

The Oftel Formula Returns

Statement

9 May 2002

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Summary

S.1 Oftel has collected financial data from Vodafone and O2 (formally BT Cellnet) on a quarterly basis since May 1994, as part of its monitoring of unfair cross-subsidy rules. The financial data (the formula return) is used as input to a statistical test (the Oftel formula) designed to assess whether the networks are cross subsidising their Tied Service Providers (TSPs).

S.2 In its consultation "*The Oftel formula returns*" – December 2001 (the formula consultation), Oftel consulted on its view that the collection of financial data for the Oftel formula would not be necessary or appropriate if the Market Influence (MI) determinations were removed from Vodafone and O2.

S.3 On April 5 2002, the Director General of Telecommunications (the Director) published determinations to remove the MI determinations from Vodafone and O2 (then BT Cellnet), "*Determinations to remove the determinations that Vodafone and BT Cellnet have Market Influence under Condition 56 of their respective licences*" (the MI determinations).

S.4 Following the publication of these determinations, and taking into account the responses received to the formula consultation, the Director considers it appropriate to cease collecting the financial data for the Oftel formula from Vodafone and O2. This document sets out in greater detail the reasons for this decision and Oftel's response to the points raised by respondents to the formula consultation.

Chapter 1 The Oftel Formula and Formula Returns

1.1 In April 1997, Oftel published its *“Fair Trading in the Mobile Telephony Market”* Statement (the Fair Trading statement). This document described the reasons for the Director’s decision to maintain on Vodafone and O2, as operators with market power, the requirement to submit quarterly returns to demonstrate compliance with the Oftel formula.

1.2 The Oftel formula uses a discounting technique to assess whether a TSP is making an adequate return over the life of a subscriber once the cost of acquiring that subscriber has been taken into consideration. The average life of a subscription is expressed in terms of high, medium or low ‘churn rates’. Results for the Oftel formula are expressed in terms of pounds per subscriber.

1.3 If the Oftel formula results in a positive value, then the TSP is earning a profit for each subscriber. If the results are negative, then the TSP is making a loss for each subscriber, implying a cross-subsidy from elsewhere within the licensee’s Group.

Comments by respondents

1.4 In its response to the formula consultation, the Mobile Independent Service Provider group (MISP), argues that the formula return is an effective, well established and well understood mechanism of monitoring cross-subsidy in the mobile sector. MISP states that the regular collection of financial data for the Oftel formula provides Oftel with a source of readily available information, which can be drawn upon should an allegation of unfair cross-subsidy arise.

Oftel’s response

1.5 The information collected under the formula return could be used in investigating an allegation of unfair cross-subsidy, but this information could also be collected during the course of an investigation, in the same way that most other information relevant to an investigation is collected. Of course, should Oftel investigate an allegation of cross-subsidy in the mobile sector, the well-established methodology of the Oftel formula is still available regardless of whether or not the results are monitored on a regular basis.

Market Influence

1.6 In the formula consultation, Oftel consulted on its view that in the absence of MI determinations, it is appropriate to cease regular monitoring of the Oftel formula.

1.7 Oftel published determinations to remove the MI determinations on April 5 2002. In making the determinations, the Director concluded that:

- there is evidence to suggest that some operators will continue to supply service providers, in the absence of a regulatory requirement to do so;
- there is no clear correlation between successful Independent Service providers (ISPs) and the MI regime; and
- the costs of the MI regime outweigh the benefits.

1.8 Oftel considers that there is no reason to continue to monitor cross-subsidy through the Oftel formula in the absence of a regulatory requirement to supply ISPs.

Comments by respondents

1.9 In response to the formula consultation, MISIP and Centrica argue that there is no evident link between the decision to remove the MI determinations and the decision on whether or not to continue to collect the data to monitor cross-subsidy using the Oftel formula.

Oftel's response

1.10 A view that the monitoring of cross subsidy is required to prevent operators with market power from forcing ISPs to exit the market is inconsistent with the decision taken in the MI determinations. As explained in the Explanatory Memorandum to the MI determinations, Oftel believes that in the absence of regulation some network operators will continue to supply ISPs. This view is supported by the fact that several ISPs have successfully negotiated supply deals commercially, outside of the regulatory framework. Therefore, Oftel considers that in the absence of a regulatory obligation to supply active monitoring of cross-subsidy, through the Oftel formula, is unnecessary and inappropriate.

Chapter 2 Cross-Subsidy in the Mobile Sector

2.1 Arrangements to monitor cross-subsidy in the mobile market, through quarterly financial returns have been in place since 1994. Changes in how the returns were used to monitor cross-subsidy, by revising the Oftel formula, were made following Oftel's Fair Trading statement of April 1997. At this time, One2One and Orange were relatively new entrants in the mobile sector and Vodafone and O2 were established operators (with market shares of around 40%), who had fully rolled out networks and significant first mover advantages.

2.2 The monitoring arrangements reflected the concern that, as Vodafone and O2 had market power at the upstream network level, they could leverage this market power into the downstream service provision level by unfairly cross-subsidising their TSPs. Such leverage would result in the profit margin of ISPs being squeezed as ISPs face the same wholesale charges as TSPs and must compete with the retail prices of TSPs. Hence, ISPs faced the risk of being excluded from the market.

Comments by respondents

2.3 In their responses MISP and Centrica argue that potential for unfair cross-subsidy between the networks and their TSPs will increase, ultimately having a negative impact upon retail competition in the mobile sector.

Oftel's response

2.4 Oftel believes that the incentives and ability of Vodafone and O2 to unfairly cross-subsidise their TSPs in order to reduce retail competition are reduced now that Orange and One2One are fully established. For this reason, and for the reasons given in the MI determinations Oftel no longer believes that ISPs face the risk of being excluded from the mobile market by operators cross-subsidising their TSPs.

Condition 66

2.5 Vodafone's and O2's respective licences allow Oftel to require the provision of financial information, should Oftel consider that there is evidence to suggest that either operator has unfairly cross-subsidised one part of its business from another part.

2.6 Condition 66 is a standard licence condition and therefore not reliant on a test of market power. It will remain possible to obtain, on an ad-hoc basis, such information relevant to determine whether there has been any unfair cross-subsidy.

2.7 The provisions of Condition 66 also cover a broad range of cross-subsidisation, and not just the specific network to TSP cross-subsidy that is currently monitored using the Oftel formula.

Comments by respondents

2.8 In its response Centrica argue that the data for the formula return should continue to be collected to monitor the provisions of Condition 66. MISPP also suggests that the return should be kept for this reason and add that by ceasing to collect the data, relying on ad-hoc requests as and when required, Oftel would incur increased costs and workload that would only serve to prolong cases, should they arise. MISPP also questions the justification behind what it sees as a shift in policy that means operators deemed to have market power will no longer be required to supply formula returns.

Oftel's response

2.9 For the reasons set out in more detail in Chapter 1 and in the Explanatory Memorandum to the MI determinations, Oftel does not consider that it is necessary or appropriate to continue to monitor cross-subsidy through the Oftel formula.

2.10 Furthermore, Oftel does not consider that requiring information in relation to an investigation following an allegation of unfair cross-subsidy on an ad-hoc basis should prove any more difficult than requiring any other necessary data.

2.11 The formula consultation did propose that Oftel changes its policy on the collection of the Oftel formula returns. It is not normal practice for Oftel to consult on internal processes such as whether or not it collects regular data, however as the Oftel formula has been subject to past statements the Director considered it appropriate to consult in this instance.

Chapter 3 – Conclusion

3.1 Having considered the comments and representations made by the respondents to the formula consultation, the Director remains of the opinion that the regular collection of the formula return for the Oftel formula is no longer appropriate.

3.2 The Director considers that the evidence and reasoning supporting the decision to remove the MI determinations also supports the decision that it is inappropriate and unnecessary to continue to require Vodafone and O2 to continue to supply data for the Oftel formula.

Annex Respondents to the consultation

O2 (formally BT Cellnet)

Vodafone

Mobile Independent Service Provider group (MISP)

Centrica
