British Telecommunications plc

A report on a reference under section 13 of the Telecommunications Act 1984 on the charges made by British Telecommunications plc for calls from its subscribers to phones connected to the networks of Cellnet and Vodafone

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Presented to the Director General of Telecommunications
December 1998

Members of the Monopolies and Mergers Commission as at 4 December 1998

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[1]These members, together with Mr S C Finch OBE (selected by the Chairman of the MMC under section 13(9) and (10) of the Telecommunications Act 1984), formed the Group which was responsible for this report under the chairmanship of Dr D J Morris.

Note by the Office of Telecommunications

Certain material has been excluded from this version of the report following a Direction made by the Secretary of State for Trade and Industry to the Director General of Telecommunications acting in accordance with section 14(6) of the Telecommunications Act 1984 as affected by the requirement of the EC Directive on a common framework for general authorisations and individual licences in the field of telecommunications services in respect of the obligation of professional secrecy and certain business secrets.

The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.

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Part I

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1 Summary

Introduction

1.1. On 5 March 1998, the Director General of Telecommunications (DGT) made three references to the MMC relating to charges for calls made from fixed telephone apparatus (fixed lines) to mobile phones. The terms of the three references are set out in Appendix 1.1. Two related to the charges made by Telecom Securicor Cellular Radio Limited (Cellnet) and Vodafone Limited (Vodafone) respectively to operators of fixed public telecommunications systems (fixed network operators or FNOs) for the delivery of calls to mobile phones on their respective mobile telephone networks, including charges for unanswered and diverted calls. The third reference related to the charges made by British Telecommunications plc (BT) to users of its fixed lines for calls made to mobile phones (fixed-to-mobile calls) on the Cellnet and Vodafone mobile phone networks.

1.2. The three references were investigated in parallel by the same Group of members of the MMC. We have reported to the DGT separately on the references relating to the charges made by Cellnet and Vodafone. This report deals with BT's charges.

1.3. Over 75 per cent of all fixed-to-mobile calls originate with BT's subscribers. BT delivers the calls to the mobile networks and makes a payment (the termination charge) to the mobile network operators (MNOs) for the connection of those calls to individual mobile phones. It then bills its own subscribers to recover the termination charges, together with costs of conveying the calls to the mobile networks, its retail costs (marketing, billing, bad debt provision etc) and a profit margin. Some 75 per cent of BT's retail charge is accounted for by the termination charge. We refer to the balance of BT's retail charge as its 'retention'.

1.4. We are required by our terms of reference to consider whether BT's retail charges for fixed-to-mobile calls connected to the Cellnet and Vodafone networks operate or may be expected to operate against the public interest, and if so whether the adverse effects could be remedied by modifications to BT's licence. If we so conclude, the DGT is required to modify the licence to remedy the adverse effects.

The public interest

1.5. We considered, in the first instance, whether there was sufficient competition for BT's calls to mobile activity to constrain its charges for these calls. BT remains in a very strong position in the market, carrying some 83 per cent of the volume (measured in call minutes) of fixed-to-mobile calls by residential users and 66 per cent in the case of calls originated by businesses. Although there are competitive pressures on BT in certain areas, such as international calls, these pressures do not in our view apply to the same extent to charges for fixed-to-mobile calls. Moreover, some of the existing competition for BT comes from operators routing fixed-to-mobile calls in the UK via other countries (tromboning) to exploit artificially low termination charges arising from historical international accounting arrangements. The future of these arrangements for international fixed-to-mobile calls, and of the competition that relies on them, is uncertain.

1.6. Fixed-to-mobile calls still account for a relatively small part of the overall telephone bill of most users. There are indications that many consumers are not particularly sensitive to the price of these calls and that they are not as yet a significant feature of price competition between the networks.

1.7. We therefore take the view that the competitive pressures on BT are currently insufficient to constrain its charges effectively. But the situation is not static. The volume of fixed-to-mobile calls is growing rapidly and the number of operators in the telecommunications market is increasing steadily. As new operators extend their range of services and fixed-to-mobile calls become of increasing significance to consumers, there is a possibility that charges for these calls will become a more important factor of competition between the networks. The present weakness in competition is therefore not a situation that we can reasonably expect to continue beyond the next three or four years.

1.8. In the absence of sufficient competition to constrain BT's retail charges, those charges should, in our view, be no more than is necessary to recover BT's properly allocated costs and a reasonable rate of return and we consider the charges from that point of view.

1.9. The termination charges paid by BT to Cellnet and Vodafone are the subject of our separate reports. Irrespective of our finding on that matter, we do not consider it to be against the public interest for BT to recover the cost of these payments from its own subscribers.

1.10. Measured in pence per minute (ppm), BT's retention on fixed-to-mobile calls in 1997/98 was nearly 150 per cent higher than its retention on local calls and 30 per cent higher than its retention on national calls. We examined the various components of this retention to establish whether such differences could be justified.

1.11. Charges by the BT Network business for the conveyance of calls to the mobile networks are already covered by cost-based price controls. We do not consider this component of BT's charge to be excessive. We also accept that, although not currently reflected in charges made by BT's Network business, call set-up costs for fixed-to-mobile calls are higher per minute than for other calls because of the relatively short duration of these calls. In our view it is not against the public interest for BT to recover these higher costs from customers making fixed-to-mobile calls.

1.12. The retail costs allocated by BT to its calls to mobile activity in 1997/98 were, in terms of cost per minute, around eight times the retail costs allocated to local calls and over four times the allocation to national calls. This arises largely because BT relies substantially on turnover as a basis for cost allocation, and because 75 per cent of the turnover of the calls to mobile activity is revenue to recover BT's substantial payments of termination charges to the MNOs. In our view, general reliance on turnover in these circumstances leads to an inefficient allocation of costs.

1.13. We therefore examined BT's retail costs item by item. We have not set down definitive cost allocation rules but we conclude that there are various bases for allocating BT's costs that produce a more efficient allocation of these costs than BT's current methodology. We accept that there is a case for allocating some costs, such as bad debt provision, on the basis of turnover; and we have identified specific drivers for some other individual cost categories. But there is a residual group of costs for which no specific cost driver can be used. We explored various ways of allocating these costs, but in the absence of good reasons to the contrary, we conclude that they should be allocated evenly across all call minutes.

1.14. Given the nature of BT's calls to mobile activity, and, in particular, the exceptionally high proportion of its turnover that is accounted for by payments to other operators or to other BT businesses, we consider that 1.5 per cent of turnover would be a reasonable rate of return on this activity. However, we accept that, in addition to this return, it would be reasonable for BT's charges for fixed-to-mobile calls to make a contribution to the recovery of BT's 'access deficit'—the deficit it has incurred in providing the infrastructure to connect individual premises to its network.

1.15. On this analysis, there is a case for BT's retention on fixed-to-mobile calls to be higher than its retention on local or national calls. But its retention of 5.80 ppm in 1997/98 was nevertheless much higher (by some 50 per cent) than could be justified by its properly allocated costs and a reasonable rate of return. This is also true of BT's current retention and we have no reason to believe that this situation will change significantly while there is an absence of sufficient competition to constrain BT's charges. This is against the interests of BT's customers and we see no offsetting benefits to the public interest.

1.16. We conclude that BT's charges for fixed-to-mobile calls to the Cellnet and Vodafone networks operate against the public interest in that BT's retention on these calls is too high. We also conclude that these adverse effects could be remedied by modifications to the conditions of BT's licence.

Licence modifications

1.17. There may be scope for BT to help to increase consumer awareness of charges for fixed-to-mobile calls, for example by improving the presentation of information on these charges on its bills. But we do not believe that this or other transparency measures would go sufficiently far towards remedying the adverse effects we have identified. We also reject the option of a control on BT's retail charges. We propose instead that there should be a control on BT's retention on calls to the Cellnet and Vodafone networks, separate from the basket of call services already subject to price controls, until the end of the financial year 2001/02.

1.18. We propose that BT's weighted average retention should not exceed 3.40 ppm for the year 1999/2000 and that this ceiling should be reduced in each of the two following years by an amount equal to RPI–7 per cent.

1.19. To ensure that Cellnet and Vodafone can respond if termination charges begin to emerge as a factor of competition between the MNOs, we consider it important that any differences in their termination charges should be reflected in BT's retail charge. At the same time we recognize that BT will need to have some control over the profile of its charges for particular times of the day or week. We believe therefore that BT should be free to determine its retention for peak and off-peak periods (provided the average weighted retention conforms to the control described above) but propose that, with only minor exceptions, in any given charging period BT should apply the same retention to calls to the Cellnet and Vodafone networks. This allows BT some control over the profile of charges while ensuring that any competition which develops in termination rates will feed through to consumers.

1.20. Our proposals on BT's retention, taken together with those in our separate report on Cellnet's and Vodafone's termination charges, would reduce the current weighted average charge for calls by BT subscribers to the Cellnet and Vodafone networks to levels around 25 per cent below those currently charged, and approximately 30 per cent below those applying when the DGT made the reference.