

9 Views of BT

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Introduction and summary

9.1. This chapter sets out BT's views on portability and is based on BT's submissions to us and the hearings BT attended. BT made 16 written submissions (many on background and technical and accounting matters) as well as responding to a large number of questions and attending two hearings. Some of the submissions are reflected elsewhere in the report. A list of submissions is at Appendix 9.1.

9.2. BT said it agreed that NP should be available and it would do nothing to impede its introduction. Indeed, the provision of NP was never in dispute. The issue which the DGT and BT had been unable to resolve was who should pay for the additional conveyance costs associated with NP. The DGT had argued that he should have a broad discretion to allocate additional conveyance costs in whatever proportion he thought 'appropriate' between BT and other operators while BT proposed that it should be allowed to recover its 'reasonable costs' as provided for in Condition 34B of its licence. In BT's view no licence modification was required. The only reason the DGT had given for a departure from the norm, in relation to interconnection, that BT should recover its costs, was the alleged existence of substantial Type 2 benefits generated by extra competitive pressure increasing BT's efficiency.

9.3. BT said that the NERA cost-benefit study on which the DGT relied was not an appropriate basis for serious policy discussion. It was extremely difficult to identify specific benefits to BT which were attributable to the introduction of NP alone. BT's case was that any inefficiencies which might be present (and there was no hard evidence of this) should continue to be dealt with under the price control formula.

9.4. BT believed the existing interconnection charging regime clearly established an appropriate method for identifying BT's additional conveyance costs in the regulatory accounts. The process of estimating per line set-up costs was being concluded in the light of trials and these, too, would be subject to the DGT's determination. BT said that in rejecting the DGT's proposed licence amendments and thus triggering the reference, BT was consciously seeking an independent review. BT invited the MMC to establish principles allowing for the efficient introduction of portability within a fair, stable and certain regulatory framework, rather than by assigning further broad discretionary powers to the DGT which would undoubtedly be

exercised against BT and would, in every practical sense, be an absolute power, incapable of review or appeal.

9.5. BT also said that the DGT's proposals were inefficient because significant claims were going to be made on BT's network which, in the absence of an appropriate pricing structure, would lead to excess demand and waste; moreover they were unfair because BT would be subsidizing the costs of its competitors, some of whom had well-capitalized US parents.

9.6. BT emphasized that it had neither resisted nor delayed the introduction of NP and indeed pointed out that the UK was leading the world in the technical solutions it offered UK customers and its competitors. At no stage since the completion of the cost-benefit analysis required by Condition 34B, and the DGT's decision to require NP to be provided, had there been any unwarranted delays due to any failings on the part of BT. Major telecommunication networks like BT's were not designed to provide NP. There was a need to re-engineer the network and to alter many complex computer systems. This was all part of the process of offering major new products. The provision of NP would inevitably involve additional conveyance of messages and signals and BT's position was that the reasonable costs of providing such additional conveyance should be recovered from other operators.

9.7. There was no question but that the existence of NP would add to the (already considerable) attraction of cable companies. BT said that its research showed that their market share would increase as a result of their ability to offer NP. BT analysis of the gross margin levels of certain cable companies showed that these were healthy and pointed to the conclusion that they would enjoy significant revenue increase even if they paid BT's reasonable costs of providing NP. The only effect of BT recovering its reasonable costs would be that those companies' gross margins would be slightly less than would otherwise have been the case. Failure to reach agreement with Videotron arose, in BT's view, because the DGT offered a justification for Videotron paying something less than BT's reasonable costs.

9.8. Finally, BT said, there was no case for the expansion of powers sought by the DGT. A remedy which gave him and his successors a power to allocate costs 'as appropriate' was undesirable if only because, in the event of disagreement, neither BT nor any other operator would have the possibility of recourse to the MMC in this matter, or even, given the subjective nature of the DGT's proposed power, to the Courts with any hope of success.

1991 BT licence amendment

9.9. BT told us that in 1991 its licence was amended by agreement to make provision for the DGT to direct BT to provide NP, subject to his being satisfied that the benefits outweighed the costs. BT had earlier received an assurance from the then Secretary of State for Trade and Industry, in a letter dated 22 February 1991, that the DGT would have no power to determine who should bear the costs of NP. This assurance was embedded in BT's licence at Condition 34B.13. Condition 35B.15 further provided that:

... nothing in this Condition shall preclude the Licensee from recovering from the operator of a Relevant System the reasonable costs associated with allocating Numbers to and routing calls to that System; save that in the case of any dispute or difference as to those costs the Director may determine them and the Licensee shall not be obliged to so allocate Numbers and route calls unless such operator agrees to bear the costs so determined.

The DGT was now seeking to renege on the Secretary of State's undertaking by proposing to allocate costs without BT's agreement. Cost recovery was an essential principle in the licence in relation to all interconnection services.

Development of technology for NP

9.10. BT said that its existing network was not designed with NP in mind. In this it was no different from comparable networks world-wide. When, therefore, other operators, notably Videotron, took their first steps towards introducing NP in the middle of 1994, the only immediate technical solution lay in the extended use of an existing BT service, call forwarding, which had been offered to Videotron on wholesale terms. This 'pre-interim solution' was followed by the rapid development of the agreed industry 'interim solution' otherwise known as tromboning.

9.11. At the time call forwarding was the best and most efficient solution available given technical feasibility and OFTEL's time-scale. Since the advent of the industry-wide solution, BT said that it had pioneered that approach, had undertaken trials throughout the period of the MMC inquiry and was presently carrying out a large pilot project. Throughout this period, BT had liaised with OFTEL over technical matters and the non-contentious aspects of a proposed licence modification. The trials and pilot projects, which were conducted in close collaboration and with the support of TeleWest, NYNEX, Videotron and Bell Cablemedia, were developing technical and operational standards and the necessary processes to support NP. The service had been offered to all fixed wire operators on 2 October 1995. BT added that its introduction would depend on the speed with which operators signed up and completed feasibility exercises. BT pointed out that the timetable for the introduction of NP was wholly unaffected by the MMC inquiry. BT added that the portability of geographic numbers had not been introduced for national deployment in any other country in the world, including the USA, where the parents of some of the cable companies operating in the UK were the companies expected to provide it.

9.12. BT told us that it had developed a further, lower-cost approach called the call drop-back solution. Its switch manufacturers had stated that the earliest possible date by which call drop-back could be implemented (allowing for delivery and trialling) was the autumn of 1997. Whether the trial was successful or not, BT would, in any event, as from 1 November 1997, reduce conveyance charges to other operators to the level which would enable it to recover only the reasonable costs of the call drop-back solution, irrespective of whether or not that solution had been implemented. The risks of successful implementation and timely incorporation would therefore be borne exclusively by BT.

9.13. In the very long run, the possibility of the introduction of an IN solution might enable NP to be provided at even lower cost. Such developments, however, were only at the conceptual stage and would involve very substantial capital expenditure. BT said that decisions on the introduction of IN solutions would not be contingent upon NP but upon a whole range of issues which would have to be considered over the next few years. In the meantime IN was confined to specialized networks offering a limited range of advanced services, usually to numbers within specific and limited ranges, such as BT's 0800 and 0345 services.

9.14. BT said that because the DGT had repeatedly stressed the importance of achieving full NP, BT had accepted that the interim tromboning solution should be applied now. There was, however, the risk that the interim solution would divert energy and resources from development of the efficient long-term approach and pose obstacles to its timely delivery.

BT's position

9.15. The costs of portability are discussed in Chapter 6 and include network and systems set-up costs, the per line set-up costs of porting each number and the additional conveyance costs associated with each call to the ported number. BT said that it had been able to accept the proposals of the DGT in relation to the first two categories of cost but unable to agree with the DGT that additional conveyance costs should be borne by telephone operators in proportion to market shares.

9.16. BT said that this was the first time the DGT and BT had failed to reach agreement on a proposed licence modification.¹ Even on this occasion there was, in fact, a high level of agreement. First, BT accepted the need for the introduction of NP. This was not in dispute. Secondly, both the DGT and BT had initially accepted the principle that, for the agreed interim technical solution, each operator, including BT, should bear

¹BT told us that the Chatline and Message Services reference to the MMC (January 1989) was made as the result of an agreement that a reference would be appropriate and not as a result of a disagreement between BT and the DGT.

all the costs associated with set-up in its own system and that all per line set-up costs should be borne by the importing operator.

9.17. The DGT's proposed solution that he should be able to allocate additional conveyance costs as he thought 'appropriate' was not acceptable to BT for two reasons. First, BT did not agree that additional conveyance costs should be allocated rather than recovered from other operators (in practice mainly the cable companies). Secondly, BT claimed that a power vested in the DGT to do what he might from time to time think appropriate was undesirable, as the results would be, in effect, unreviewable by either the MMC or the Courts. The DGT would always have the final word.

9.18. BT said that, as the reference illustrated, reasonable people might disagree over the proper solution to a problem. Indeed they might disagree fundamentally over policy objectives. The Board of BT did not think it right, or in the interests of all BT's stakeholders, that it should accept a licence modification which would exclude any effective independent scrutiny of an important issue. The DGT's proposals for allocation of conveyance costs by market share would, if accepted, result in BT meeting virtually all of these costs.

9.19. BT's fundamental position was that no licence modification was required because the licence already provided for the identification of the 'reasonable costs' of routing calls. In the event of any dispute regarding NP, the DGT had the power to determine those costs. The DGT believed, as was shown by his statements and declared position, that BT should not be able to recover its reasonable costs of providing NP and should only recover such portion (if any) as he deemed appropriate. This would inevitably constitute a subsidy to BT's competitors. The DGT's underlying purpose appeared to be to accelerate the reduction of BT's market share, without regard to the aptness of the objective or the method chosen to accomplish it.

9.20. BT proposed that portability should be introduced on the following basis:

- (a) all operators should be obliged to offer portability on a reciprocal basis;
- (b) operators should meet their own system set-up costs for the agreed interim technical solution;
- (c) per line set-up costs should be charged to the importing operator; and
- (d) additional conveyance costs should be charged to the importing operator in a manner consistent with the principles for interconnection charging (fully allocated costs and a reasonable rate of return on relevant capital employed), with the DGT having a final power of determination.

The level of the additional conveyance costs was the result of accelerating the introduction of NP by using an interim technology, although costs would diminish with the introduction of the call drop-back solution (see Chapter 5).

9.21. BT said that the use of portability to facilitate customer capture was likely to vary from operator to operator. Cable companies were still in the market entry phase of development with prices set at a discount to BT's to help build market share. BT believed differentials would narrow over time. (For discussion of market shares, see paragraphs 4.6 to 4.14.) The effect of portability could be to bring forward that narrowing, because a switch to cable telephones would be more attractive to customers. Those offering or receiving NP had no interest in mitigating the costs of the inefficiencies imposed on BT's network. It followed that there should be a role for price. The pricing of NP should be such as to discourage as far as possible unnecessary short-term investments and alterations to networks, thus minimizing the possibility of capacity becoming redundant when a more advanced solution was applied, or of deferring the introduction of IN through an artificially created incentive to secure a return on inefficient investment. (BT's views on pricing are discussed in Chapter 6.)

9.22. In BT's view, there was no reason why there should be any departure from the fundamental principle of cost recovery from other operators. They then had the commercial options of offering NP free, charging for it specifically and/or increasing their general charges.

9.23. BT emphasized that if NP was underpriced demand would be higher than otherwise and line set-up and conveyance costs increased. This demand would be concentrated in certain parts of the network and would arrive in stages related to the roll-out and marketing of competing networks. It would impact on the BT network in several different ways. In some instances the demand for NP and therefore for capacity to

accommodate tromboning might preclude the rationalization of networks and reduction of capacity which would normally follow loss of market share. In other cases additional capacity might be required earlier than would otherwise be the case. This would mean that either the quality of service would deteriorate or that additional investments in the network would be required, or that networks would be larger, more costly and less efficient than otherwise. In practice all these elements would co-exist in varying mixtures and degrees. The potential arrival of the IN solution in the long term might mean that earlier investment in conveyance capacity in order to implement the interim solution would be at least partially wasted.

9.24. BT said that given the nature of investment in a common network infrastructure (supporting both BT retail services and services to other operators) the costs of providing capacity should be recovered on the average actual costs of capacity usage. This methodology was embedded in BT's licence for all interconnect products and should be applied to NP. Further, BT pointed out that the interconnection and accounting separation provision in BT's licence (see Appendix 6.3) required all operators, including BT, to pay the fully allocated costs of their capacity usage. BT believed it should recover its costs from those operators which wished to offer NP. BT could not be sure if those operators would pass on the costs but BT's research showed that some customers placed a value on NP and they would be willing to pay a price to obtain it. Those that did not value it would be deterred by a charge from taking it up and therefore from causing costs and inefficiencies on BT's network. The DGT's view that all consumers benefited and therefore should contribute to the costs restricted the role of pricing as an influence over demand. BT believed the DGT's reasoning on this to be unsound.

9.25. BT emphasized that NP using the interim tromboning solution had been offered on 2 October 1995. Further, BT had not required a formal service contract to be entered into before the pilot stage, because the other operators would have resisted this and the pilots would have been delayed. BT had agreed that the pilot would run under the trial contract and had agreed to apply any licence modification retrospectively for the apportionment of costs.

The disagreement between BT and Videotron

9.26. BT said that the DGT had made known to other operators his position on the appropriate method of charging for NP in the course of their preliminary negotiations with BT and, understandably, any offer from BT which fell short of the generosity of the DGT's position had been regarded by them as unacceptable. BT claimed that the failure to reach agreement with Videotron as to the basis upon which it would pay for NP was a direct consequence of this difference of position between BT and the DGT. It certainly did not arise as a result of any desire by BT to delay the arrival of NP. Before NP could be introduced, the relevant licence condition required a detailed process of evaluation by the DGT, including a cost-benefit study, before any decision on the introduction of NP could be taken. Indeed, the DGT had delayed substantially. Although the licence amendment had been introduced in September 1991, the draft terms of reference for the cost-benefit study had not been sent to BT until September 1992.

9.27. The cost-benefit analysis had been conducted on behalf of OFTEL by NERA. Its methodology and conclusions had been strongly contested by BT but, nevertheless, BT accepted that NP should be introduced, and from March 1994 had embarked upon the necessary industry-wide discussions to develop the appropriate technical solution. Although the interim solution was not determined by the NICC until June 1994, BT had been in a position to offer NP to Videotron using the pre-interim, RCF product by October 1994.

9.28. In BT's contention Videotron had believed the DGT was going to take some action that would make NP virtually free and therefore saw little point in coming to a commercial agreement because waiting would bring a better deal. BT thought if it had not been for Videotron's rather precipitate and confrontational approach and a new DGT who favoured cost allocation rather than cost recovery and was willing to ignore existing agreements, a commercial solution could have been reached, as it had been a number of times for different interconnect arrangements.

The reference

9.29. BT said that if the DGT had used his power in Condition 34B.15 to determine the reasonable costs of routing calls as a means of resolving the dispute between BT and Videotron, the public interest question in the reference would not have arisen. Videotron could have been granted NP and paid BT its reasonable costs

incurred. Costs were defined in Schedule 1 of BT's licence as including a reasonable profit. Thus the inability to reach commercial agreement with Videotron was the direct consequence of the different positions adopted by BT and the DGT.

9.30. BT submitted that the matter had been referred to the MMC because the DGT was seeking more than the ability to determine reasonable costs. He wished to change the arrangements agreed in 1991 so that he could prevent BT from recovering the continuing additional conveyance costs of providing NP. The DGT's proposed licence amendments, which BT had rejected, would empower the DGT to determine the basis of cost allocation at his discretion and would enable the DGT to reduce BT's market share by various ways of subsidizing BT's competitors. Indeed, BT felt that he obviously meant to allow BT to recover less than its reasonable costs. BT could not accept a discretion so broad that it exposed its shareholders and customers to the risk of solutions being imposed which would conflict with their interests and with BT's responsibilities towards them, and without the ability to appeal to the MMC if the DGT appeared to have acted unfairly. Moreover there seemed to be no reason for resorting to so open-ended a discretionary power.

The beneficiaries of NP

9.31. In BT's view the principal beneficiaries of NP were those who ported their numbers and their receiving network operators. Under the DGT's proposals the low-spending consumer, for whom a change of operator might not be worthwhile, would effectively be subsidizing the higher-spending consumer who received benefits from porting. Operators who lost market share had lower revenue against which to offset fixed and other costs. The more market share was lost, the more costs would have to be borne by the remaining customers of that network. If the operator was price-capped, as BT was, either prices might have to rise (or fall more slowly) outside the cap to compensate, or shareholders would pay through reduced or more slowly growing dividends, with implications for the future cost of capital and thus for investment, research and development, and prices.

9.32. BT recognized that its view of the beneficiaries was not shared by the DGT. His view appeared to be based on the conclusions of the NERA report (for discussion of the NERA report, see Chapter 7).

9.33. BT took the view that the total quantum of benefits was much smaller than NERA had calculated and that tangible benefits accrued to porting customers and receiving operators. If BT (and other operators) were forced to become more efficient by competition in the telephony market, it was impossible to ascribe the resulting benefits to NP on anything approaching the scale of the NERA report, and on that basis to assert that the benefits outweighed the costs. Competition was already a potent force even without NP. Given also the challenging level of BT's price cap, it was evident that the pressures to secure efficiency were in place and that appropriate instruments existed for the extraction of any inefficiencies within BT. Over the last eight years the number of BT's employees had fallen from over 250,000 to less than 135,000 and the reduction in staff numbers was continuing, albeit at a slower rate.

9.34. In BT's view if Type 2 benefits were as dominant as NERA and the DGT argued, this would have profound implications. It would mean that BT's remaining customers would benefit from any loss of BT's market share. Similarly, any means of bringing that about would be worth subsidizing. BT added that by extension it was in its own interests and those of its customers to invest in loss of market share rather than to respond positively to the effects of competition. This placed an unusual interpretation on the desirable operation of competitive markets.

Effects on BT

9.35. BT also argued that the DGT had failed to take properly into account the impact of the loss of market share on BT's costs in circumstances where there were important economies of scale and scope. BT's customers would inevitably lose from the increase in unit costs which would follow from a lower volume of business. Other operators' customers might obtain a corresponding or partially corresponding gain in addition to the benefit of free tromboning. NERA's assumption was that such scale effects cancelled out.

9.36. OFTEL and NERA had further ignored the fact that other operators already received entry assistance. The extent of this assistance also cast doubt on the assumption that movements of customers to

competitors who charged lower prices meant a shift to operators who had lower social costs. In general this assumption seemed to be false. NERA had made an *ad hoc* adjustment for this effect in its calculations but BT considered this to be inadequate. Finally BT argued that the NERA/OFTTEL analysis seemed to ignore the existing, flourishing competition, especially from cable companies.

Incentives to invest

9.37. BT argued that the price of NP would decline over time as enhancements to the interim tromboning solution reduced additional conveyance costs. Eventually prices might fall further if, as expected, IN solutions were implemented. There were many competing priorities for BT's investment. Excess reliance on an interim solution and demand which was artificially inflated through underpricing would divert investment resources to relieving temporary surges of demand and congestion, at the cost of the opportunities which would otherwise be addressed.

9.38. BT believed that a charge for NP, including the recurrent cost of conveyance, was both warranted and desirable. Customers should not be encouraged to port their numbers unless they bore a charge (either directly or indirectly) which ensured that they would not port unless their gains exceeded their costs. BT was willing to commit itself to adoption of the most efficient future technology at the appropriate time. In the case of the IN solution this was expected to be in eight to ten years.

Regulation

9.39. In BT's submission, UK telecommunication regulation had succeeded in creating a market characterized by choice and fast-growing competition. By comparison with other operators BT had the advantages of its past position in the market and the scale and experience that represented. However, BT's competitors in turn enjoyed many advantages currently denied to BT. These included:

- (a) unregulated pricing;
- (b) the opportunity to target key customers or the most profitable niche businesses or consumer groups without wider service obligations;
- (c) the opportunity to exploit BT's price structure and in particular BT's inability, brought about by regulation, to rebalance its charges;
- (d) the opportunity to gain a high level of disclosure of BT's costs and revenues while providing no comparable disclosure;
- (e) the freedom to exit the market when necessary;
- (f) for some operators, the freedom to use low-cost radio technologies to connect customers;
- (g) for others, the monopoly right to combine broadcast and telephony services and to exploit converging markets and technologies;
- (h) in most cases, waiver of contributions to the access deficit; and
- (i) less onerous rules on cross-subsidy between business units.

The UK telephony market was widely regarded as one of the most open to new entrants in the world. BT had far fewer comparable opportunities to compete outside the UK.

9.40. BT saw the creation of opportunities for new entrants through the advantages of regulation listed above as a direct cost or opportunity cost borne by BT's customers and shareholders. BT understood that these were transitional arrangements and that over time regulation would decrease.

9.41. When BT's licence was modified in 1991 to accommodate the provision of NP, BT had been given to understand by the then Secretary of State that the new condition would not empower the DGT to determine how the costs of portability were to be borne. OFTEL was privy to this situation. The new condition enabled BT to recover the reasonable costs of NP and the DGT to determine those reasonable costs if there was a dispute. BT explained that licence changes were not lightly accepted and frequently involved complex trade-offs between conflicting interests and objectives. The process of regulation was weakened if agreements were made only to be selectively ignored later on.

9.42. BT's concerns also needed to be considered within a broader context. The regulatory framework controlling BT had evolved over time. As competition had grown, so had the demand by the DGT for greater regulation and greater discretion in the hands of the DGT. The balance between explicit, predictable rules and the exercise of regulatory discretion had shifted significantly in favour of the latter. This had led to an increase in the unpredictability and uncertainty of the environment of a fast-changing industry.

9.43. The DGT's objectives under the Act formed a loose framework of reference, permitting a wide range of actions. Judicial review was the only route of challenge directly available to BT. If BT did not agree to proposed licence amendments it faced an inquiry by the MMC. These were measures of last resort rather than accessible routes of appeal, and held considerable costs for BT. BT said that it had grown increasingly concerned over extensions to the powers of the DGT and particularly the wider discretionary powers he sought. It was in the light of these broader concerns that the approach to NP needed to be reviewed. BT sought greater regulatory certainty and invited the MMC to establish the ground rules in any suggested licence amendment.

The DGT's claim for greater powers

9.44. BT said that the DGT claimed that he needed a power to direct who should bear the costs of NP. The DGT had said in his justification that such a power would 'be consistent with providing an incentive to BT to reduce or remove costs and to implement efficient solutions for the introduction of NP'. The DGT said further that he should not be bound 'to a rigid cost-allocation framework in making determinations, as this would prevent him from responding effectively to rapidly changing technology and dynamic market developments'. These statements alarmed BT. The DGT sought discretion which would effectively enable him to change BT's licence conditions without going through the procedures that were set down in the Act and which would at present need either agreement by BT or a reference to the MMC. The 1991 licence amendment specifically said that he should not have the power to allocate costs.

9.45. BT said that it accepted that there were examples in BT's licence where the DGT was vested with a discretion to exercise his judgment in a particular matter. A few of these areas were particularly important. In the main, in most situations where the DGT was obliged to intervene, he had to do so in accordance with certain predetermined principles, for example with regard to interconnection under Condition 13. Those predetermined principles were typically set out at some length and afforded the DGT, BT and other operators guidance and confidence.

9.46. BT said that it did not follow that the existence of such a discretionary power would provide any additional incentives to BT to reduce or remove costs, or to implement efficient solutions, which were not available anyway under the existing provisions of the licence and driven by the tough RPI-7.5 per cent price cap. Again Condition 34B.15 only allowed BT to recover its *reasonable* costs. Costs that could not properly be described as reasonable were not recoverable. Further powers for the DGT could only, therefore, be used to force BT to absorb costs even though they were admittedly reasonable.

9.47. In its approach to the reference BT said that it had advanced one proposition, namely that of cost recovery. Once that principle was accepted its implementation was relatively simple, especially in the context of the accounting separation regime recently accepted and implemented by BT (see Appendix 6.3). BT could not identify any 'rapidly changing technology' which could cause the DGT to justify any departure from a simple cost recovery principle. As IN solutions emerged the principle of cost recovery would still remain appropriate.

9.48. BT said that the DGT's reference to 'dynamic market development' only reinforced BT's suspicion that what was behind the DGT's efforts was an impatience with the rate at which BT's market share was being

reduced, notwithstanding a very open telecommunication market and well-resourced and experienced new entrants at all levels. BT took the view that the DGT was seeking to use the proposed powers to subsidize BT's competitors, by forcing BT to offer up its network and resources to competitors at below cost. If this really was the intention of the DGT, there were many other, more efficient, methods by which BT's resources could be so transferred than by way of underpricing NP. BT said that NP should not be used as a means of subsidy for competitors, to be turned on (and presumably off) at the sole discretion of the DGT.

9.49. As BT had demonstrated over the last 11 years, it had not unreasonably resisted licence modifications when they had been based rationally and coherently on the facts and were in the public interest. In such situations, both the DGT and BT knew that failure to agree would result in the matter being put to the MMC for a review. Both parties had had to weigh up the consequences of a failure to agree in the light of that fact. The existence of the MMC's jurisdiction had undoubtedly led to a willingness by both parties to arrive at mutually acceptable solutions without recourse to the MMC.

9.50. The DGT had pointed to the existence of judicial review as a sufficient safeguard for BT's interests. This was misplaced: judicial review was a review, not an appeal. The Courts would not substitute their own judgment for that of the DGT: they would consider only whether he had jurisdiction to arrive at a particular determination. By contrast, the MMC had power to recommend substitution of their own judgment for that of the DGT, in the light of the public interest. The Courts under judicial review were not the means by which BT's interests could be protected in the face of disagreement with the DGT: Parliament had decided otherwise and vested this responsibility in the MMC. It was therefore doubly inappropriate for the DGT to make, and for the MMC to accede to, a request that this Parliamentary guarantee should be ceded away.

9.51. BT said that what was needed was a clear statement of the principles on which BT services should be extended to its competitors and, in BT's view, these principles were already established within the licence and worked well. Indeed, since the advent of the accounting separation reporting system, it was possible to generate data on BT's costs for the purpose of interconnection, which were reviewed by OFTEL, and which had to be applied on a non-discriminatory basis between BT and its competitors, thus affording BT no competitive advantage.

9.52. What BT proposed, therefore, was the maintenance of the *status quo* in that competitors should be charged their reasonable costs, consistent with the existing regime within Condition 13 for all interconnection services. BT was also concerned to eliminate the inequity of having all the burden of providing NP, subject to reciprocal arrangements with those to whom it offered NP, but not being in a position to demand it of any operator that chose not to seek it from BT. There was an inequity there which needed to be remedied.

The impact of NP

9.53. BT reiterated that it supported the introduction of NP as a desirable objective. However, the impact of NP on effective competition in the UK market-place was, in BT's view, less dependent upon the decisions of BT than upon the decisions of the other operators. There was little question that NP would be a popular feature of most of the other operators' propositions to customers.

9.54. But, BT said, it was important to distinguish two situations. The first was when customers, having made the decision to change operators, also decided to retain their existing numbers. For these people NP was a convenience, saving them the trouble and ordinary costs associated with changing a number. For such people NP had a value. This situation, BT claimed, had no direct relevance to the question of whether competition was promoted by NP or whether the additional competitive pressures said to be associated with NP reduced BT's costs or prices. These customers would have moved to other operators even in the absence of NP, but having decided to move elected to retain their numbers once this was possible. The absence of any pricing mechanism would increase the magnitude of the claim made on BT's resources under this situation and the resulting congestion and deterioration of service quality was, of course, relevant.

9.55. The second situation was that of customers who moved only because they could port and would not otherwise move to another operator, or would only move if other considerations, such as the other operator's charges, were particularly favourable. The advent of NP therefore meant that a section of customers, who in the absence of NP would never move, would have the option of moving. However, BT stressed two points with respect to this group. First, it represented a relatively small proportion of the customer base: in aggregate

the newly-found ability of this group to switch would not appreciably increase the competitive pressures upon BT. Secondly, in any event, the very fact that members of the group valued their telephone number suggested that they would be likely to be willing to pay a reasonable charge to keep it.

9.56. BT said that the terms of the inquiry could not, of course, result in an obligation being placed upon an operator other than BT to provide NP to its customers or to dictate how NP was to be offered to its customers. The most that could be achieved was that BT might, on a reciprocal basis, require an operator to which it afforded NP to offer NP in return. It would therefore be open to an operator, notwithstanding the obligations on BT generally, to decide for itself whether to offer NP and, if so, on what terms. It was most unlikely that a charge levied by BT would prevent an operator from offering NP to actual or potential customers, so the only remaining consideration was the terms on which NP was available for those customers and the impact of those terms on competition.

9.57. BT supposed that some operators would offer NP free whether or not BT was allowed to recover its costs. They would view free NP as a valuable feature of their total range, as they already viewed free local calls or any other feature. They would assess that the future income stream from those customers who would not have changed operators except for the provision of free NP would be greater than the charge levied by BT on that operator. In this scenario customers who ported because they moved operator and those who moved operator because they could port would be treated as if they valued NP equally. The paradox of this was that customers for whom NP was so important that its absence prevented any move to another operator would be treated as if they valued NP so little that *any* charge would prevent the move. If any operator wished to expand market share and increase revenue, the only impact of BT recovering its reasonable costs would be a slight reduction in the operator's gross margin.

9.58. Some operators might decide to levy a charge in order to recover all or part of the costs that they themselves had had to bear as a result of any charges BT might levy, thus preserving some or all of their gross margins. They might even decide to levy a charge (or, more likely, increase their charges overall) whether or not BT was allowed to recover its costs if, in their assessment, NP had a value to some or all customers. The overall pattern of operators' discounts in relation to BT's prices was very varied, but, if a discount did exist, the logic of the situation was that, once NP became available, operators would be in a position to reduce their discount and not lose market share.

9.59. BT said that it had simulated the effect of different charging arrangements on the market shares of other operators, using various assumptions. This research, in effect, offered a simulated demand curve for NP by customers. Taking the case most favourable to the cable companies, if residential customers were all offered free NP, cable's share of the residential lines (where cable was available) was estimated to lie between [*] and [*] per cent in 1999/2000, an increase from the range [*] to [*] per cent if NP was not available at all. If a £[*] fee was levied by the operator, BT said, the range of cable's market share of residential lines was calculated to lie between [*] and [*] per cent.

9.60. BT said that this research did not indicate that BT should not recover its reasonable costs from the operator. It simply implied that if NP were offered free to the customer by the operator, the operator would increase market share by more than if it were not offered free. Nevertheless it would still be profitable for cable companies to offer NP free to their customers even if a charge was made. The public policy objectives of introducing NP and making it available to customers would have been satisfied even if BT was allowed to recover its reasonable costs. All that would change would be that the gross margins of any operator would be slightly less.

9.61. The importance of this analysis, BT concluded, was that the case for BT not recovering its reasonable costs appeared to be based upon critical assumptions that were not realistic, namely that no operator would offer NP unless BT was forced to offer it virtually free. But if NP was as critical to winning customers as the cable companies suggested, it had a value which, commercially, it would be sensible for them to pay for. In fact BT believed that virtually all operators would offer NP once it became available even if they had to pay BT's reasonable costs. Thus, the DGT's case opposing BT's objective of costs recovery was not persuasive.

*Figures omitted. See note on page iv.

9.62. BT claimed that if it was not permitted to recover its reasonable costs, then owing to the size and complexity of its network relative to its competitors, it would incur quite high variable costs. The result would be a redistribution from BT to the operators which would be equivalent to the waived costs of NP. This was no different from BT meeting any of the other operators' expenses whether for NP or postage. This could be justified by reference to section 3 of the Act, if it could be demonstrated that the *existence* or *viability* of an operator, and thus 'effective competition', was contingent on a reduction in that operator's costs. BT said that this was in fact very far from the case. Any requirement obliging BT to waive its charges for NP was simply a means of increasing the profitability of the cable companies at the expense of BT. If this was appropriate public policy, BT was sure that it could propose more efficient methods of subsidizing its competitors.

9.63. It should be emphasized that BT was already subject to very tough targets established by the RPI-7.5 formula currently in force. Furthermore BT was losing lines at a substantial monthly rate and was already confronting intense and effective competition. NP, of itself, played a minor role in adding to the strong regulatory and competitive pressures facing BT and it would be a mistake to assign such importance to it that this was used as justification to depart from the fundamental principle of cost recovery. If the DGT genuinely believed BT was inefficient he already had the power of initiative in the price control formula review, which was imminent, to remedy the position.

9.64. BT said that it was unlikely that it could be both efficient and 'unresponsive' to customers. First, competition was extremely effective and BT would simply lose more customers if it was unresponsive. Secondly, BT was severely constrained in its market behaviour because of regulatory constraints.

9.65. In summary, BT said that to attribute any material benefit measured in terms of 'increased responsiveness' to NP was, in practice, implausible. BT was content to accept that competitive pressures would continue to increase; these competitive pressures would be reflected in a desire for even greater economies and even greater responsiveness; the net effect of NP over and above all other aspects of competition in the UK market was impossible to identify and hence impossible to quantify. In any event BT considered that, viewed in the context of all the pressures upon BT, the decision whether to allow BT to recover its reasonable costs would not appreciably affect that impact. In addition, serious economic inefficiencies had been identified to follow from the subsidizing of NP. The benefits, if any, flowing from this subsidy had not been demonstrated. To base policy conclusions on this which would potentially cost BT in excess of £200 million in additional conveyance costs was inappropriate.

9.66. BT concluded by saying that if NP did in fact have a material effect on BT's efficiency and the DGT therefore thought himself entitled to reduce BT's charge for other operators' use of BT's facilities, there was no element of any interconnection service for which such a claim could not be made. Any waiver of BT's costs would advantage its competitors, increase their profits, *might* enable them to compete more effectively, *might* cause a loss of BT's market share and *might* increase BT's efficiency (but not in the mechanical way proposed by the DGT). The problem of identifying BT's latent 'inefficiencies', quantifying them and translating them into a predetermined proportion, before docking the bill, suggested a degree of market engineering and intervention which, BT submitted, would be impossible to implement with any semblance of accuracy. The economic consequences of being wrong, given the scale of BT's operations, vastly outweighed any benefits which might accrue. BT believed its reasonable costs should be recovered and that questions of its efficiency should not be confused with that principle, but should instead be dealt with by the application of the price control formula in the licence.

The consequences for BT of not recovering its reasonable costs

9.67. BT said that cable company penetration would increase as a result of the increase in areas covered by them (which was inevitable as cable roll-out progressed in line with franchise obligations), and also by the perception (not always justified) that cable companies offered better value for money than BT. As the total demand for NP was, in BT's view, mainly the effect of a decision to switch operators rather than the cause, this would place demands on BT's network and, in particular, would result in additional capacity being required if the quality of service was not to degenerate in areas where competition from the cable companies was strong, and demand for ported lines correspondingly high. Some of this capacity would not be required once the tromboning solution had been superseded by the call drop-back solution and would therefore be 'stranded'. Under BT's proposals for usage-based charging it bore the risk and would absorb the costs of any stranded investment.

9.68. BT said that if NP was offered to operators at no cost, there would be no incentive for operators to introduce a pricing system allowing the marginal valuation of NP to be reflected in a price equal to the cost of BT providing NP. BT's interest in efficient allocation of its resources would be of no importance as compared to the operators' commercial decision to maximize market share or profits, or both. If the operator paid BT for the total cost of NP taken up by its customers the demand for NP would not necessarily be constrained by the operators' pricing policies but at least BT would recover its costs.

9.69. The worst case, according to BT, would arise if it could not recover its costs and operators offered NP free. Demand would be unconstrained yet BT would be obliged to provide its network, without compensation, for the commercial benefit of its competitors. This was both inefficient and unfair.