cent or more, the Director may determine that the Controlling Percentage for the following Relevant Year shall be RPI reduced by 4.

70.7 If the Percentage Change in any Relevant Year is less than the Controlling Percentage, then the Controlling Percentage for the following Relevant Year shall be determined in accordance with paragraph 70.6 but increased by the amount of such deficiency.

70.8 Where the Licensee makes a material change (other than to the amount of a General Price) to any service for which a General Price is charged or to the date on which its financial year ends, this Condition shall have effect subject to such reasonable adjustment to take account of the change as the Director may, after consultation with the Licensee, determine to be appropriate in the circumstances; and for the purposes of this paragraph a material change to any service includes the introduction of a new service wholly or substantially in substitution for that existing service.

70.9 If the Licensee imposes a specific charge or an increased charge in relation to any goods or service which up to the time when the charge or increased charge is first imposed had been provided without charge or at a lower charge and the Director determines, after consultation with the Licensee, that some or all the costs properly attributable to that service had previously been attributed to services to which General Prices apply and that it would be proper in the circumstances for the newly introduced or increased charge to be controlled, that charge shall, unless the Director determines otherwise, be a General Price and this Condition shall have effect subject to the following provisions:

(a) the Licensee shall produce a forecast of the revenue expected to accrue as a result of the charge or increased charge for the goods or service over a period of twelve months from the date of introduction or increase of the charge; and

(b) the Percentage Change in the aggregate of General Prices shall be re-calculated to take account solely of the imposed charge or increase in the manner which the Director determines, after consultation with the Licensee, to be appropriate in the circumstances.

70.10 For each Relevant Year, the Licensee shall inform the Director in writing, no later than three months after the end of the Relevant Year in question, of the volumes and revenues which the Licensee reasonably believes to have been derived from each service in respect of which a General Price is charged such that the supplied information is sufficient to enable the calculation of the Percentage Change in the aggregate of General Prices in accordance with paragraph 70.2.

70.11 For each Quarterly Period, the Licensee shall inform the Director in writing, no later than three months after the end of the Quarterly Period in question, of the volumes and revenues which the Licensee reasonably believes to have been derived from each service in respect of which a General Price is charged. In this paragraph, “Quarterly Period” means a consecutive three month period, the first of which begins on the 1 August 2002 (or such date no later than 1 February 2003 that the Licensee is able to install and bring into operation the systems to enable such reporting to be carried out) and the last of which ends on the 31 July 2006.

70.12 Without prejudice to its obligations under Conditions 7 or 58, the Licensee shall inform the Director, in writing, at such times as the Director may reasonably request, of the changes made, or new charges imposed, by the Licensee in relation to any General Price specifying, without prejudice to the generality of the foregoing, its nature and amount and the service for which the General Price is charged.

70.13 The Licensee shall not in any of its charging periods apply a Retention for Calls to Mobiles to any Specified Mobile Operator which is different from the Retention for Calls to Mobiles to any other Specified Mobile Operator, except:

(a) to the extent necessary to enable the Licensee to round to the nearest 0.1 of a penny per minute the charge made by the Licensee to its Subscribers for calls; or

(b) following a request by the Licensee, insofar as the Director General may consider to be appropriate, and so direct the Licensee.

70.14 In this Condition, any reference to “service” which is not part of the expression “goods or service” shall be taken to include a reference to goods for the purposes of paragraph 70.9.

70.15 This Condition shall not apply to such extent as the Director may determine upon request by the Licensee.

(DELETED CONDITIONS)

The following conditions in Part 2 of Schedule 1 to BT's Licence shall be deleted:

- Condition 72; and
- Condition 74.

Annex C

Price control monitoring and other issues

C.1 This annex covers a number of general issues relating to the operation of the new price control arrangements, including the monitoring of charges for wholesale line rental.

Retail price control

C.2 Oftel's approach to monitoring BT's compliance with retail price control requirements will be broadly similar to the one adopted for the current control although there will be a number of changes made to the monitoring process. These changes reflect both policy evolution and a general simplification of the existing process, which can, in many respects, be regarded as unnecessarily complex. Oftel believes that a simplified approach is appropriate given the move to a safeguard cap. There is some cost to both BT and Oftel in producing and checking the monitoring data and Oftel wishes to ensure that these costs are minimised.

Reference prices and discounts

C.3 The existing price regime consists of two separate processes. First, Oftel requires BT to nominate 'reference' prices for the residential line rental and call prices and the cap is applied directly to these prices only. Second, BT is required to maintain a minimum value of discounts to residential customers, the 'Score', the value of these discounts relative to the reference tariff being called the 'Discount Yield'. This is a complex set of arrangements that Oftel believes can be simplified

C.4 Oftel's new approach to monitoring will consist of one single process. In simple terms BT will be required to ensure that its net revenues in any relevant year (ie including discounts) from all residential customers in the bottom eight deciles are equal to or less than the net revenues received from those customers in the previous year. This process can be considered more transparent as it measures actual prices paid by residential consumers.

C.5 To ensure that this calculation is not affected by volume or compositional changes Oftel will continue to use a prior year weighting process. This adjusts the revenues in any given year to the level they would be had the volume of each service (eg individual call type) remained unchanged from the previous year. This is important as expenditure levels can increase from year to year because of factors other than price increases, such as, growth in new services.

C.6 Oftel will not allow any increases in the value of BT's current standard inclusive call allowance (ICA), currently £6.45 per quarter to count towards meeting the requirements of the new 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 the standard ICA counted to 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. Oftel will, however, consider any decrease in the value of the standard ICA as a price rise and this will count towards the cap calculation. ‘Opt-in’ schemes which allow consumers to purchase a certain volume of ‘free’ minutes for a fee additional to their standard line rental will also be allowed to count towards the cap calculation.

Price cap timing constraint

C.7 BT's existing licence 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.

C.8 This requirement will be removed under the new regime. By monitoring actual annual net revenues Oftel will effectively compare the average prices paid over the course of the year with those paid over the previous year. A price change late in the year will apply only for a relatively small proportion of the year. BT’s scope to influence compliance with the cap by introducing large price reductions late in the year is thus limited. The removal of the timing constraint will also contribute to the overall simplification of the monitoring process. The price control year will continue to run from 1 August to 31 July.

Prices of calls to mobiles

C.9 The only change to the structure of the price control basket itself is the inclusion of BT’s retention on calls to mobiles, which is currently monitored separately. The inclusion of BT’s retention in the basket will further simplify the whole monitoring process.

C.10 Competitive conditions in the provision of retail calls to mobiles are broadly similar to those for other call types. While BT’s returns on calls to mobiles are lower than on other calls, and thus potentially less attractive to competitors, BT’s share of calls to mobile volumes is similar to its share of local and national calls. The restriction to BT’s retention recognises the relatively high level of mobile termination charges, which means that BT has less control over the full retail price. However, to ensure BT meets its non-discrimination obligations, Oftel will continue to monitor BT’s retention to each individual mobile network operator separately to ensure that its retention for calls to each network is the same.

The appropriate index for price control

C.11 The control will continue to be 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.

Duration

C.12 The new control will last for four years, and will initially be set so that BT is not permitted to raise its prices in absolute terms ie by more than RPI-RPI. However, Oftel proposes to relax the cap when it is satisfied that BT has introduced a wholesale line rental product which successfully stimulates competition. From such time that Oftel is satisfied that such a product is available then the cap shall be RPI itself ie BT will not be permitted to make any ‘real’ increases in prices of the basket of services.

Provision for carry-over

C.13 Under its current licence, 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. Oftel intends to continue these arrangements under the new regime.

Monitoring the wholesale line rental charge

C.14 The starting charges for each of the Access Services were set out in chapter 3. BT will be required to meet a basket price cap including all the Access Services set at RPI-2 per cent each year for the four years. In addition, Oftel intends to place a sub-cap set at RPI-2 per cent on the transfer charge. Consistent with the retail price control there will be no timing constraint – prices will be averaged over the course of a full year. The Relevant Year will be 1 September to 31 August.

C.15 Oftel is concerned that this flexibility within the basket could allow BT to make little or no alternation to, say, the line rental charge, and make large increases in the transfer charges. This could discourage other providers from purchasing the service and so competition would not be enhanced. As explained in paragraph C.14, Oftel has therefore proposed to set a sub-cap on the transfer charge.

Annex D

Wholesale line rental (WLR): Other issues

D.1 Set out below in italics are views expressed by respondents on the WLR product and processes. Oftel's comments are intended to provide guidance for the industry groups set up to develop the Product Specification.

There should be a highly automated transfer process

D.2 Oftel agrees that manual intervention should be used sparingly. If possible, all orders should be handled electronically. Nevertheless, manual intervention might be required if order requests are not correctly completed or where automatin is not cost effective. The service provider requesting service has to ensure that its operations are suitably established.

Low forecasting requirements and no financial penalties

D.3 Oftel does not wish to provide incentives for service providers to over-forecast safe in the knowledge that any costs arising from over-forecasting would be borne by their competitor. But it also believes that forecasting requirements should not be too onerous. On penalties, Oftel believes that it is appropriate for penalties to apply to service providers that provide wildly inflated forecasts. However, these penalties could be operational rather than financial (for example, by limiting future orders).

BT to face penalties if it fails to meet the requirement to provide a workable Wholesale Line Rental product

D.4 Oftel has accepted that there is a need to provide BT with incentives to offer a workable Wholesale Line Rental product. Partly for this reason, Oftel has now proposed to relax to a degree the retail price controls should the Director General be satisfied that the Wholesale Line Rental product was being offered in accordance with the Product Specification, was fit-for-purpose and was being actively taken up by service providers. Additionally, BT might be faced with contractual penalties for failing to meet the service level agreement for WLR.

The capacity of the service provider gateway (for order handling) and back end office functions need to be able to meet demand

D.5 Oftel agrees that the capacity of the gateway needs to be able to meet high demand, but does not believe that it should be over-engineered to meet demand that is unlikely to arise.

BT to share the service provider's debt risk

D.6 Anyone providing service runs the risk of bad debt and it is not acceptable to load that risk onto BT. BT Retail is faced with the risk of bad debt when it serves its own retail customers. The charges determined for WLR reflect BT's bad debt risk in providing a wholesale service.

Transfer of lines with Rented Equipment

D.7 Service providers have indicated that the presence on lines of BT rented equipment attached, where Calls and Access is being requested, has led to the rejection of the transfer request. Oftel believes this issue should be considered as part of the development of the Product Specification

Simple transfer process between service providers

D.8 In general, Oftel anticipates that service providers would wish to focus their offering on the difference between themselves and BT. This is only natural given BT's dominant market position. Nonetheless, end-users should be able to switch between service providers and Oftel agrees that this process should be simple.

Service providers deal with all complaints and enquiries from their customers

D.9 This is a fundamental characteristic of WLR. By definition, if the service provider takes on the retail relationship, it should expect to handle the customer relationship. Of course, for the purpose of installing and maintaining the line, BT might need access to the end-user's property and its engineers might need to deal with technical queries during the course of that visit.

Neutral branding of BT engineers, such as neutral uniforms and vans, when interacting with a customer to install or repair service

D.10 Oftel does not view this as an essential element of WLR at this stage. The infrequence of engineers' visits suggests that this is not of as great a competitive significance as other branding issues, such as 'one bill' and the ability to deal with all customer enquiries. Oftel believes that the industry should agree a procedure that BT engineers should follow in face-to-face interaction with end-users. In addition, BT could choose to provide on commercial terms a neutrally branded offering if a service provider were willing to pay any relevant costs. (BT already offers neutrally and positively branded services for directory enquiries.) This issue will be considered again as part of the 2004 market review and, if at that stage neutral branding appears to be a significant competitive issue, Oftel will consider what remedies are available to it.

Full separation of BT Wholesale and BT Retail

D.11 Oftel does not propose to use the review of price control arrangements to consider the structure of BT and the effects that this has on the competitive process.

Full transparency of amount BT Retail pays for Wholesale Line Rental

D.12 Oftel agrees that full transparency of costs and demonstration of non-discrimination of the WLR product range is essential.

BT Retail should not hold the details of service providers' customers

D.13 In principle, Oftel agrees that BT Retail sales and marketing functions should not have access to service providers' details relating to the service provider's customers.

Minimal 'save/winback' activity

D.14 Oftel agrees that it is appropriate for 'save' requests to be limited. In its paper 'Wholesale Line Rental: possible approach', Oftel suggested that the Calls & Access approach could be adopted ie one save telephone call only. However, Oftel is not convinced that 'winback' activity thereafter should be limited. This might detract from the competitive process.

Protection from 'slamming' should be limited to that which is necessary to protect consumers

D.15 In principle, it is right that rules on suppliers' marketing behaviour should not go beyond what is necessary to protect consumers. However, it is necessary for consumers to have confidence that their service provider would be changed only if they chose to switch. Oftel will ensure that appropriate measures are in place to ensure that this is the case.

BT should not be permitted to refuse to allow a customer to switch whilst debt remains outstanding

D.16 Oftel agrees that BT should not be permitted to veto a switch. However, Oftel does not expect any advertising that might encourage customers to switch and to leave debts unpaid.

Formal modification process for developing product once launched

D.17 A formal modification process (for changes after the implementation of the Product Specification) should be established.

End-to-end conveyance

D.18 In its response to *Protecting consumer by promoting competition*, Centrica proposed that BT Wholesale should be required to provide end-to-end conveyance on cost-based terms to competitors of BT Retail. It argued that the cost base of interconnecting operators is higher than that of BT because of the additional switching stage used by an interconnecting operator.

D.19 As noted in Oftel's competition assessment, current retail call prices are well above costs. This allows IA operators an adequate margin to compete with BT on all call types, including local calls, despite the cost penalty caused by the need for additional switching. Oftel is not therefore minded to require BT to offer cost-based end-to-end conveyance as part of the retail price control review. It would, however, be prepared to reconsider this view at a later date. It would then decide, in the light of competition conditions prevailing at the time, and of the implications for incentives for static and dynamic efficiency, whether BT should be required to offer a cost-based end-to-end conveyance product, perhaps for a subset of call types such as local calls. Clearly, this would require that BT had an entrenched dominant position in the relevant market. Oftel is not at present convinced that BT has such a position in any relevant calls market given the potential impact of CPS and the proposed wholesale line rental product.

D.20 Oftel accepts that there is an inherent difference in the cost structure that indirect operators are faced with compared with the cost of BT end-to-end calls. Other infrastructure providers could also benefit from their investments in this way and their cost-base could be lower than BT's for their own end-to-end calls. Although Oftel does not propose to mandate end-to-end conveyance now, it believes that it would need to review this decision in the future if WLR had not increased retail competition to any significant extent.

Annex E

Wholesale line rental: starting charges

E.1 Oftel's proposed starting charges for the wholesale line rental (WLR), connection and transfer products were set out in chapter 3. Oftel has derived these charges from the determined rental charge for an unbundled local loop (LLU). The two products share major components, most obviously the subscriber line, and it is important that a consistent approach be adopted. However, there are also a large number of differences, with some costs being relevant to LLU but not to WLR and vice versa. This annex describes the adjustments which Oftel has made to the LLU rental charge to obtain the charge for the WLR product.

Rounding

E.2 The determined LLU charge of £122 per annum was based on 1999/2000 data on the cost of a metallic path facility (MPF). This is a rounded number and, in setting the charge for WLR, Oftel has first removed the effects of rounding.

LLU specific costs

E.3 Oftel has then removed the cost of certain activities and equipment which are specific to LLU. These are:

(i) MDF general maintenance. In the case of the WLR, MDF maintenance is included in the costs of exchange accommodation which are then reflected in the overall charge. Hence, it is not necessary to include MDF maintenance as a separate item.
(ii) Pair Gain adjustment. LLU cannot be provided over lines using pair gain equipment. The charge for LLU therefore reflects the additional costs of new line provision to an LLU customer whose existing PSTN service was provided using pair gain equipment. WLR can be provided to such customers without the need for a new line, so these additional costs are removed from the WLR charge.
(iii) NTE Upgrade Adjustment. This adjustment was intended to cover the costs of upgrading NTEs to make them suitable for LLU. As such upgrades will not be required for the WLR, the costs are removed from the charge.
(iv) Dedicated LLU billing staff costs. The costs of BT's LLU-specific billing activity are not relevant to the WLR. An allowance for the cost of WLR billing is included in the adjustments below.
(v) The LLU charge is based on the average cost of an MPF. However, in addition to PSTN access, MPFs may be used to provide ISDN and private circuit local ends. The costs of the latter two are not relevant to WLR and so are removed.
(vi) The LLU charge includes a fault reporting and repair adjustment to allow for the additional such costs incurred as a result of taking LLU. These costs are not included in the WLR charge.

Additional WLR costs

E.4 The LLU charge does not include an allowance for a number of "service provision" cost categories which were deemed inappropriate to a wholesale product or were already captured elsewhere in the LLU charge. In some cases, Oftel has accepted that a portion of these costs should be reflected in the WLR charge, either because the cost of the equivalent activity in the case of LLU is among the LLU-specific costs excluded, or because the activity is relevant to WLR but not LLU. Into this category fall the following cost items:

(i) Billing for the WLR;
(ii) Research and development related to fault repair and field engineer management; and
(iii) Provision of free phonebooks.

E.5 Some other costs incurred in the provision of PSTN access were also excluded from the LLU charge, either because they were not relevant to the latter or were recovered in separate charges, notably that for collocation at the local exchange. The following such cost items are included in the WLR charge

(i) PSTN line card;
(ii) Accommodation costs recovered through the LLU collocation charge;
(iii) Pair gain equipment (this is the corollary of the removal of the pair gain adjustment described above); and
(iv) Non-metallic path costs (fibre and associated duct and radio links).

Excluded costs

E.6 BT argued that a number of other cost items should also be included on the grounds that they are relevant to both LLU and WLR and had, in its view, been erroneously excluded from the former. Into this category fall the following costs:

(i) General support;
(ii) Personnel;
(iii) Customer support;
(iv) Finance;
(v) Network enabling computers; and
(vi) Field support.

E.7 Oftel has not included these costs in the WLR charge on the grounds that to do so would be inconsistent with the LLU charge. There is also a danger of introducing an asymmetry into the process by accepting additional costs for inclusion identified by BT without also considering whether there are items which were included in the LLU charge, but which would in hindsight have been excluded. Oftel intends to address the issue in its forthcoming review of LLU charges. If these costs are included in a future LLU determination, there would be grounds for subsequently including these costs in the WLR charge.

FAC 'discount'

E.8 BT also proposed to add back a 'discount' resulting from the fact that the cost of LLU on a long run incremental cost basis, including an equal proportionate mark-up for common cost recovery (LRIC + EPMU), was below the cost calculated on a fully allocated current cost (CCA FAC) basis. BT argued that the LLU calculation of LRIC + EPMU was understated and that a more granular analysis would have resulted in a figure closer to the CCA FAC figure. Oftel has not made this adjustment on the grounds that to do so would be inconsistent with the LLU rental and the network charge control (which was set on the basis of LRIC + EPMU data consistent with LLU).

Allowed rate of return

E.9 The LLU line rental is based on an allowed rate of return on capital of 14.5 per cent per annum. In the WLR charge, Oftel has included an allowance for BT's cost of capital of 13.5 per cent.

Drop wire connection costs

E.10 The LLU rental charge includes a specific allowance for the cost of drop wire renewal and repair. Drop wire provision and installation costs are recovered in the PSTN connection charge rather than the line rental. These costs were not included in the LLU connection charges, as the LLU connection charges were based on a bottom-up costing of work necessary for LLU. The drop wire provision and installation costs were therefore instead recovered in the LLU rental charge.

E.11 In the case of the WLR, drop wire provision and installation will be recovered in the connection charge, except where from 2000/01, these costs have been capitalised and recovered in the rental charge.

2000/01 and 2002/03 costs

E.12 The final adjustment made to arrive at the WLR charges is to recalculate the allowed cost items on the basis of 2000/01 data rather than the 1999/2000 data used for LLU and project these forward to mid-year 2002/03, which is appropriate as the starting charges will take effect from September 2002. BT has not provided a fully satisfactory estimate of 2000/01 costs on a basis consistent with that used for LLU. Oftel has therefore used BT's 2000/01 cost estimates where it believes these to be reasonable, but otherwise has estimated 2000/01 costs from the 1999/2000 data on the basis of movements in aggregate access costs. Changes in unit costs between 2000/01 and 2002/03 are projected using Oftel's financial model of BT.

Bad debt and product management costs

E.13 BT has also argued that additional bad debt and product management costs should be included. It argues that experience with LLU and Calls and Access has shown that levels of wholesale bad debt are in excess of current retail levels and that a "more realistic" allowance should be included. Oftel's view is that recent experience with these products is unlikely to be representative of bad debt rates over a longer period of time. Moreover, as BT can charge in advance for the wholesale line rental, no additional bad debt charge should be accepted and the allowed bad debt cost should be below retail levels. Oftel notes that, in the costing of the retail PSTN service by direct debit, BT proposed that there would be no bad debt cost on the grounds that these charges are recovered 3 months in advance. Oftel believes that BT should only recover a minimal bad debt cost since it is open to BT to devise incentives for operators to pay promptly, including possible penalties for non-payment. It has therefore set the charges for the WLR on the basis that only a minimal allowance for bad debt costs is included. However, this is conditional on BT and service providers reaching agreement on the measures reasonably required to achieve this minimum. If, following consultation, no agreement is reached on reasonable bad debt reduction measures, then it may be necessary to increase the allowance for bad debt costs in the WLR charge.

E.14 BT has argued that significant development of the “service provider gateway (SPG)", the interface between BT and customers for "Calls and Access" and the WLR, will be necessary in order to support the latter product. Oftel believes however that as the wholesale access product is essentially similar to the Calls and Access product, the additional product development and management costs incurred for WLR should be limited. It has not allowed for any further product development of the SPG from 2004/05 onwards as the product should be fully fit for purpose by then. However, as it accepts that the WLR will largely supplant Calls and Access, Oftel has allowed for the undepreciated component of past costs and ongoing support costs to be recovered in the WLR charge.

Connections and transfers

E.15 The charge for a new connection is derived from 2000/01 LRIC + EPMU data from BT's accounts, projected forward to 2002/03. As with the rental charge, Oftel has adjusted BT's estimates of network costs, has removed certain wholesale costs and has allowed only a minimal bad debt cost.

E.16 Oftel believes that only incremental costs should be recovered from transfer charges, on the grounds that this is a new activity and no implicit allocation of common costs or overheads has been made in the costing of other activities (eg LLU, network charge control). This would also be consistent with the approach adopted for LLU line sharing.

E.17 Oftel also believes that the bulk of transfer costs should be recovered through the rental as even a relatively low transfer charge could deter switching. The transfer charge therefore reflects only the direct labour cost incurred. An amount equivalent, in net present value terms, to the total of other costs incurred when a customer is transferred to a service provider is then recovered through the rental.

Annex F

Cost benefit analysis

F.1 Annex D of the consultation document entitled *Protecting consumers by promoting competition* set out a cost benefit analysis (CBA) of Oftel's proposals for measures to replace BT's retail price cap.

F.2 Oftel compared the costs and benefits of its preferred option of a cost-based wholesale access product combined with a safeguard price cap with a base case in which the retail price control is removed, but no additional action is taken to stimulate competition or protect consumers. It was assumed that Oftel's proposals would result in substantially lower call prices than in the base case as these were brought into line with costs by competitive pressure.

F.3 The net annual benefit of reducing call prices to cost was estimated at some £430m per annum at 2001/02 prices, equivalent to a net benefit of about £2.4bn in present value terms over a ten year 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. Other benefits were not quantified but included possible efficiency savings resulting from increased competition, the avoidance of inefficient entry, the benefits of increased choice and increased innovation. Against these, compliance costs, relative to the base case of no controls, were considered likely to be relatively very small.

F.4 Annex C to BT's response to *Protecting consumers by promoting competition* is a critique of Oftel's CBA by the consultants **.**econ.

F.5 **.**econ characterises Oftel's proposals as regulatory intervention. Oftel's view, in contrast, is that they are deregulatory. This has important implications for the CBA. In particular, **.**econ argues that Oftel should take account – as a cost of its proposal – of the distortions caused by price caps.

F.6 **.**econ does not specify the source of these distortions, but they presumably arise from prices that do not reflect costs (allocative inefficiency). Other possible sources of distortions would be reductions in incentives to reduce costs (dynamic inefficiency) or inconsistent treatment of capital and operating costs (productive inefficiency).

F.7 The National Audit Office has recently considered the efficiency properties of the price cap regime operated by Oftel (and other regulators) in its recent report on *Pipes and Wires* (HC 723, April 2002). It concluded that "RPI-X…provides strong incentives to improve efficiency for the ultimate benefit of customers", whilst also noting that there were some risks to these incentives. For reasons set out in the NAO report, Oftel believes that its approach to setting the price cap minimises any resulting distortions even when the price cap is the main constraint on prices. Moreover, under Oftel's proposals, competition should eliminate these effects at the retail level and in any case they are more relevant to the network control where capital investment is more significant.

F.8 A key feature of Oftel’s proposal, crucially, is removal of the price cap once competition is judged to be effective in a market review (which, under new EU regulations, must be carried out before the end of July 2003). The calculated benefit reflects an assumption that prices are in fact driven to costs as a result of competition, rather than a price cap. It is not clear therefore that there would be any significant distortions remaining if Oftel’s proposal is successful. Oftel agrees that a price cap would be less desirable than competition because of the attendant costs (indeed, this is reflected in Oftel’s objectives and the thinking behind its proposals). It was therefore able, in the CBA, to test the most deregulatory option consistent with Oftel’s objectives, confident that other options would be inferior.

F.9 However, if competition does not develop as intended, which is possible even if the wholesale line rental product is introduced, then the RPI-RPI or RPI+0 cap may be the binding constraint on prices. But this would result in significant net benefits compared to a situation of unrestrained exploitation of market power. This is because prices would be closer to costs, ie less distorted, than if BT raised them to the profit maximising level.

F.10 **.**econ does not dispute that reducing excessive prices to cost will have a significant benefit as measured by a CBA – indeed it would be contrary to much of competition economics to dispute this. Such price reductions are the source of the benefit calculated by Oftel.

F.11 **.**econ argues that Oftel's proposals are a package and that each element should be subject to an individual CBA. A difficulty, not acknowledged by **.**econ, is that the aim of, for example, the proposed extension of LUS to customers in decile 3, is distributional. To the extent that this requires some prices to be above or below cost, this will inevitably result in a net loss as measured by a CBA. It is not possible to quantify in any meaningful way the benefit of ensuring that no customers are made worse off by Oftel's proposals. Oftel therefore has to make a judgement that such protection is desirable.

F.12 **.**econ argues that Oftel's assumption that access prices will be the same in both the "policy" and counterfactual cases implies that the policy proposals must include unnecessary measures. Oftel accepts that, in practice, BT might well not set the same line rental in the two cases. However, it is likely that, if anything, Oftel has understated the extent to which access prices would rise in the counterfactual case (it is assumed that they just cover costs) as there would be no control preventing them rising to the profit maximising level. This would increase the apparent benefit of the proposed measures.

F.13 **.**econ argues that Oftel should take account of an alleged "substantial" disincentive to invest in infrastructure resulting from its proposals. As the cost of the wholesale line rental will be based on LRIC plus an equal proportionate mark-up for common costs and including the cost of capital, it is unclear why any disincentive should result, particularly given that Oftel has assumed that the retail rental rises to the same level in the counterfactual case which, as noted above, is likely to yield a conservative estimate of benefits. **.**econ refers to the option value of investment which, BT has previously argued, should be added to the cost of capital. These arguments have been considered by Oftel previously (see Oftel's statement entitled *Proposals for Network Charge and Retail Price Controls from 2001*, February 2001, Annex E) and not found persuasive.

F.14 **.**econ argues that the proposals will stimulate retail competition but not network competition and that Oftel has, as a result, overstated the possible efficiency gains. Oftel accepts that increased pressure to reduce costs as a result of its proposals is most likely to be felt at the retail level. However, it is possible that some investment in competing networks could be stimulated, in particular by those providing conveyance (such as CPS operators) and indeed by access operators as the retail rental rises towards costs. In any case, as is clear in Annex D of *Protecting consumers by promoting competition*, the figure for potential efficiency gains calculated does not enter into the main CBA calculation and so cannot affect the result. It is simply noted as an additional benefit which cannot readily be quantified. The figure given is purely indicative of the potential scale of such benefits.

F.15 Oftel believes therefore that the conclusions of its CBA are robust.