

6 Views of BT

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Introduction

6.1. BT provided us with detailed views and other evidence principally in 18 written submissions, in its responses to our questionnaire and at three hearings (including the joint hearing referred to in Appendix 1.1). This evidence related to the three references made by the DGT relating respectively to the termination charges levied by Vodafone and Cellnet and to BT's retention on fixed-to-mobile calls. As explained in Appendix 1.1, the investigation for all three references was conducted by the same Group of members in parallel, and evidence was not sought separately for each of them, but rather all evidence was considered in relation to each reference where relevant. In this chapter we summarize BT's key arguments on the major issues relevant to this inquiry.

Competitive pressures on retail prices

The nature of competition

6.2. BT told us that the market for calls to mobile phones was changing rapidly. It was contestable and increasingly competitive. Calls to mobile phones represented the fastest-growing call type in UK telecommunications. New operators had entered the market at an average rate of three a week during the course of our inquiry and operators were increasingly featuring calls-to-mobiles prices explicitly in their marketing.

6.3. BT told us that calls-to-mobiles were offered by almost all of its competitors (see paragraphs 4.32 to 4.34) and that overall the supply of calls-to-mobiles was at least as competitive as the supply of other inland call types. BT said that the nature of competition which it faced could be separated into two types:

- (a) on the one hand, many competitors sought to compete with the entire range of services offered by BT by offering savings on total spend across a range of telecommunications services; and
- (b) on the other hand, some competitors sought to compete specifically on the price of a particular service, reflecting, for example, strategies to:

- (i) concentrate activity on a narrow portfolio of telecommunications service; for example, some of the indirect operators who had begun by offering only international calls had gradually introduced more services; or
- (ii) 'cherry-pick' the most profitable services which customers purchased; or
- (iii) attract some part of a customer's business in the hope of subsequently winning more and eventually providing the entire range.

6.4. BT commented that the way in which operators chose to compete with BT was in part driven by the way in which customers preferred to purchase their telecommunications services. Large users of the whole range of telecommunications services were free to source their telecommunications needs from one company offering a complete range of services or from more than one company for one or more services. For the largest companies making significant volumes of calls-to-mobiles, they could and did bypass BT completely and connected directly with the MNOs. For companies whose level of spending was not so great there were many other operators competing with BT and, therefore, considerable choice was available. It was common for a company to source calls from alternative suppliers to BT: two-thirds of all international calls were already made in this way and there was no reason why the efforts of ISRs to undercut BT in calls-to-mobiles (see paragraphs 3.5 and 3.26) would go unrewarded.

6.5. Increasingly, business customers made use of modern switches which enabled them to select the least-cost route available for delivery of calls. It was possible to programme switches to attempt to route calls via the operator of first choice, and if that failed, via the next choice operator according to the ranking of operators on the switch. One of the ways in which BT experienced the effects of competition was that it was relegated to lower positions on customer switches. This meant that whilst BT might not lose customers altogether it would lose business from customers as increasing volumes of calls were delivered via operators more highly ranked on customer switches.

6.6. There had also been a growth in 'cherry-picking' competition, particularly from new indirect operators. A key feature of the competitive threat from indirect operators was the ease with which customers could choose to use their services, on an ad hoc basis, without having to make a decision to move away from their existing telecommunications provider. Whilst, initially, indirect operators mainly focused on international calls, many now offered other call types including calls-to-mobiles. In addition, the introduction of prepaid cards, which were particularly attractive to residential customers, demonstrated an absolute ability for customers to exploit competition from indirect operators on a call-by-call basis without any need to establish a prior contractual relationship with the operator.

6.7. It was still the case that, for many customers, telecommunication services were frequently—but not invariably—*offered* as a bundle of services, and frequently—but not invariably—*demanded* as a bundle of services. If any one element of the bundle was subject to especially strong competition, even if the prices and quality of all other components of the bundle remained unchanged, customers had an incentive to switch supplier for *all* their telecommunications needs. This was borne out by BT's experience and was the reason why competitors frequently marketed their bundle of services by reference to guaranteed savings over an existing BT total bill, rather than by advertising specific call price reductions.

6.8. BT said that the effect of these varied pressures from its competitors was to sharpen its competitive response across the range of services supplied. Thus, if a purchaser was attracted to a competitor, such as CWC or WorldCom International Limited, for its international calling service, there was every likelihood that the purchaser would also switch to that competitor all or a substantial part of its requirements for other calls, including calls-to-mobiles (even if only modest savings were available on these calls). This was especially so if the competitor operated discount schemes based on aggregate spend. In assessing the extent of competitive pressure in the market place for a bundle of services what mattered was the overall competitiveness of the total bundle. BT was increasingly aware of the ability of its competitors to attract customers, on an ad hoc basis, to take advantage of specific price offers. This had already had a significant impact in relation to international calls and highlighted the importance for BT to ensure that all prices were competitive both on an individual basis and as an element of the overall bundle.

6.9. BT also pointed out that price was far from the only competitive determinant. The TMA Annual National Survey for 1998 stated that 'overall quality of service was of paramount importance to [business] customers when deciding on a new supplier or when extending an existing contract'. Accordingly, BT must offer an attractive combination of price and quality for all telecommunications services.

6.10. Furthermore, BT said that regulation operated alongside the competitive pressures on BT's prices at all levels in the market place. Condition 17 of BT's licence required BT not to show any undue preference or undue discrimination. On any individual case it fell ultimately to the DGT to determine whether any preference or discrimination was undue. In practice Condition 17 operated as a mechanism for transmitting competitive pressure from one area to another: if BT wished to make a competitive response in relation to any of its services, including calls-to-mobiles, the benefit of that competitive response must be shared with all customers in a way which was not unduly discriminatory.

6.11. BT told us that all these competitive factors constrained its freedom to set its retention on calls-to-mobiles. Since 1996 its retention had fallen by 23 per cent. This fall had been accompanied by an increase in competitors' market share, for business calls-to-mobiles from about 30 per cent to around 37 per cent and for residential calls-to-mobiles from just over 15 per cent to about 18 per cent. Taken together, this all pointed to a part of the telecommunications market which was obviously exposed to competition and certainly no less so than for other inland calls.

6.12. BT added that there were specific forces within this market place which served to intensify the competitive environment. The incidence of calls-to-mobiles was largely concentrated among those who made the most calls of all kinds, namely businesses and the top-spending 20 per cent of residential users. Of all BT's fixed-to-mobile calls, 86 per cent were made by these customers. These were the users who, by definition, had most to gain from shopping around; BT's competitors had most to gain by securing their custom; and BT had most to lose by letting them go. To a greater or lesser degree, they were informed purchasers, aware of the broad cost of the services they consumed and of the alternatives to BT. The DGT had explicitly recognized this position in relation to fixed-to-fixed calls in 1996,¹ and BT was currently regulated accordingly.

Prospective competition

6.13. As to the future, it was BT's view that few observers would question that the UK telecommunications market would become more, rather than less, competitive in future. The cable companies' 'roll-out' programme was progressing; technology was reducing the cost of least-cost routing, making it available to more users; new players were entering the market at a rate of three a week; the market in terms of business minutes was growing at about 10 per cent a year; and of this, the calls-to-mobiles segment was growing fastest, at about 35 per cent a year. As growth in calls-to-mobiles was largely determined by the growth of mobile phone ownership, which already stood at over 9 million customers and was growing at nearly 25 per cent a year, it was safe to assume continuing high growth in calls-to-mobiles, making it an increasingly attractive part of the market for competitors. Moreover, mobile phone ownership and those who made calls-to-mobiles would expand significantly in the residential sector. Generally, as volumes of calls-to-mobiles grew, these calls would account for a larger part of customers' telecommunications budgets and demand for such calls from all customers was therefore likely to become increasingly price sensitive.

6.14. BT was concerned to emphasize that competitors had entered, and were continuing to enter, the calls-to-mobiles sector, and that this was occurring on a non-transient basis, using technology which was easily and inexpensively adaptable to switch both international calls and calls-to-mobiles. Barriers to entry were low. Only marginal costs were incurred when an existing indirect operator began also to offer calls-to-mobiles. The pre-existing customer relationships with these operators (for example, for international direct dialling calls) overcame any customer inertia and reduced switching costs. If it was the case that new entrants were primarily motivated by the profitability of international calls and not calls-to-mobiles, the MMC should accept the logic of the observation, confirmed by BT's

¹ *Proposals for Price Control and Fair Trading*, OFTEL, June 1996, paragraph 2.13.

accounts, that the profits were not excessive and that BT's retention was reasonable. BT fully expected its competitors to continue to offer calls-to-mobiles and to seek to increase their share in the market overall. However, BT commented that the continuing commitment of its competitors to the market for calls-to-mobiles might change if regulatory intervention were to squeeze their existing margins still further.

6.15. As regards international tromboning (see paragraphs 4.55 to 4.62), the largest and most significant of BT's competitors did not, to the best of BT's knowledge, make use of this. But for those competitors that did, it was likely that changes to the regime would not be straightforward and might take some time; even then, changes would be gradual across routes. To date, BT had only addressed excessive tromboning on the US route, and had only sought to raise the international accounting rate to 7.3 ppm to cover BT's losses. This would still leave an attractive margin and was unlikely to eliminate incentives to tromboning even on this route. Tromboning would only be eliminated if, following pressure from the MNOs, international accounting rates for calls-to-mobiles were raised to levels equal to the termination rates for national calls-to-mobiles. The difficulties BT had had reaching agreement to even a 7.3 ppm accounting rate on the US route demonstrated the problems that were likely to be involved. Tromboning was therefore likely to continue for some time.

6.16. Other arbitrage opportunities, arising from alternative technologies, would also continue to maintain pressure on BT. Direct mobile-to-mobile arbitrage was already established. It was important to emphasize that there was nothing secondary or temporary about arbitrage. It had been a potent source of competition in telecommunications since the liberalization of the UK market.

Other factors

6.17. BT added that tromboning and other forms of arbitrage were not the only means by which a competitor could undercut BT. First, it was open to competitors to negotiate lower termination charges with the MNOs. Secondly, competitors' cost structures might well be different: such companies had greater flexibility over their methods of marketing, the ability to demand alternative payment arrangements (such as prepayment) to reduce bad debt provision and the option of offering services which might, in certain instances, be of a lower cost and quality than those offered by BT. Thirdly, they had greater pricing flexibility, allowing them to recover their common costs using a variety of pricing packages which were not normally available to BT.

6.18. Finally, BT submitted that the comparatively small proportion of the customer's bill accounted for by calls-to-mobiles was not a relevant issue for competitors in deciding whether to compete in this market. Moreover, for some customers calls-to-mobiles was already a very significant part of their overall telecommunications spend. Due to the high growth rates of calls-to-mobiles, these services would increasingly form an important part of the total bill for many customers.

6.19. For all of these reasons BT firmly believed that the competitive threat to its position in the calls-to-mobiles sector was likely to be continued into the foreseeable future. It told us that this conviction formed the basis of its future planning.

Allocation of costs

6.20. BT stated that its cost allocation was robust and based on established and agreed methodologies. The cost allocation methodology complied with the principles laid down in the Accounting Documents formally approved by the DGT and was set out in more detail in the DAM, which was a published document available to anyone on request from BT free of charge. BT said that the level of detail at which the methodologies were agreed was considerable. For example, the Accounting Documents, which covered 65 pages, stated in relation to the attribution of publicity within the Marketing and Sales costs:

The cost of product publicity and market research are apportioned using analyses of campaign/project expenditure. Campaigns are either directly linked to activities on the basis of campaign/project by marketing departments, or are apportioned using the relevant turnover for the type of campaign.

BT said that the adherence to this methodology left it no flexibility in the attribution of these costs. BT's operating licence gave the DGT the opportunity to challenge any of these methods and to require alternatives to be substituted. BT told us that the DGT had not used this power.

6.21. BT stated that its case on cost allocation was simply that the costs of any of its services, including calls-to-mobiles, which could be allocated on a basis of causality should be so allocated. In many instances turnover was the basis of causality. Some costs, typically some of the common costs, could not readily be allocated on a direct causal basis. BT believed that relevant turnover was generally the most appropriate proxy cost driver for such costs.

6.22. BT said that its retail costs were, to a very large extent, common costs spanning a number of services (for example, national calls, international calls and calls-to-mobiles). While these costs could, in principle, be attributed to specific services, in practice it was extremely difficult—and ultimately impracticable—to identify the precise drivers and so proxies were required. BT accepted that there was no unique accounting procedure that dictated how these costs should be attributed across services. However, it was BT's view that relevant turnover was the best proxy for the true cost drivers and that call minutes was a very poor proxy and would not be a reasonable basis for attribution. In addition, for some common costs there was an element of fixed costs for which there was no 'correct' causal basis. However, BT believed that the extent of fixed common costs was fairly modest. The only question was what was the 'best' basis for cost apportionment—accepting that (whether in a regulated or a competitive environment) BT could reasonably expect to recover all its costs, including its efficiently incurred common costs. This then became a question of the criteria on which 'best' should be judged.

6.23. Mindful of its licence obligations to provide separated accounts and the DGT's obligations under section 3 of the 1984 Act, BT considered that there were four potential criteria to which the MMC should have regard in determining the appropriate allocation methodology: cost causality; consistency; economic efficiency; and social considerations.

6.24. BT said that it had a sophisticated and detailed accounting structure based, so far as possible, on the first of these, cost causality. This was the primary basis for its cost apportionment methodology, which complied with the principles laid down in the Accounting Documents approved by the DGT and which was set out in more detail in the DAM (see paragraph 6.20). BT and OFTEL had made great efforts to isolate and allocate costs capable of allocation on the basis of causality. The problem arose in relation to the allocation of those common costs which could not readily be attributed causally. BT's consultants, Arthur Andersen, took the view that the allocation of bad debts and field sales force costs could be viewed as 'appropriate' (that is, where the use of revenue as the basis of allocation was following direct cost causality). For other cost categories, Arthur Andersen concluded that BT's apportionment was 'reasonable' (that is, although not based on direct cost causality—as no direct causal relationship could readily be established—there was no obviously better driver). In particular, even where surveys or other information could be used to attribute costs between groups of products (lines, calls, equipment etc), the final attribution down to call types could not practicably be done in this way and had to be done using a more general driver such as revenue. (Further details of the MMC's discussions with BT on the potential bases of apportionment of the key categories of costs and the reasons why BT believed those costs justified in terms of cost causality or, for some common costs, believed that revenue was a reasonable proxy, are given in paragraphs 5.16 to 5.40.)

6.25. On the second criterion, consistency, BT took the view that, in the absence of any clearly superior basis of apportionment of BT's common costs, there were strong arguments, both on consistency grounds and in line with conventional accounting practice, for using the currently agreed cost allocation methodology. BT regarded accounting consistency as an important factor in the inquiry. Given the implications for the future regulation of other industries with price-capped services, BT considered that the current agreed cost allocation methodology should not be set aside without persuasive evidence that an alternative allocation method was preferable. Within this methodology relevant turnover was used, in conjunction with other information, to allocate costs between relevant services where no direct causal driver was available. Turnover was a more robust methodology than cost per call minute, which had no logic, and maintenance of the cost allocation methodology used elsewhere in the BT regulatory regime had the further merit of consistency. If an adjustment was made to one service's costs, it must inevitably impact on all other services. The existing cost allocation methodology not only provided the basis of the RPI-X formula used in the BT retail price control but was

also used in a wide range of day-to-day regulatory decisions on the legitimacy of the pricing of individual services. An ad hoc change to one element would require compensating adjustments elsewhere.

6.26. As to economic efficiency, BT submitted that where costs could not be based on causality it was economically efficient to recover them by reference to demand elasticities. Such costs should be recovered from those services where market demand elasticities were lowest in order to minimize any reduction in consumption and welfare loss.

6.27. So far as social considerations were concerned, in regulating BT's prices, the DGT had shown a particular regard in the past for the impact on less well-off customers and, in particular, lower-spending customers. Indeed, section 3 of the 1984 Act included these considerations as an aspect of the public interest. As BT had shown, 86 per cent of all calls-to-mobiles were made by businesses and the top-spending 20 per cent of residential customers. Among residential customers, calls-to-mobiles were made predominantly by the young and affluent. If the MMC were to decide on a new method of cost allocation which moved costs from calls-to-mobiles and international calls toward inland calls, and in particular local calls, and if this were reflected in relative price changes, then it would increase the bills of the less well-off.

6.28. Judged against these criteria BT believed its current cost methodology was 'reasonable'. Over a number of years, BT and OFTEL had developed a detailed system of cost allocation which used revenue in the final stages of the allocation of common costs between call types. The relevant revenue was carefully defined, making extensive use of surveys and other data. In accounting terms, allocating common costs by reference to revenue was conventional and, indeed, had been frequently adopted in earlier MMC investigations of the profitability of multi-product scale monopolists, for example in the postal franking machines and contraceptive sheaths inquiries.¹ Taken in the round, it was an unexceptionable method in accounting practice generally, even where an outpayment, such as the POLO, was present and important. The outpayment was only marginally less important for international calls and the current methodology produced a result which was internally consistent across all of BT's services.

6.29. BT highlighted that revenue, as the primary driver in relation to marketing and the sales force, had been endorsed by Arthur Andersen and Professor Peasnell as not merely 'reasonable' but as 'appropriate' (ie causally driven) (see paragraphs 5.21 to 5.33). It was always possible for external consultants and others to criticize a company's method or to question attributions. In this case, BT's auditors and accounting consultants—and hitherto the DGT—had all accepted BT's methodology. BT submitted that the MMC ought to give due weight to these views.

6.30. BT believed the resulting attribution was neither perverse nor unsustainable, either in relation to the costs attributable to calls-to-mobiles or to the other services offered by BT—the latter, logically, being no less important. In many cases, revenue was the only practical basis for allocating costs across services because, for example, the same salesperson would market calls of all descriptions and also equipment, lines, private circuits and other products and services (see paragraph 5.23). Recourse to minutes as a basis of allocation would entirely omit for accounting purposes his or her efforts other than for marketing calls. Revenue provided a common base for allocation across services.

6.31. BT told us that there was no reason why costs, expressed as ppm, should not exhibit disparities as between calls-to-mobiles and inland calls: turnover, for example, was a causal driver for significant elements of the costs of all the services and this would be reflected in different costs per minute.

6.32. BT believed that unless the MMC were committed to a solution which resulted in a reduction in the cost of calls-to-mobiles as an objective in itself, any solution must be capable of general application across the range of BT's services. Further, given that there was no disagreement as to whether these costs had been efficiently incurred, all common costs must be recovered. The current methods of cost allocation underlay the price control on its retail services. Any reallocation of costs away from

¹*Postal Franking Machines: a report on the supply, maintenance and repair of postal franking machines in the United Kingdom*, HMSO, Cmnd 9747, March 1986; and *Contraceptive sheaths: a report on the supply in the UK of contraceptive sheaths*, HMSO, Cm 2529, March 1994.

calls-to-mobiles would involve an increase in the allocation of costs to other calls, which would, in principle, have resulted in a lower value of 'X'. As the DGT had set the RPI-X cap on the basis of the current allocation, it was inappropriate for the methodology to be changed in subsequent cases. The DGT's argument that the impact on the existing price cap of the difference between the costs apportioned to calls-to-mobiles under the present cost allocation methodology and the costs the DGT now considered appropriate would be *de minimis* was not consistent with BT's estimate that the difference in costs would amount to around £310 million over the lifetime of the present price cap. BT told us that it would not have accepted cost allocations which departed from the usual basis in 1996 without ensuring that the central principle of full cost recovery was observed, especially as between regulated and unregulated activities, whatever the sums involved. This would inevitably have resulted in a somewhat different value of X from that agreed between the parties. (If agreement had not been reached and the matter had gone to the MMC on this point of principle alone, BT would have hoped that the principle would have been upheld by the MMC.) What the DGT appeared to be suggesting was that, as the adjustment would be *de minimis*, BT's shareholders should be asked to absorb the costs likely to be reallocated away from calls-to-mobiles and toward other services. This was far removed from fair and equitable regulatory practice and would set an unfortunate and undesirable precedent for other regulated sectors.

6.33. The problem of consistent application of cost allocation procedures between regulated and unregulated activities was an issue that would become more common as regulated industries expanded further into unregulated areas that had common costs with the regulated activities. If the regulatory regime allocated a specific proportion of the costs for recovery from regulated activities then the remainder, which had been allocated to the unregulated activity, must be considered legitimately as the costs of the unregulated activity as they could only be recovered from that activity. BT believed that the general principle was clear. Even if there were a reasonable alternative to turnover as a basis for allocation, it would be inappropriate simply to apply it in this context, as the regulator had adopted the use of turnover in determining the costs of BT's regulated activity. In such cases, subsequently treating the unregulated activity as if it were a stand-alone activity would radically increase regulatory risk and inevitably reduce the incentives inherent in price cap regulation. Such a decision must inevitably add to the risks of all undertakings which conduct both regulated and unregulated activities. Since such a risk was purely regulatory it could not be avoided.

6.34. BT submitted that there was a serious public interest question as to whether the benefits in terms of lower costs in the calls-to-mobiles activity were outweighed by the regulatory signals sent to all undertakings, that settlements based on one cost convention might be overturned subsequently—with the possibility that some elements of costs could not then be recovered at all. There would be a significant disincentive for regulated companies ever to agree licence conditions on the basis that they would be likely to end up at the MMC in any event. Furthermore, to the extent that greater uncertainty would thereby be introduced, margins and the cost of capital would consequently rise, to the detriment of the public interest.

Appropriate rate of return

6.35. BT commented that while it might be possible for the MMC to form a clear view on the most appropriate allocation of BT's costs for calls-to-mobiles, the question of the appropriate rate of return on sales was inherently more vexed and did not admit of a definitive answer. BT presented to us a range of possible benchmarks which it believed, viewed together, allowed an assessment to be made as to the reasonableness, or otherwise, of BT's returns (see paragraphs 5.49 to 5.51). It put it to us that the conclusion from this was overwhelmingly that, at least on the basis of BT's current method of cost apportionment, the returns earned on calls-to-mobiles were not excessive. It recognized that, if significant levels of costs were allocated away from calls-to-mobiles, at prevailing prices BT's returns would increase—perhaps to a point where they could be judged to be excessive. However, it considered that this highlighted that the issue was essentially about the structure of BT's prices across services, not about the overall level. If calls-to-mobiles were deemed too expensive, it was purely an issue of the cost allocation methodology. There was no need for the MMC to attempt to identify a unique figure as an appropriate rate of return.

6.36. BT said it had gained the impression that the MMC had been trying to establish a reasonable rate of return for calls-to-mobiles in isolation from consideration of the other aspects of the inquiry. It submitted that the return that BT could reasonably expect to earn was a reward for risks taken. The extent of these risks depended in part on the position the MMC adopted in allowing or disallowing certain costs and on the nature of any price control that might be proposed. In particular, BT would face significant additional risks if the retail price was regulated in isolation from the termination rate. BT was also vulnerable to fluctuations in the MNOs' time-of-day traffic mix. Under certain of the scenarios hypothesized by the MMC, BT would require a higher return than the modest margin it currently earned on calls-to-mobiles. Thus it was only when agreement had been reached on the approach to cost allocation and the form of the control that a final view could be taken of the appropriateness of the current return.

6.37. BT submitted that, in judging the reasonableness of its return on calls-to-mobiles—a retailing business with low (or negative) capital employed—return on sales was the appropriate measure. This was widely accepted as a reasonable measure for a retailing business. Indeed it had been used extensively in the past by the MMC. The challenge lay in identifying a relevant benchmark.

6.38. What was clear to BT was that, of all the comparators that could be chosen, the supply of electricity was one of the least appropriate. Electricity supply was a mature, stable, low-growth industry with little technological change and a single product which, in the case of Scottish Hydro-Electric plc reported on by the MMC in the recent past, faced limited effective entry and attrition from its former statutory monopoly position (see paragraphs 5.50 and 5.51). By contrast, the telecommunications market was acknowledged as one of the world's most dynamic and fast-changing industries. While BT was a partially regulated business, the DGT had made it clear that it was not a utility:

DGT believes there are a number of ways in which telecommunications and the telecommunications market is no longer a utility and is very different from the other regulated industries. These include the market structure and the stage of market development, the international future of the industry, the scope for infrastructure competition and the variety of services and products delivered over that infrastructure.¹

6.39. Furthermore, whereas a rate of return of 0.5 per cent was applied by the MMC in the case of Scottish Hydro-Electric, in more recent price reviews OFFER and OFGAS had allowed a profit for supply businesses of 1.5 per cent, in recognition of the increased risk resulting from the introduction of domestic competition—albeit with projected market share losses at around half the rate at which BT was already losing share on calls-to-mobiles. While the high growth rates on calls-to-mobiles might mitigate BT's market share losses, they caused difficulties in assessing future demand and the appropriate scale of BT's operations, network capacity, computer billing, customer service centres, and so forth—which were then exacerbated by the unpredictable loss of market share. These were not risks that Scottish Hydro-Electric or, indeed, any conventional utility, ever faced, and returns earned by BT should be commensurately higher.

6.40. In addition, BT considered it appropriate to seek to adjust for what it saw as the much wider range of activities undertaken by BT on marketing, sales, billing, customer service etc, in recognition of the more complex market. It pointed out that the relatively low level of value added in the electricity supply business had been recognized by the MMC in the Scottish Hydro-Electric case. Accordingly BT converted the return on sales figure from the recent OFFER and OFGAS determinations into a return on retail costs of 25 per cent. It believed this provided a somewhat more realistic benchmark compared with which its returns of 21 per cent on the current cost methodology, after allowing for ADCs, were not out of line (see Table 5.6).

6.41. BT was firmly of the view that, in the light of these considerations, any comparison with Scottish Hydro-Electric was fundamentally flawed.

¹OFTEL submission to DTI Review of Utility Regulation, September 1997, paragraph 1.5.

6.42. BT stated that in assessing the public interest both the DGT and the MMC must have regard to the return required to sustain and develop competition. A rate of return which signalled low rewards for new entrants or current players would fail to address this obligation and send a signal to potential entrants in all regulated industries that rewards were low, uncertain and vulnerable to unforeseen regulatory intervention. A careful balance had to be struck between the immediate benefits of one-off price cuts accruing to those who currently made calls-to-mobiles and a drying-up of profitable opportunities for new entrants which would lead to less competitive pressure on prices and quality, to the longer-term detriment of all customers, both current and future. If the MMC were to find that there was currently inadequate competition in this market, this would support BT's view that the margins could not be excessive since, given the ease of entry, more competitors would otherwise have entered. Reducing BT's margin could only serve to exacerbate any perceived problem.

6.43. Addressing these concerns BT submitted that any benchmark must therefore be forward-looking and based on the return on sales (ROS) earned in conventional retailing activities which were competitive and where there was also some similarity in the activities undertaken. BT had considered a number of comparable industries with an average ROS of 9 per cent and had also found a range of ROS of between 4 and 15 per cent for all retailers in the FTSE 350 index. BT also said that in other MMC inquiries, notably the supply of recorded music,¹ the MMC had taken ROS as the appropriate measure given that the capital employed was so small: the range of ROS found not to be excessive by the MMC in that report was 2.9 to 5.9 per cent. In the fine fragrances inquiry,² ROS of 7.4 per cent was not judged excessive. More recently, the MMC found that ROS of 6.8 and 21.5 per cent did not give rise to adverse effects in the National Express/West Midlands merger inquiry.³

6.44. BT considered its ROS on calls-to-mobiles of 3.1 per cent after ADCs to be modest by comparison. It also pointed out that the DGT had used a benchmark of 5 per cent ROS as a minimum that must be achieved on BT's apparatus supply business to ensure that it was not being unfairly cross-subsidized. BT said that as a regulated company it must price in a 'window', the lower level reflecting its obligation not to unfairly cross-subsidize and the upper level its obligation not to unfairly exploit its market position. The test for whether these principles were infringed was based on the published regulatory accounts and the accepted conventions of cost allocation. On this basis BT's charges for calls-to-mobiles were closer to levels which would in other circumstances trigger regulatory concerns of underpricing and unfair cross-subsidy than to vulnerability to a charge of excess returns.

6.45. Finally, BT said that judged against the benchmark of the return that it earned on other calls—in its view the most directly relevant comparator—the returns on calls-to-mobiles were low. Indeed in BT's view the current rate of return was unacceptable from a commercial perspective. BT firmly believed that the level of its prices did not act against the public interest and that, given its limited margins, any further reduction would threaten to undermine the development of competition.

Hypothetical remedies

6.46. BT suggested that if the MMC were to find that BT's retail price for calls-to-mobiles acted against the public interest, this could only reasonably be based on concerns that:

- the termination rates charged by the MNOs were too high;
- competition was not yet adequately constraining the prices BT could charge to lower-spending residential customers;
- lower-spending residential customers were not receiving appropriate protection from the existing regulatory regime;

¹*The supply of recorded music: a report on the supply in the UK of pre-recorded compact discs, vinyl discs and tapes containing music*, HMSO, Cm 2599, June 1994.

²*Fine fragrances: a report on the supply in the UK for retail sale of fine fragrances*, HMSO, Cm 2380, November 1993.

³*National Express Group PLC and Midland Main Line Limited: a report on the merger situation*, Cm 3495, The Stationery Office, December 1996.

- BT's cost allocation methodology resulted in an inappropriately high proportion of the common costs being allocated to calls-to-mobiles; and
- having adjusted for those cost allocations, the returns that BT made on these calls were excessive.

6.47. BT told us that it had been subject to price controls since 1984. During this period, considerable thought had been given to the principles of effective price cap regulation, whilst the price cap mechanism itself had evolved into a far more sophisticated control than originally envisaged. BT suggested to us that the following conclusions had emerged:

- (a) A careful balance should be achieved between providing protection to customers whilst not discouraging potentially-efficient competitors, who might not have attained efficiencies of scale.
- (b) Controls should provide a continuing incentive for efficiency.
- (c) Broad caps, where a number of services were controlled under one umbrella cap, were preferable to narrow caps because they were:
 - (i) less prone to the problems resulting from divergence between forecast and reality, in particular in fast-growing, volatile markets;
 - (ii) less likely to result in an ossification of tariff structures in a situation where the market was evolving; and
 - (iii) able to ensure that customers obtained the full benefit of the required cuts, whilst allowing the supplier to choose communicable price points on preferred dates.
- (d) Once-only adjustments were, in general, detrimental to the development of sustainable competition in that they introduced an element of unpredictability impacting adversely on a company's ability to devise and deliver a sound strategy and investment programme. A glide-path, which adjusted returns to the required level over the period of the control, could be seen as being closer to the working of a competitive market.
- (e) As competition developed, price control regulation should be rolled back.

BT told us that the DGT had explicitly recognized that competition was a better incentive mechanism for restraining prices than price control. To that extent BT was in full agreement with the DGT. BT also pointed out that the DGT had recognized that parts of the market, specifically businesses and the top 20 per cent of residential customers by bill size, were already experiencing effective competition and therefore did not need the full weight of formal price cap protection.

Termination charges

6.48. As regards the level of the termination charge, that was the subject of separate references in respect of Cellnet and Vodafone. BT was committed to pass on to its customers reductions in termination charges arising from those inquiries: this reflected its consistent policy and practice of passing on reductions in termination charges hitherto. While BT had the legal freedom to depart from that past policy, it had indicated that it would not do so. No adverse effect arose from the maintenance of a legal freedom which BT had indicated it would not exercise. Accordingly, no licence modification was required to ensure that BT continued its policy of passing on reductions in termination charges, howsoever arising. However, if all the MNOs had termination charges which differed by a fraction of a penny from each other BT said that it would be quite resistant to the idea of reflecting that in its retail prices because it did not think that would be good for its customers.

6.49. BT added that its submissions had been designed to allay the MMC's concerns in each of the remaining areas. If, nevertheless, the MMC remained of the view that there was an adverse public interest effect to be remedied, it was clear that the option of a retail price control, with no regulatory

control over the termination charge, had nothing to commend it. It would place the burden of controlling 75 per cent of the retail price on BT's negotiating ability over the MNOs and would be, bluntly, an abrogation of responsibility. If the MMC found termination charges to be excessive, then law and reason would dictate that it should make appropriate recommendations to remedy the adverse effects through modifications to the MNOs' licences. The DGT would then be able to take appropriate and direct action to remedy or prevent those adverse effects. A solution which relied on BT for this would have no objective guarantee of eliminating the adverse effects.

6.50. BT commented that while it had negotiated effectively in the past to achieve reduced termination charges, the success of the negotiations was ultimately secured by the MNOs' self-interest in seeing retail prices reduced. If, however, retail prices were already set through a retail price control, the MNOs would have no incentive to agree the requisite lower termination charges or to increase their efficiency. It would seem perverse to regulate BT whilst leaving unregulated the termination charge which was generally accepted as the least competitive part of the price. Moreover, this would leave BT exposed to significant financial risk: if it failed to achieve a lower termination charge, its margins would be rapidly eroded. If the matter went, as would be inevitable, to the DGT for determination, it was by no means clear that, in making a determination of the appropriate interconnection charge, the DGT would be entitled to have regard to the adequacy of BT's retail margin.

6.51. BT emphasized that in the light of the relevant provisions of the 1984 Act it believed that a proposal to control retail prices alone, as a substitute for effective remedies, in the face of adverse findings on termination rates, would be unlawful. On the assumption that any concern the MMC might have with the level of termination charges would be addressed directly, this left the question of BT's retention.

BT's retention

6.52. In BT's view, in arriving at a remedy which would address any lingering MMC concerns over the effectiveness of competition, particularly at the bottom end of the market, the appropriate cost allocation methodology and the resulting rate of return, the MMC were faced with a number of issues:

- Any reallocation of costs away from calls-to-mobiles raised an issue of regulatory consistency with the assumptions used in setting RPI-X in the current retail price control. The concern was that these costs would effectively be disallowed, thus increasing the level of regulatory risk for BT and all other regulated industries where a reallocation of common costs between regulated and unregulated activities took place within an existing price control regime.
- The increase in competition risked being stifled if the margins available on calls-to-mobiles were significantly reduced.
- Detailed micro-regulation had inherent risks and removed the flexibility from BT to set prices in response to wider market considerations. In particular, it would exacerbate the problem of low customer awareness and confusion if it became difficult for BT to set communicable price points because of the need for annual price reductions of a fraction of a penny.

6.53. However, there was one remedy which addressed directly what BT understood to be the MMC's concerns, while providing satisfactory solutions to these issues: inclusion of the retention on calls-to-mobiles in the current RPI-4.5 per cent basket of retail prices.

6.54. BT said that if regulation of its retention was judged necessary at all, it could be considered in two parts, a possible initial price cut applied to the existing retention and regulation to maintain the price cut and to reflect anticipated efficiency gains.

6.55. Regarding the continuing regulation element, the incentives on BT to improve efficiency already existed through the main RPI-X control, which required BT to act on costs which were common across all call types, including calls-to-mobiles. At the very least, there was no reason why

calls-to-mobiles should be subject to a different regime, in terms of continuing efficiency targets, than applied to BT's presently regulated services, especially in relation to costs which were common.

6.56. The other aim would be to provide a safeguard for customers who were not yet adequately protected by competition, ensuring, *inter alia*, that the benefits of any initial price reduction were not reversed. BT believed that inclusion of the calls-to-mobiles retention in the main RPI-X basket would provide this. If, however, the MMC required an additional safeguard, this could be provided in the form of a separate sub-cap such as had been used, for example, between 1993 and 1997 when all regulated services were subject to a sub-cap of RPI-0 per cent except line rentals which were subject to an additional sub-cap of RPI+ 2 per cent.

6.57. BT commented that a safeguard sub-cap could be introduced to meet any particular objective. It said that sub-caps sat within baskets, in that the overall price cap still applied to that service, and changes contributed to the basket total. For example, an RPI-0 per cent sub-cap would act as a safeguard to ensure that BT's retention would never be increased in real terms, whilst an RPI-RPI sub-cap would ensure that BT's retention did not increase in nominal terms. Such a sub-cap would also have the advantage of safeguarding BT's commitment to pass through any reductions in the termination rate.

6.58. As to the question of a possible initial 'P₀' cut to its existing retention on calls-to-mobiles, BT re-emphasized the importance of maintaining consistency with the current RPI-X retail price control. It suggested that a straightforward solution that would also be consistent with the principles of the Better Regulation Task Force would be for the retention to be included within the current RPI-X basket and for any requisite P₀ change—and the implied cost reallocation—to be made in the current basket. BT added that if the retention rather than the retail price were included in the basket there would be no need to worry about dovetailing this with any price control on termination charges.

6.59. BT commented that the effect of including calls-to-mobiles in the basket would be to increase the aggregate total of reductions BT would need to deliver to meet the cap. This was because the total revenue for basket services would be increased. This would have no impact on the levels of prices of other services in the cap if BT reduced its retention on calls-to-mobiles by exactly RPI-4.5 per cent. Were BT to decrease the retention by more than RPI-4.5 per cent (for example, to grow the market or to achieve communicable price points), BT would be entitled to reduce other prices by slightly less, so that, on average overall, consumers paid RPI-4.5 per cent for all price-capped services. Conversely, were the retention to be reduced by less than RPI-4.5 per cent, BT would be required to reduce other basket prices by more than they would have otherwise fallen. In effect, consumers would be fully compensated for the below-average reduction on calls-to-mobiles by larger decreases on their other services. Obviously, BT's ability to reduce the retention on calls-to-mobiles by less than RPI-4.5 per cent would be dependent upon whether a sub-cap had been applied to those calls.

6.60. BT added that, in the particular case of a P₀ reduction made inside the basket, BT would be entitled to reduce other prices by less than would otherwise have been the case in that year. This would effectively allow for some of the implicit reallocation of costs to services already subject to price control to be recovered. However, the overall financial impact would still be strongly negative as, for customers outside the basket, the P₀ reduction on calls-to-mobiles would be worth more in absolute terms than the call price reductions they replaced. (Further details on the workings of the basket are given in paragraph 3.47 and Appendix 3.2, paragraphs 25 to 33.)

6.61. BT submitted that, if the MMC were to conclude that the retail price of calls-to-mobiles gave rise to public interest concerns, that would be, at least in part, because those prices had not been included in the current retail price control in 1996. If the public interest finding were couched in these terms this would point directly to a remedy of the form suggested by BT, so aiding a speedy resolution. An appropriate recommendation might be that BT's licence should be modified to achieve an effect equivalent to that which would have resulted from calls-to-mobiles being included in the basket from the outset, together with a specific P₀ reduction if required. Such a licence modification would then include a term for BT's retention in the basket, with a weighting calculated in the normal way, along with any safeguard sub-cap if this was judged necessary.

6.62. BT said that the main attraction of its proposal lay in its ability to secure the reallocation of costs implicit in any required P₀ reduction and thus avoid the need to reopen the 1996 settlement.

While only partially offsetting the financial impacts of any P_0 reduction, it would address the issue of principle of consistent treatment of costs. The end result was essentially a simulation of what would have arisen if, in 1996, calls-to-mobiles had been included in the RPI-X formula at a particular level and BT had decided to reduce calls-to-mobiles charges by the full extent of any P_0 cut.

6.63. BT said that such an approach would also be consistent with its view that as calls-to-mobiles were no less competitive than other types of calls, they should not be subject to any greater regulation. Furthermore, it would have the merits of being simple to implement and administer (making use of the existing regulatory mechanism), proportionate and effective in targeting the lower-spending segments of the market where competition might be judged to be weakest and consumers most in need of protection. While providing a measure of flexibility to BT, this would also ensure that the efficiency incentives of the retail price control applied equally to calls-to-mobiles.