



Retail Price Controls

Explanatory statement

Statement

Publication date:

19 July 2006

Contents

Section		Page
1	Summary	1
2	Introduction	5
3	Responses to the consultation and Ofcom's comments	8
4	Recent Regulatory and Market developments	17
5	Conclusions following the March Consultation	29
Annex		Page
1	Ofcom's Communications Plan	32
2	Ofcom's Communications Plan - Advertisements	34
3	BT market shares in relevant markets	36
4	List of respondents to the consultation	39
5	Impact assessment	40

Section 1

Summary

- 1.1 This statement confirms Ofcom's proposal, set out in its March Consultation document, to allow Retail price controls (RPC) to lapse on their expiry on 31 July 2006. This is a landmark decision and affirms Ofcom's intention to withdraw from regulation as soon as competitive conditions allow.
- 1.2 RPCs have been in place since 1984 when BT was privatised. These controls have delivered substantive benefits for consumers and have protected them by securing year on year price reductions in real terms in markets where competitive pressure alone has until now been too weak. These price reductions for telephony services mean that the UK now has some of the lowest prices for residential telephony among developed countries¹.
- 1.3 Reductions in prices have been accompanied by a significant increase in the choices available to consumers and reflect an increased level of competition in the retail markets which continues to strengthen and grow. This competition has been facilitated by the improved effectiveness of regulation of the wholesale telephony markets. At the same time consumer protection measures have been enhanced through changes in other regulation including BT's Universal Service Obligation (USO).
- 1.4 Ofcom notes that retail price regulation can have an impact on the wider market (e.g. possibly restricting tariff innovation) and therefore, allowing the RPC to lapse means that from August 2006 the market, rather than regulation, will determine the price of retail telephony services. BT will be in a similar position to all other communications providers and will have the ability to set the price of their services in response to competitive conditions in the retail markets.
- 1.5 There will also be additional safeguards for certain low spending consumers. At the same time as the RPCs lapse, BT has provided a number of assurances for the period up to the end of 2007.
- 1.6 The Communications Act and the European regulatory framework on which it is based require Ofcom to undertake reviews of markets from time to time. Ofcom will be conducting the next full review of the markets for fixed narrowband retail services next year. As part of this review Ofcom will assess the impact of removing the RPC and could, if it were necessary, take steps to address any adverse consequences.

Background

- 1.7 The current set of controls was put in place in June 2002 by Oftel's review of the fixed telephony market entitled "Protecting consumers by promoting competition: Oftel's conclusions"². The controls started on 1 August 2002 and were for a period of four years; these controls expire on 31 July 2006. The RPCs regulate the price of a basket of residential retail telephony services, namely: local, national and international calls, calls to mobiles, operator assisted calls and exchange line rental. The RPC applies to the expenditure on these services of the lower 80% of BT's

¹ See page 141 of Ofcom's 2005 Market Report:
<http://www.ofcom.org.uk/research/cm/cm05/telecommunications.pdf>

² <http://www.ofcom.org.uk/static/archive/oftel/publications/pricing/2002/pcr0602.htm>

residential customers by spend. The effect of the controls, which is now set at RPI+0% is that BT cannot increase charges for the basket of services in real terms (i.e., overall retail prices cannot go up by more than RPI).

- 1.8 These controls and their scope were confirmed by the market review statement dated 28 November 2003 entitled "Fixed Narrowband Retail Services Markets - Final Explanatory Statement and Notification" ("the Final Statement")³. This document set a condition placing the original control of RPI-RPI on the services BT provides in the relevant markets under the new European regulatory framework. This condition also provided that the control was to be relaxed to RPI+0% after BT had provided a "fit-for-purpose" Wholesale Line Rental (WLR) product that was being taken up actively by BT's competitors.
- 1.9 On 15 December 2005⁴ Ofcom determined that BT's WLR product was fit-for-purpose, reflecting a range of factors including the fact that the product had had a significant impact in the market with over one million WLR lines used by residential consumers. Accordingly, the RPC was relaxed to RPI+0% with effect from 1 January 2006.
- 1.10 In September 2005, Ofcom accepted undertakings from BT in lieu of a reference to the Competition Commission under the Enterprise Act 2002⁵. By the terms of these undertakings, BT is required to provide various wholesale products at a standard known as "equivalence of inputs" (Eol). By this standard, BT is obliged to use the same wholesale products and services itself as it provides to other communications providers. BT is required to implement Eol in relation to WLR products by 30 June 2007. However, if BT fails to implement EOI by 31 December 2006, it is required to provide other communications providers with a specific allowance.

The March Consultation

- 1.11 On 21 March 2006 Ofcom published a consultation document entitled "Retail Price Controls"⁶ (the March Consultation). In the March Consultation, Ofcom identified a number of options for the future of regulation once the existing price controls expired on 31 July 2006. These were:
- **Option 1:** no regulation in place of RPC – no charge control from 1 August 2006 with no additional consumer protection 'assurances' from BT;
 - **Option 2:** roll-over of the existing charge control – a continuance of the safeguard cap (RPI+0%) on a basket of access and calls for Y% of subscribers by expenditure (currently Y = 80%);
 - **Option 3:** safeguard cap on BT's entry level tariff, BT Together 1 (BTT1), or any replacement; and
 - **Option 4:** no charge controls from 1 August 2006 but voluntary assurances provided by BT.

³ http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/fixedenarrowbandrsm.pdf

⁴ Wholesale Line Rental: Fit-for-Purpose Assessment, available at http://www.ofcom.org.uk/consult/condocs/line_rental/wlrffp_statement/statement.pdf

⁵ <http://www.ofcom.org.uk/telecoms/btundertakings/btundertakings.pdf>

⁶ <http://www.ofcom.org.uk/consult/condocs/retail/>

- 1.12 Having analysed all four options Ofcom proposed that the RPC should be allowed to lapse but with certain safeguards. Ofcom's recommended option was therefore Option 4. The proposal took account of commercial, regulatory and market-led developments that have occurred since the market review in 2003. These developments have led to increasing competitive pressure on BT in the retail markets. The consultation explained how increasing numbers of consumers have switched to BT's competitors. These competing providers offer WLR, LLU, CPS/IA and VoIP services. The range of services, the ability to switch and the migration of increasing numbers of customers represent an increasing constraint on BT's prices for its retail services. The March Consultation also noted that the ability of other communications providers to compete effectively would be enhanced further when Eol is delivered by the middle of 2007.
- 1.13 In considering what should happen after July 2006, Ofcom was mindful that certain groups of vulnerable consumers may require more protection than the average consumer who could switch easily. The Universal Service Obligation protects specific consumer groups through the special tariff scheme supplied by BT⁷. There are however, also low spending consumers who may not qualify for protection through the USO. For these consumers competition in the services they purchase may be weaker, leaving them vulnerable to price rises. However, the availability of alternative WLR services and the fact that switching has become easier places competitive pressure in general on prices in the market.
- 1.14 Therefore, as a safeguard over and above the protections offered by the USO, BT agreed with Ofcom to offer a number of assurances relating to the pricing of the line rental (i.e., the monthly fixed fee) that it charges for its basic exchange line services, and to the pass-through in respect of mobile termination rates.

Consultation responses and Ofcom's decision

- 1.15 A range of responses was received to the March Consultation. Ofcom has considered and analysed them in light of its statutory duties. Many of the responses, including those from BT, the Scottish Executive, the Welsh Assembly Government and the Communication Workers Union provide support for Ofcom's proposal.
- 1.16 Industry respondents acknowledged there had been significant developments in both wholesale and retail markets since the RPC was imposed in 2002 although in general, they favoured delaying deregulation until after the delivery of Eol. Ofcom understands the concerns that have been expressed by such respondents but believes that the RPC should not be used as a lever in relation to wholesale regulation when retail competition has developed to such a point that, along with other safeguards, the RPC is no longer needed.
- 1.17 In relation to concerns that were raised particularly by individual respondents, Ofcom considers that BT's assurances, in conjunction with ongoing regulation such as BT's obligations under its USO, are sufficient to ensure that prices faced by low spending consumers are appropriately controlled. Ofcom, having taken account of all respondents' views, has therefore decided to allow the RPC to expire. There will be no further price control regulation on BT's retail prices with effect from 1 August 2006.

⁷ This is currently the Light User Scheme (LUS) although this will be replaced next year by a new targeted scheme aimed at customers in receipt of certain state benefits.

- 1.18 As indicated in the March Consultation, Ofcom will also undertake a full market review of the retail markets during 2007. It is anticipated that this review should be completed at about the same time as the assurances provided by BT will expire.
- 1.19 The ending of retail price control after more than twenty years is a major alteration in the regulatory regime. The March Consultation outlined that Ofcom was considering a public information campaign to raise consumer awareness of the change. This UK wide campaign will commence forthwith and will help consumers to understand that from 1 August 2006 consumer choice rather than regulation will be the key determinant of the price and quality of services that customers receive. Annexes 1 and 2 set out the details of this information campaign.

Section 2

Introduction

Legal and Regulatory framework for setting Retail Price Controls

- 2.1 The 2003 Communications Act (the Act) which implemented a set of EC Communications Directives into UK law sets out the legal and regulatory framework for retail price controls (RPCs).
- 2.2 Where a communications provider has Significant Market Power (SMP) in an identified services market Ofcom has the ability to impose a range of regulatory obligations, one of which is retail price controls. Section 87(9) of the Act provides that, subject to satisfying the 'tests' in section 88, Ofcom may set SMP conditions including a retail price control.
- 2.3 The Act, in accordance with the EC Communications Directives, requires Ofcom to carry out periodic analyses of identified services markets (known as 'market reviews'). There are various potential triggers for market reviews. One would be an updating of the list of relevant markets; another trigger would be where Ofcom considers it timely to review a previous market power determination. Ofcom is planning a review of the fixed narrowband retail services markets during the course of 2007. Ofcom considers this timing to be appropriate in that it represents sufficient time for the full effects of recent regulatory and market developments to take effect and to be taken into account in conducting the market review.
- 2.4 The March Consultation was not a market review under section 84(2) of the Act. As explained in the March Consultation, it was an analysis of the existing RPC, a consideration of the options available to Ofcom and a consultation on the proposal that the RPC should be allowed to lapse.

The legal basis for the existing retail price control

- 2.5 The review of the fixed telephony market⁸ which resulted in the imposition of the current RPC was concluded in 2002. The control was set to last for four years, with its expiry on 31 July 2006.
- 2.6 In 2003 a new regulatory framework for electronic communications networks and services was implemented into UK law by the Act. The Act requires Ofcom to carry out market reviews to ensure that regulation remains appropriate in the light of changing market conditions.
- 2.7 In accordance with the Act, a market review in respect of the fixed narrowband retail services markets was undertaken and the outcome was published in November 2003. The final Statement confirmed that the RPC set in 2002 would continue, including the control of RPI-RPI on a basket of products. This control, subsequently modified, was set to last until 31 July 2006. The RPC is applied to the spending patterns of the lowest 80% of residential customers and based on a basket of residential services in the following retail markets in the UK (excluding the Hull area) where BT was found to have SMP:
 - Residential analogue exchange line services;

⁸ <http://www.ofcom.org.uk/static/archive/oftel/publications/pricing/2002/pcr0102.htm>

- Residential local calls;
 - Residential national calls;
 - Residential IDD category A calls;⁹
 - Residential IDD category B calls (on a route-by-route basis);¹⁰
 - Residential calls to mobiles; and
 - Residential operator assisted calls.
- 2.8 The RPC also has an additional element in relation to mobile pass-through. BT has to ensure that its average retention on calls to mobiles to a given mobile provider, across all charging bands, within a twenty-four hour period, is within five per cent of its retention with respect to any other mobile provider. This obligation is not a stand-alone provision; it is part of the RPC. The requirement on mobile pass-through will therefore also expire on 31 July 2006.
- 2.9 The November 2003 Statement explained that the RPC could become unduly onerous for BT if inflation turned out to be higher than expected. The control was therefore capped at RPI-4% if inflation was greater than 4% per year.
- 2.10 In addition, the November 2003 Statement analysed the impact of the development of wholesale line rental and determined that the RPC should be modified from RPI-RPI to RPI+0% when Ofcom was satisfied that WLR was “fit-for-purpose”. BT triggered an assessment of its WLR product by Ofcom on 8 July 2005 and Ofcom decided that it was fit-for-purpose in December 2005¹¹. The RPC was relaxed to RPI+0% with effect from 1 January 2006.

Other relevant conditions

- 2.11 The RPC is not the only obligation applied to BT with respect to the fixed retail markets. In respect of customers of fixed narrowband retail services BT is also required to comply with the following conditions, specifically, BT must meet:
- A requirement not to discriminate unduly (Condition D2); and
 - A requirement to publish charges, terms and conditions (Condition D3).
- 2.12 These conditions are not time-limited: they remain in place and were not considered in the March Consultation. Within the RPC itself (Condition D1), BT is required to provide Ofcom within 3 months of the end of a Relevant Year with sufficient information to enable Ofcom to assess compliance with the RPC. BT will consequently be required to comply with this requirement for the final year of the RPC, after which this obligation will fall away.
- 2.13 In addition, BT will continue to be required to comply with financial reporting obligations in respect of the fixed narrowband retail services, specifically a cost accounting requirement for the reasons set out in page 15 of the July 2004 statement

⁹ The market for IDD calls where the underlying wholesale routes have been found to be effectively competitive.

¹⁰ Individual markets for IDD calls, defined on a route-by-route basis, where BT has SMP.

¹¹ http://www.ofcom.org.uk/consult/condocs/line_rental/wlrrfp_statement/

*(“The regulatory financial reporting obligations on BT and Kingston Communications Final statement and notification – Accounting separation and cost accounting”)*¹².

These conditions will be evaluated as part of next year’s market review.

- 2.14 BT is also subject to certain requirements in order to protect vulnerable consumers. These requirements form part of BT’s Universal Service Obligation (USO). BT has to provide one or more special tariff schemes that would not be provided under normal commercial conditions for its customers who are on low incomes or have special social needs. At present, BT provides the Light User scheme (LUS), the terms of which provide for a rental rebate against the normal line rental charge in the event that call charges are below a defined level¹³. During the course of next year, this scheme will be replaced by a new scheme aimed at those on certain state benefits.
- 2.15 Finally, as part of its USO, BT is also required to set prices for narrowband retail services, within the scope of the USO, on a uniform basis throughout the UK (excluding the Hull area)¹⁴.

¹² http://www.ofcom.org.uk/consult/condocs/fin_reporting/fin_report_statement/finance_report.pdf

¹³ The LUS currently has around 1.1 million customers. BT also offers the In Contact (IC) service which has around 55,000 customers

¹⁴ USO Condition 1:

http://www.ofcom.org.uk/static/archive/oftel/publications/eu_directives/2003/uso0703.pdf

Section 3

Responses to the consultation and Ofcom's comments

Comments on Ofcom's Policy proposals and Ofcom's responses

- 3.1 A total of 30 responses were received, 8 were from industry members, 4 from consumer and citizen groups and 18 from members of the general public. A full list of respondents is set out at Annex 4.

Groups representing consumers and citizens

- 3.2 Citizen and Consumer Groups generally welcomed the proposals. They also noted the importance of the assurances particularly with regard to vulnerable consumers. Ofcom was asked to consider how to continue protection for such consumers after BT's assurances expire in 2007. Ofcom was also asked to ensure that the assurances were adhered to.
- 3.3 The Citizens Advice Bureau (CAB) and Scottish Executive (SE) pointed out that from their perspective competition remained limited particularly in rural areas. The SE also sought confirmation that prices would continue to be geographically uniform so that those living in remote rural locations would also benefit from competitive prices targeted at urban consumers. The Welsh Assembly (WA) noted that the rate at which BT's market share is diminishing varies across the nations and that in some areas the effects take a longer time to materialise. In regard to BT's assurances the WA acknowledged their commercial sensitivity but said that without access to them they were unable to make an absolute judgement.
- 3.4 The Communications Workers Union (CWU) welcomed both Ofcom's proposals and BT's assurances, adding that Ofcom's favoured option was appropriate in light of increasing competition.
- 3.5 The CAB noted research which suggested that switching amongst telecoms consumers was not as high as in the utility industries and would have welcomed further Ofcom research into switching amongst more vulnerable consumers.
- 3.6 Ofcom's promise of a market review in 2007 was welcomed and a request made for a clear timetable.

Ofcom's response

- 3.7 Ofcom agrees that it is important for it to monitor BT's compliance with its voluntary assurances and will assess what, if any measures need to be taken after 2007 in the market review due to be completed by the end of that year.
- 3.8 Ofcom considers that there are already opportunities for consumers in rural areas to take advantages of the choices available throughout the UK. CPS providers are available to all UK consumers as are a range of providers offering WLR. The rate at which BT's share is diminishing in different geographic areas may be affected by a variety of factors, including the need to know about the availability of alternative providers. Ofcom's information campaign which will follow this statement is designed to raise awareness of the opportunities available to consumers in all locations.

- 3.9 Ofcom acknowledges the importance of transparency in relation to the assurances; this is why the substance of them has been made public. The details cannot be published because they include commercially sensitive detail of BT's business, in particular with regard to price points, which would not be available to BT's competitors under normal competitive conditions. This point is addressed further in paragraph 3.32.
- 3.10 Ofcom notes that levels of switching vary according to the sector. Such differentials may occur for a number of reasons including the fact that telecoms services are more complex, have different pricing structures and the absence of incentives such as dual fuel. In regard to the issue of further research, Ofcom has an extensive research programme which will continue to monitor patterns of switching; such research always tries whenever possible to take account of demographic differences including those relating to 'vulnerable' consumers.

Individual consumers

- 3.11 The responses from individuals were varied in views. Some individuals welcomed the prospect of deregulation with the resultant increase in competition leading to lower prices. Others, the majority, did not agree with the proposal being concerned that it would enable BT to increase prices for services for which they asserted consumers had no choice, such as line rental. A number of respondents believed deregulation would allow BT to reduce its prices to levels the competition could not match causing them to exit the market and providing BT with a monopoly position.
- 3.12 A number of the individuals opposing Ofcom's proposal believed that BT needed tighter controls which should be extended to other types of BT products and services. Some added that either the USO or price controls should also be extended to some of BT's competitors who they stated either follow BT's prices or do not allow their customers access to providers offering cheaper calls. A few disagreed with the existence of line rental charges as these are no longer levied by the utility sector. Examples of poor service and excessive pricing were also cited as reasons why the industry should be more tightly controlled.
- 3.13 Some comments were made about the apparent lack of competition to BT in fixed line telecoms outside of cable franchise areas.

Ofcom's response

- 3.14 Removing the price controls does not mean that BT can now increase prices when it could not do so before. Despite being subject to controls for many years BT could and did increase certain prices (although prices more often fell than rose). BT has been able to increase line rental and did so most recently in January of this year. This is because to-date it has made a loss on this service. Removing the RPC will therefore not provide BT with a new power to raise prices. However, under the RPC BT could only increase line rental on condition that it reduced other prices by an amount sufficient to ensure the overall price increase remained within the price cap, currently set at RPI+0% for each year. Now, with the removal of the RPC BT will have to be mindful of the competition from alternative suppliers including those offering wholesale line rental products. Ofcom will also continue to monitor the market as it continues to evolve.
- 3.15 Ofcom would like to reassure respondents that the concerns expressed by them about exclusionary anti-competitive behaviour can be dealt with through application of Ofcom's competition law powers. Ofcom also notes that the RPC was, in any

event, not designed to prevent BT from reducing prices but was an overall control on retail prices that for the most part led to price reductions.

- 3.16 For the reasons explained in this statement Ofcom does not agree that further, nor tighter, controls are necessary on BT. In relation to other providers, none (aside from Kingston communications) has SMP in the retail markets. Ofcom therefore has neither power nor any need to impose regulation on other providers.
- 3.17 Only BT is required, by virtue of its market power, to allow its customers to choose to use other providers for their calls. Other providers can do so but are not subject to obligations requiring them to provide access.
- 3.18 In regard to comments on the existence of telephone line rental charges when other sectors such as gas and electricity no longer tend to have such charges, it should be noted that in these other sectors, the providers have chosen to move to a new form of charging based on significantly higher per unit prices and the cost of delivering via the pipes and infrastructure was subsumed into that charge. It would be open to the telecoms market to move to this form of pricing, but it will not alter the underlying fact that the cost of providing the fixed line into a person's household has to be paid for in some form.
- 3.19 It may be the case that certain consumers outside cabled areas are not fully aware of the increasing number of providers offering 'one bill' (line rentals and call charges combined) solutions through the use of WLR. Here again, Ofcom's information campaign is designed to raise awareness of the competitive opportunities available to consumers.

Telecoms industry respondents

- 3.20 The responses from industry respondents were similarly mixed. BT welcomed the proposal and stated its preference for Option 1. However, BT recognised that complete deregulation in one move might not be widely welcomed hence its offer of assurances designed to protect vulnerable consumers. BT also requested that the requirement for publication of regulatory financial information be withdrawn once the price controls lapsed.
- 3.21 Ntl supported the principle of deregulation believing that competition could be sustained without regulatory intervention. Post Office Ltd also agreed and welcomed the opportunity to open up competition in the market which is beneficial for customers. Post Office Ltd added, however, that appropriate safeguards need to be put in place and monitored to protect low spenders and prevent market distortion by BT through abuse of its dominant position. T-Mobile also welcomed Ofcom's proposal to 'retire' from regulation further suggesting that this should be extended to mobile markets where there is stronger competition.
- 3.22 Hutchison 3G (H3G) also welcomed Ofcom's conclusion that a position of 'strong' SMP does not necessarily require a remedy of price control. It was unable to comment, however, on whether this applied to retail markets in which BT operated. H3G was more concerned about BT's moves to re-enter the mobile market and its potential to leverage its market power from fixed markets into that market.
- 3.23 H3G, however, added that ex-ante safeguards on competition may be required, as well as basic rules around BT's ability to bundle different products, sold in markets in which BT has and does not have SMP. H3G urged Ofcom to provide assurances to the industry that issues such as this will be kept under review, considered as part of

the next retail fixed market review and that, if necessary, Ofcom will act promptly to ensure competition is maintained.

- 3.24 The other industry respondents were more cautious about deregulation. The UK Competitive Telecommunications Association (UKCTA) considered the fact that Ofcom had sought assurances from BT suggested that the market was not sufficiently competitive. UKCTA also questioned whether confidential undertakings were justified in the regulatory regime and questioned whether they are lawful under the EU Directives or relevant UK legislation such as the Communications Act 2003 or the Enterprise Act 2002.
- 3.25 UKCTA agreed with Ofcom that the residential retail voice market is increasingly competitive, but that it is not quite yet fully competitive. They believe it to be critical that the process for BT to implement its Enterprise Act Undertakings should be allowed to run its full course before deregulation takes place.
- 3.26 Cable & Wireless (C&W) believed BT's dominance in voice could enable it to use higher voice call prices to cross-subsidise the price of broadband. They were concerned that a bundle of calls, access and broadband could leave competitors with insufficient revenue to compete in retail broadband. C&W sought comfort that (a) accounting separation is sufficient to enable Ofcom to scrutinise BT's costs and (b) ideally BT should have to seek Ofcom prior approval for any bundles.
- 3.27 C&W supported the need for further protection for vulnerable consumers but believed BT's assurances need to be transparent and made public.
- 3.28 Scottish and Southern Energy (SSE), whilst supportive of Ofcom's preference against regulatory intervention, felt that given BT's dominance in the communications market, Ofcom should be very cautious about removing any aspect of regulation on BT. SSE argued that the concept of "equivalence", developed during the telecoms strategic review (the TSR), particularly EoI, should be the main principle for evaluating whether to allow any relaxation of ex-ante regulation on BT. EoI for WLR will only be delivered in 2007. SSE was also concerned that there is some way to go before a trouble-free, smoothly operating transfer process can be assured for customers in the retail telephony market.

Ofcom's response

- 3.29 Ofcom has considered carefully BT's request to consult on the maintenance of the requirement for BT to publish its regulatory financial information, but has decided not to commence an immediate consultation. This obligation will be reviewed as part of the market review in 2007. The financial reporting requirement was applied by Ofcom's statement entitled "*The regulatory financial reporting obligations on BT and Kingston Communications - Final statement and notification*"¹⁵ published on 22 July 2004. Ofcom considers that as this obligation was linked to BT's SMP rather than the RPC alone and that it should remain in place until there has been a market review. Continuation of this requirement will also provide Ofcom with audited regulatory information for assessment as part of the market review due to be completed in 2007.
- 3.30 In relation to BT's ability to introduce bundled offers, this is not prevented by the RPC. As for future prices reductions, this will continue to be conduct which is subject to the Competition Act and Articles 81 and 82 of the EC Treaty.

¹⁵ http://www.ofcom.org.uk/consult/condocs/fin_reporting/fin_report_statement/finance_report.pdf

- 3.31 Ofcom does not consider that BT's assurances amount to a de facto continuation of controls. They were designed to offer protection to vulnerable consumers who represent a very small portion of the overall retail market. In addition, all retail consumers are fully able to choose the best deal for them from the wide range of competitors now active in the market.
- 3.32 Ofcom notes the comments made by UKCTA and a number of other respondents in relation to the fact some of the details of the assurances have not been put in the public domain. Ofcom's comments are set out at paragraph 3.9 above. In regard to UKCTA's question about the legality of withholding such information, the commercially sensitive nature contained in the detail of the assurances means that disclosure may confer a commercial advantage on BT's competitors as it would give them greater certainty over future pricing which would not otherwise be present. It may also encourage price-following behaviour. It may, therefore, encourage prices to converge to particular price points in a way which would not be present as part of the normal competitive process. However, as indicated in the consultation document and this statement, the substance of the assurances concerns the price of line rental products and mobile pass-through.
- 3.33 Ofcom understands SSE's concerns about the time it will take before EoI will have full effect following its introduction by BT. However, Ofcom maintains that any requirement for retail controls is not dependent on conditions in wholesale markets. Furthermore, processes are in place to monitor progress towards BT's achievement of its TSR undertakings and Ofcom retains powers to take action where necessary.
- 3.34 A summary of respondents' comments on the two consultation questions is set out below together with Ofcom's responses.

General Comments and Ofcom's Conclusion

- 3.35 Ofcom welcomes the responses that have been received and has taken full account of all comments in reaching its decision. The support that has been shown for Ofcom's proposal by citizen and consumer groups is welcomed. In relation to many of the concerns that have been expressed, particularly by individuals, we consider that the assurances offered by BT are sufficient to protect more vulnerable consumers in the short term and the situation will be reviewed again before the assurances expire at the end of 2007. At this time Ofcom, will decide whether consumer safeguards remain necessary. Ofcom set out in March this year its Statement on BT's Universal Service Obligation. The obligation ensures that there will continue to be uniform pricing for BT's retail services for residential consumers. This means that for voice telephony services BT cannot offer different prices for consumers living in urban and rural areas. The USO will therefore continue to offer protection for consumers in rural areas and those in genuine need. It should be noted, however, that with regard to connections (rather than line rental or calls) prices could be varied geographically under certain circumstances¹⁶.

¹⁶ Under the USO BT and Kingston are required to provide a connection upon reasonable request and at uniform prices, irrespective of geographical location. Where the installation of a new line costs £3,400 or less, BT sets a standard charge. Where installation will cost over £3,400, BT requires the customer to pay the excess costs (plus its standard connection charge). Ofcom concluded in its review of Universal Service that it would be clearly justified for BT not to charge uniform prices in these circumstances. Ofcom therefore consented to BT charging non-uniform prices above £3,400 and published guidance which, amongst other things, suggests BT applies the standard charge when costs exceed £3,400 for particularly vulnerable customers. These conclusions were set out in a Statement *Review of the Universal Obligation* published on 14 March 2006.:

- 3.36 From the responses received from individuals it appears that there may be some confusion as to how price controls have operated and what they are designed to achieve. The current controls take the form of a limit in relation to BT's prices for a 'basket' of products which includes both access charges and calls. Generally this 'limit' has necessitated year on year reductions in prices. Within this basket, BT can increase prices for individual products (e.g. line rentals) only if it makes compensating reductions in the prices of other products in the same basket (e.g. calls).
- 3.37 Ofcom also notes some consumers' concern over BT's recent increases in line rentals followed by price rises for rental by other providers. It is for BT's competitors to determine their pricing strategy. Ofcom believes that growing competition between providers should serve to constrain the prices charged for the line rental component – although it should be noted that historically line rentals were below cost. Ofcom will, nevertheless continue to monitor the market and retains powers under competition law to take action should it be necessary.
- 3.38 Ofcom welcomes the views of those communications providers (CPs) who agreed that price controls are no longer necessary in the fixed line retail market, whilst recognising the concerns of those who consider that it is too early to relax controls before either the 2007 market review has been completed or until BT has delivered Equivalence of Inputs for WLR.
- 3.39 Ofcom considers that the objectives of price controls in the retail markets are distinct from and not dependent on BT's commitment to or delivery of its wholesale obligations. BT's Enterprise Act Undertakings have their own monitoring and control mechanisms which exist separately from retail regulation.
- 3.40 Whether to continue retail price regulation has to be evaluated with reference to whether it is necessary to have this form of protection for residential consumers taking account of the developing situation in relation to competition in the retail market alone. Research undertaken by Ofcom has shown that most consumers are aware that they can make choices and most understand that switching is an easy process. Ofcom believes that now is the right time to withdraw this form of regulation to foster competition by relaxing controls on BT.
- 3.41 Ofcom's Communications Campaign – which will commence after this statement is published – should assist in further raising consumer awareness. The market is also experiencing considerable media coverage not least because of the recent high profile advertising by providers offering new deals bundling services of voice telephony and broadband.
- 3.42 The increasing use of Local Loop Unbundling (LLU) and the trend towards consolidation of providers offering fixed, mobile and high capacity internet services capable of high quality audio-visual streaming, is encouraging the development of bundles of products and services which are likely to increase competitive pressures on BT. Such developments are an important reason why Ofcom considers the market is ready for deregulation.
- 3.43 In addition, as BT retains SMP in the residential retail markets, BT remains subject to a number of regulatory obligations namely the requirement to publish retail prices and the requirement not to discriminate unduly.

Comments made to the consultation questions

Question 1 – Do you consider there to be other forms of regulation that Ofcom should consider?

3.44 None of the consumer groups made any specific comment about Questions 1 or 2. Of the consumers themselves, 6 said yes to the question but only 4 added any comment. One respondent said that prices should be regulated for products where competition was not working, such as line rentals. Another said that Ofcom should put consumers first rather than relying on competition theory. One individual argued for regulation of access charges for services offering lines only and another added that BT should continue to be regulated and Ofcom should also regulate other providers. Three consumers said no to the question. No industry respondent suggested an alternative but C&W requested that care be given to the possible implications of bundling voice with broadband products and the potential for margin squeeze.

Ofcom's response to views on question 1

- 3.45 Ofcom understands individual consumers may have concerns about the potential for increases in line rental charges. It is, however, the case that in addition to ex ante regulation Ofcom has the ability to deal with issues such as excessive or predatory pricing through its powers under competition law. The options that Ofcom proposed were based on an analysis of whether there was a need for specific rules on pricing in retail markets. The options for consultation included further price controls which would have offered the type of protection some individuals consider to be still necessary. It is Ofcom's view, however, that the market has changed considerably. In particular, with WLR services now universally available and switching to alternative providers being very straightforward, consumers now have a range of options open to them, which places competitive pressure on prices in the market.
- 3.46 In addition, Ofcom considers that the combination of BT's continued obligations under the USO and BT's assurances will serve to protect consumers less able to take advantage of competition by limiting the amount of any price increases before the end of 2007. By this time, Ofcom should have completed its full review of the market for retail products and services and will have assessed whether competition has developed sufficiently to constrain price increases that vulnerable consumers are less able to avoid. Ofcom will then decide whether further protective measures are necessary.

Question 2 – Do you agree with Ofcom's conclusion, and the assessment on which that conclusion is based?

- 3.47 Ntl and the CWU both agreed with Ofcom's conclusion as did Post Office Ltd although it added that appropriate safeguards need to be put in place and monitored to protect low spenders and prevent market distortion by BT through abuse of its dominant position.
- 3.48 The views from individual respondents were mixed. Three consumers agreed with the question while ten other respondents said no to the question. Individuals also commented on various issues including competition concerns and that the timescale was too short.
- 3.49 C&W disagreed with the question saying that the removal of controls in July 2006 is premature and should not occur either before the market review is undertaken in

2007 or at least until BT have delivered EoI for WLR. SSE also disagreed saying that the market is not ready and that continuation of the safeguard cap would continue to give Ofcom justified visibility of BT's retail revenue at a time when competitive processes in the relevant markets are at an early stage of development.

Ofcom's response to views on question 2

- 3.50 Ofcom will continue to monitor the prices of services in the retail markets including line rental and Ofcom retains competition law powers to deal with excessive or anti-competitive pricing.
- 3.51 Ofcom has given detailed consideration to the issue of whether controls continue to be needed when the current RPC expires. Our detailed analysis of market developments and our research into consumer switching, however, indicates that consumers are aware of the choices available to them and the ease with which they can change providers. Competing providers in the industry have the opportunity and incentives to raise consumers' awareness of the choices available to them. It is Ofcom's view that regulation should not be applied to BT's retail prices where it is no longer necessary. Ofcom will continue to monitor the market including BT's product offerings and prices and has competition law powers available to it if any form of anti-competitive behaviour was to take place.

Other points made by respondents (including comments on Ofcom's impact assessment)

- 3.52 No comments were offered in relation to the impact assessment.

Ofcom's conclusion from the consultation

- 3.53 Ofcom has taken due account of all the views and evidence set out in the responses to the March 2006 consultation. Ofcom remains of the opinion that its analysis of increasing competition, declining prices and consumers' ability to switch providers is correct and that now is the right time to allow the RPC to expire. Furthermore, BT's assurances, the continuing USO and Ofcom's power to take action in the event of future market failure will continue to ensure that all consumers, and particularly the more vulnerable, remain adequately safeguarded.

Comments on the proposed information campaign including responses to the draft advertisements

- 3.54 In Annex 7 to the March Consultation, it was explained that Ofcom planned to run a targeted and neutral consumer information campaign to seek to ensure that consumers are sufficiently informed of the change in regulation to begin to explore their options in residential telephony given the absence of a price control.
- 3.55 The Annex included examples of possible advertisements which were included for illustrative purposes only. Comments were sought on the planned campaign including the text of the advertisements. A number of respondents offered comments.
- 3.56 The CAB welcomed Ofcom's public awareness campaign to raise consumers' awareness of the ability to switch. CAB noted however that there is only one PASS accredited service and it stated that is only web based. CAB emphasised the need for adequate information in the marketplace so that consumers can make informed choices.

- 3.57 The WA welcomed the campaign requesting that Ofcom ensure it was bilingual. None of the consumers who responded commented on the campaign.
- 3.58 BT said it was committed to the campaign and asked Ofcom to enlist the support of other providers.
- 3.59 UKCTA had a number of comments on the campaign. They expressed concern that the campaign might confuse customers who are unfamiliar with telecoms regulation. They also suggested that the campaign may need to be clearer as the reference to consumer safeguards could be confusing and taken to mean that safeguards are in place for services provided by all operators. Finally, the providers had reservations about the suggestion that consumers ask their current provider to “ensure” they are on the right package, as this is likely to cause problems as providers cannot guarantee this outcome.
- 3.60 Post Office Ltd also commented on the proposed campaign. They noted the absence of research into consumer awareness or understanding of the RPC. This led to a concern that a public information campaign could end up causing confusion and inertia in the market. Any advertising on this subject should have a clear call to action so that customers are able to contact an independent party for further advice and understanding about what this means for them. Post Office Ltd requested that media schedules to support the campaign be made available to all service providers, including BT, at the same time.
- 3.61 Ntl were also concerned that the proposed advertisement may confuse rather than clarify. As a consequence, ntl stated that they did not believe the initiative was relevant to their customers. Instead they intend to ensure their call centres are prepared with relevant information. They would also supply information to bring to customers’ attention the full range of products on offer, singularly or bundled, into marketing campaigns so that customers can make an informed choice to continue with ntl’s service.
- 3.62 In relation to the wording of Ofcom’s proposed campaign ntl said it would prefer if the information were more neutral and referred merely to the end of old controls and that all telecoms providers are free to set their own retail prices.

Ofcom’s response

- 3.63 Having taken note of comments about the draft advertisements these have been updated and copies of the revised documents are attached at Annex 2. In the revisions, Ofcom has responded to and dealt with the concerns expressed, in particular relating to the invitation to call the relevant service provider. Ofcom has also provided interested parties with details of the communications campaign including timings and the media being used. Ofcom welcomes the fact that many providers will embrace the campaign in various forms through their own communications channels. The advertisements themselves include reference to a new section on Ofcom’s website (www.ofcom.org.uk/itsyourcall) where consumers can obtain advice and information. Ofcom believes this will meet the concerns expressed by stakeholders about raising awareness of channels for finding information.

Section 4

Recent Regulatory and Market developments

4.1 In deciding whether to proceed with the proposals set out in the March Consultation, it has been necessary to consider and take account of the regulatory and market developments that have occurred since 2002. The March Consultation contained a detailed account of these developments. The analysis has been revised to take account both of new and more detailed data made available since the March consultation as well as a number of important commercial and market developments that have occurred in the intervening period. The revised analysis is set out below.

Regulatory and market developments

Wholesale line rental

- 4.2 WLR provides alternative fixed telephony operators the opportunity to send one bill to customers, as well as to further differentiate their products from BT, including the enhanced ability to bundle narrowband telephony with other products.
- 4.3 The March Consultation explained that in September of last year, Ofcom had completed its Telecoms Strategic Review. As part of this Review, BT agreed to a set of undertakings in lieu of a reference to the Competition Commission under the Enterprise Act 2002, wherein BT committed to separate its access business (now branded as BT Openreach) from the remainder of BT, and to provide "equality of access" to include both equivalence at the product level and supporting organisational changes by BT. One of the products in relation to which BT has agreed to provide equality of access is wholesale line rental (WLR).
- 4.4 Ofcom has already determined, in December 2005, that BT's WLR product was consistent with the fit-for-purpose definition¹⁷, set out as a product specification and process implementation published in March 2003¹⁸, and through an analysis of the market impact of WLR assessed against criteria also set out in March 2003¹⁹.
- 4.5 A relevant factor in deciding whether to allow BT's RPC to expire is the extent to which developments in relation to WLR and other access products have yielded competition in the market for residential analogue exchange lines. The March Consultation indicated that there were one million consumers using WLR by the end of 2005. The rate of growth has continued its upward trend, suggesting an increasing competitive pressure on BT's position in the market. The diagram below shows the rapid take-up of residential WLR lines, from close to zero in early 2004 to nearly two million by the end of June 2006.

¹⁷ http://www.ofcom.org.uk/consult/condocs/line_rental/wlrrfp_statement/statement.pdf

¹⁸ http://www.ofcom.org.uk/static/archive/oftel/publications/whole_line/2003/wlr_1_0303.htm

¹⁹ The definition was framed by way of three tests: whether the product met the required specification, whether the functionality was such to minimise barriers to competition, and whether it had sufficient market impact to achieve effective retail competition.

Figure 1 - Residential WLR take-up

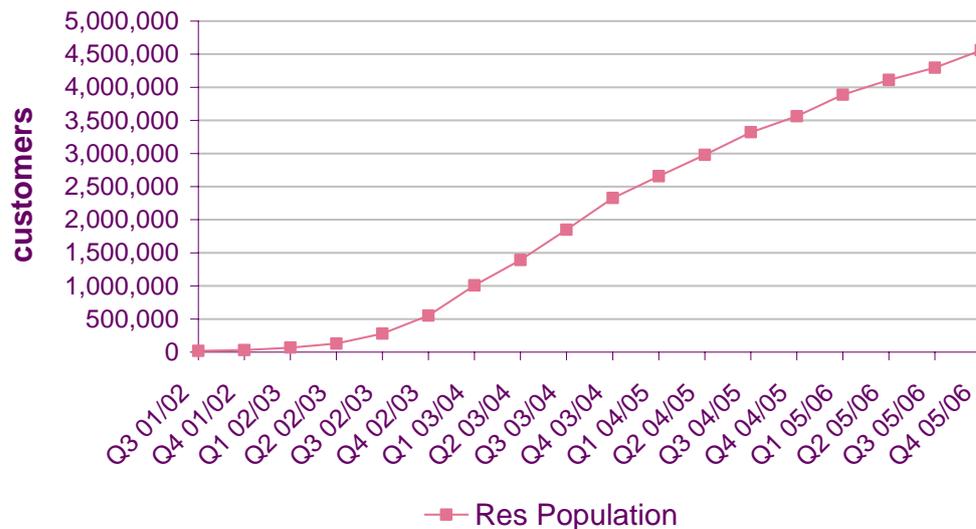
Source: BT

- 4.6 In the Undertakings²⁰ provided to Ofcom by BT pursuant to the Enterprise Act 2002, BT has committed to be “Ready for Service” (RFS – the date when an EoI product or service is available for use by other CPs for their end users and is available for use by BT) for analogue WLR on 30 June 2007. Ofcom expects this further step to strengthen the competitive pressure on BT’s share of the market for residential analogue exchange lines and, consequently, the relevant calls markets, as providers using WLR seek to provide both access and calls to subscribers.

Carrier pre-selection and Indirect Access

- 4.7 Wholesale line rental is not the only wholesale product supplied by BT that impacts upon developments in competition in the fixed narrowband retail calls markets. There has also been substantial growth in the volumes of calls provided via carrier pre-selection (CPS), as shown in the graph below, which is updated to show the figures for the first quarter of 2006.

²⁰ <http://www.ofcom.org.uk/telecoms/btundertakings/btundertakings.pdf>

Figure 2 - Carrier Pre-selection residential customer volumes

Source: BT

Changes in BT's market shares

4.8 The March Consultation also considered the extent to which BT's shares of the relevant retail markets²¹ have changed over time. Ofcom believes this factor to be relevant in assessing the development of competition. Underpinning the finding of SMP in the 2003 market review was BT's very high market shares. The March Consultation acknowledged that BT still retains high market shares across all the markets under consideration. The consultation also emphasised that understanding the changes in market shares is also relevant to consideration of the extent of competition and hence in assessing the regulatory options with respect to the RPC. Updated market share information is set out in the charts in Annex 3; In summary, when considered between 2002Q3 and 2005Q4:

- Since the introduction of the current RPC BT's market share, by volume, of residential analogue exchange lines has declined from 83% to 77%. This is consistent with the growth in both WLR and LLU. Looking to the immediate future, it seems likely that this decline in BT's market share will continue, and the rate may increase with the introduction of WLR on an EoI basis from December 2006 (or June 2007)²² and the expected growth in use of LLU for residential access products;
- For calls to mobiles, IDD calls, local, and national calls BT's shares of these markets have reduced significantly, on both a volume and value basis. The latest figures are set out below:
 - Local call market share has fallen from 77% to 56% by volume, and 70% to 63% by value;

²¹ Residential analogue exchange lines and calls markets for the UK excluding Hull.

²² BT has committed in its Undertakings (para 3.2.1) to providing WLR on an EoI basis by 30 June 2007. However, BT plans to deliver earlier and has agreed to provide an allowance to Communications Providers for each month after 31 December 2006 that it is not available.

- For national calls, BT’s share by volume has fallen from 70% to 59%, and by value from 73% to 54%;
- International call market share has fallen from 53% to 44% by volume and from 67% to 56% by value. Whilst the greater market share by value than volume may suggest higher pricing by BT, it could equally be consistent with BT serving a larger proportion of higher-value routes;
- For calls to mobiles, BT’s share by volume has fallen from 75% to 60%, and by value from 71% to 53%; and
- BT’s reductions in call market shares have been mainly due to operators using CPS. For example, local call market share of CPS operators has grown from 7% to 18% by value, with national call share growing from 10% to 33% and international call share growing from 21% to 32%.

4.9 The March Consultation noted that in relation to operator assisted (“OA”) calls no data is collected; the assumption is that its share is proximate to its share of retail residential exchange lines.

4.10 In reaching its decision to allow the retail price control to lapse, Ofcom has taken account of the clear downward trend across all relevant residential access and call markets.

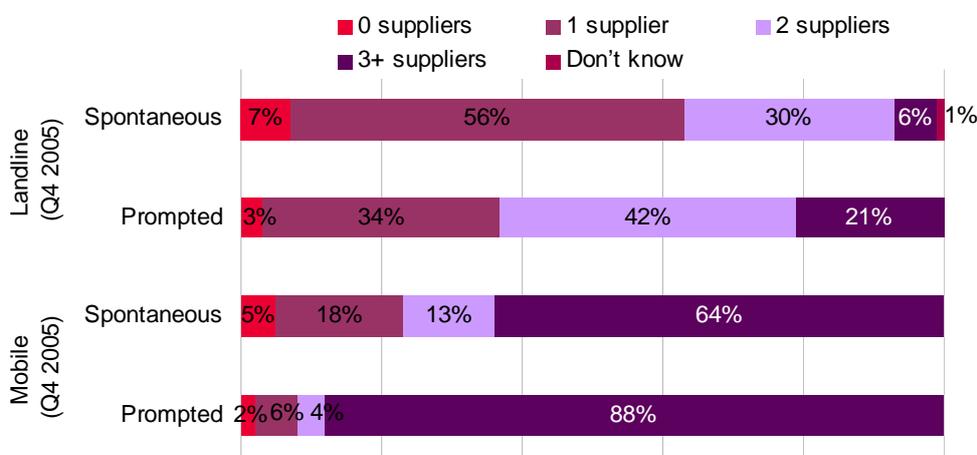
Evidence of customer switching

4.11 Another factor that has been taken into account in deciding to allow the RPC to lapse is the evidence of consumer switching.

Awareness of alternatives

4.12 There is a relatively high awareness of alternative fixed line suppliers: 92% are spontaneously aware of at least one competing supplier. Moreover, when prompted with a list of alternatives awareness of at least one alternative supplier rose to 97% with a fifth (21%) able to recognise 3 or more alternatives. As shown in the chart below, awareness of multiple alternatives is higher in the mobile market.

Figure 3 - Awareness of competing suppliers



Source: Ofcom Residential Tracking Survey, Q4 2005 (Base: 1925 UK adults with a landline, 1700 UK adults with mobile)

Saving threshold for switching

4.13 The March Consultation referred to the finding from research that consumers say they would need about £6 per month saving on fixed line rental in order to persuade them to consider searching for a new supplier. Research also suggests that consumer expectation about the maximum possible savings is lower than that. One reason why switching may not be more prevalent is that customers may not be sufficiently aware of or value the savings it would provide.

Figure 4 - Perceived gains from switching²³

Median Score (£)	Mobile Phone	Landline Rental	Landline national and International calls	Broadband
How much potential savings per month would tempt you to search for a new supplier?	£10	£6	£5	£5
How much is the most you could save per month from shopping about?	£5	£5	£5	£5
Approximately, how much do you pay on average?	£20	£15	£10	£18

Source: Survey conducted by MORI on behalf of CCP, referenced in Annex 5 of Consumer Policy consultation document, Q2 2005

4.14 The March Consultation summarised data contained in the Consumer Policy consultation document²⁴ which suggests that fewer fixed line customers have assessed the benefits of switching their supplier than broadband or mobile consumers: 62% of fixed line customers have not yet considered searching for savings in the landline rental market, these figures are higher than for the broadband (50%) and mobile (45%) markets.

Extent and ease of switching

4.15 Just over four in ten (41%) residential fixed line customers have switched their line and/or calls supplier. The residential tracking survey conducted by Ofcom shows that about 28% of consumers said they had switched their fixed line supplier (which may include some using an indirect access supplier) while 23% said they had switched their landline calls supplier, with 10% of landline customers switching both their line rental and calls supplier.²⁵

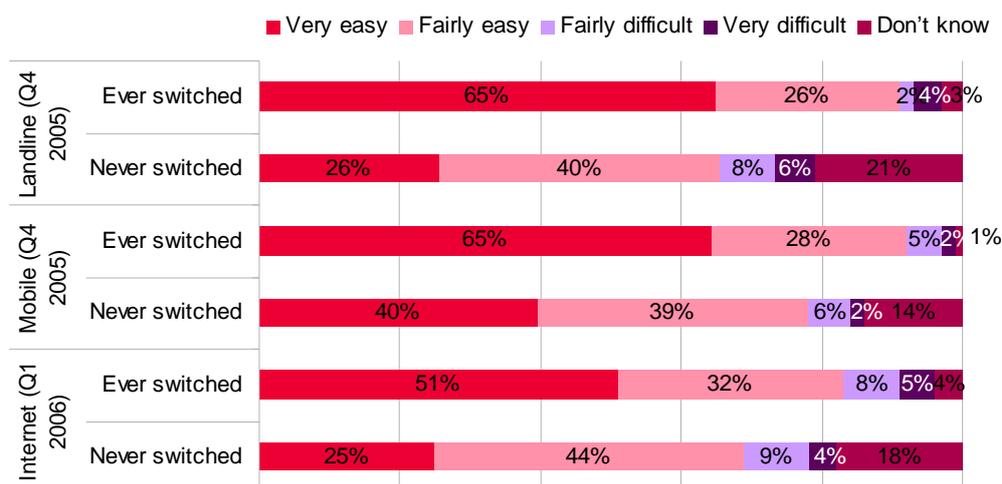
²³ Base: 1404 landline decision-makers, 1307 landline calls decision-makers, 1551 mobile decision-makers, 567 broadband decision-makers, survey conducted by MORI for CCP, Q2 2005

²⁴ http://www.ofcom.org.uk/consult/condocs/ocp/ocp_web.pdf

²⁵ However, it is recognised that this is a relative assessment, which says nothing about the extent to which switching barriers may exist within the comparator sectors.

- 4.16 From Figure 5 below, it can be seen that of those that have switched their landline supplier, the majority said that this was easy (very/fairly easy at 91%). Just over two-thirds of those who have never switched landline supplier perceive it to be easy (very/fairly easy at 66%). This pattern is consistent with the mobile and Internet sectors. Nevertheless, around 1 in 5 non-switchers were unsure how easy switching might be in the fixed market – with slightly lower proportions expressing such uncertainty in the mobile (14%) and internet sectors (18%).

Figure 5 - Actual and perceived ease of switching for different telecoms services



Source: Ofcom Residential Tracking Survey, Q4 2005 (Base: 1925 UK adults with a landline, 1700 UK adults with mobile) Q1 2006 (Base: 2144 adults with internet)

Consumer satisfaction with existing suppliers

- 4.17 Most fixed line customers are satisfied with their supplier. Research from Ofcom's Residential Tracking survey conducted in Q4 2005 indicates that 93% of landline customers are satisfied.
- 4.18 In reaching a conclusion on the expiry of the retail price control, Ofcom has taken into consideration the significant evidence that consumers can and do switch and that switching is perceived by the majority of consumers to be easy even if they have not switched.

Pricing and profitability

- 4.19 A further consideration that has been taken into account in reaching the decision to allow the control to lapse is the extent to which BT has pricing freedom due to its SMP in the relevant markets. Ofcom has also examined whether excessive returns are being made, and whether competitive pressure is leading to price reductions.

Residential exchange lines

- 4.20 In the March Consultation, Ofcom explained that BT historically has made a loss on its access business. This was in large part cross-subsidised by higher profits on calls. As Ofcom also explained, use of Return on Capital Employed (RoCE) is not very useful in representing the profitability of the business. The capital employed in the residential retail markets is negligible (in calls) or even negative (in exchange lines and for the consolidated residential business). Instead, Return on Sales (RoS) is a

more meaningful indicator of profitability for retail markets, although Ofcom notes that there is no definitive level of RoS which signifies excessive pricing from an economic perspective²⁶.

- 4.21 The regulatory accounts provide the following data on BT's revenues and RoS in retail analogue exchange lines:

Figure 6 - BT Retail residential analogue exchange lines – Revenues and Return on Sales

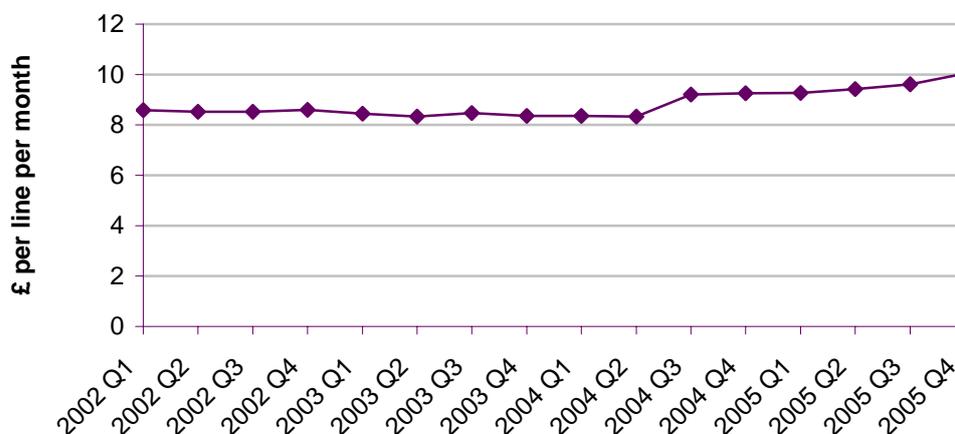
Year	01/02	02/03	03/04	04/05
Revenue – residential analogue exchange lines (£M)	2,054	2,121	2,028	2,136
RoS – residential analogue exchange lines		-31%	-18.3%	-17.0%
Revenue – residential exchange lines and calls (£M)	n/a*	n/a*	3,898	3,837
RoS – residential exchange lines and calls	n/a*	n/a*	10.1%	8.8%

Source: BT current cost financial statements

*not available in a consistent form from prior financial statements

- 4.22 As indicated above, these figures show that BT's retail residential exchange lines business is not profitable (on a fully allocated cost basis) although the level of BT's loss has altered as BT has rebalanced its line rental and call prices. Exchange line profitability will also be improved by the reduction in wholesale exchange line costs. The average revenues chart has been updated from the March consultation to show the latest available data.

²⁶ The RoS which would be consistent with a competitive market may vary widely depending on capital intensity. A figure of 1.5% was, however, used as a benchmark by the Monopolies and Mergers Commission (MMC) in the original Calls to Mobiles inquiry for markets with little or no capital. http://www.ofcom.org.uk/static/archive/oftel/publications/1995_98/pricing/bmmc1298.htm, para 1.14.

Figure 7 - Residential Exchange lines average revenues (£ per month) excl. VAT

Source: Ofcom / BT

Retail narrowband residential voice calls

4.23 The position in the residential call markets contrasts with that of the fixed line business as BT has for many years earned a higher RoS, as detailed below.

Figure 8 - Profitability of retail residential calls markets

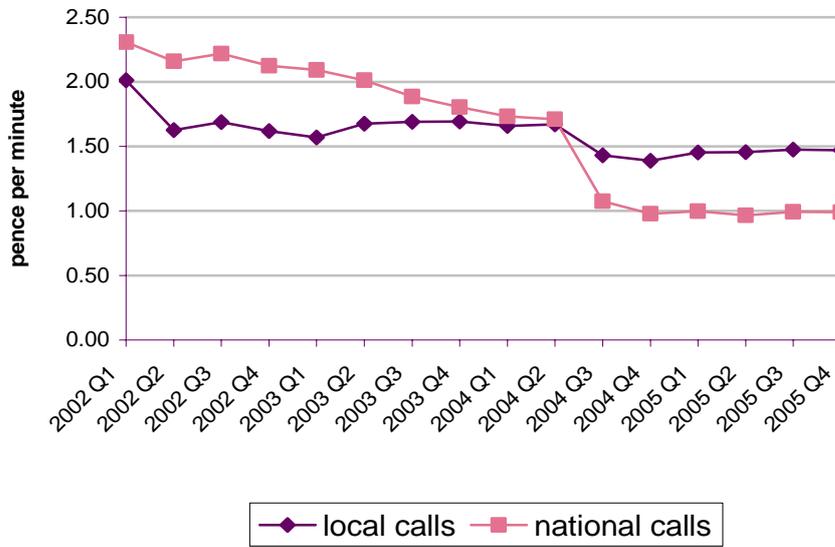
Market	Revenue (£M)		RoS	
	03/04	04/05	03/04	04/05
Residential local calls	794	659	59.7%	61.7%
Residential national calls	354	223	52.2%	36.0%
Residential IDD calls category A	n/a	209	n/a	36.4%
Residential IDD calls category B	n/a	21	n/a	76.4%
Residential calls to mobiles	722	583	14.4%	20.1%
Residential operator assisted calls	n/a	6		68.5%
Consolidated retail residential business (exchange lines and calls)	3,898	3,837	10.1%	8.8%

Source: BT current cost financial statements

4.24 However, whilst it is the case that BT is making considerable returns from calls, across all call types its average revenue per call minute has been in decline.

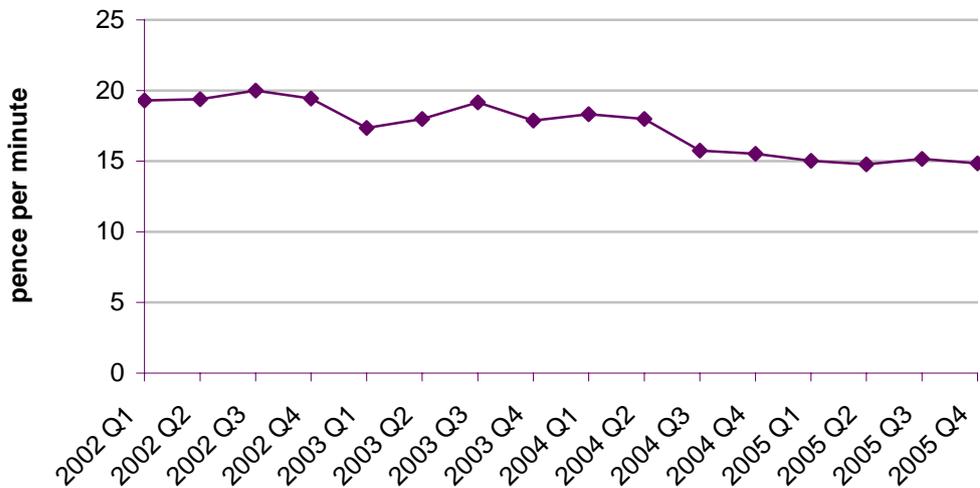
4.25 BT's average per minute revenue for local, national, international and fixed to mobile residential calls is shown in Figures 9 – 11.

Figure 9 - Residential local and national average call revenues (pence per minute)

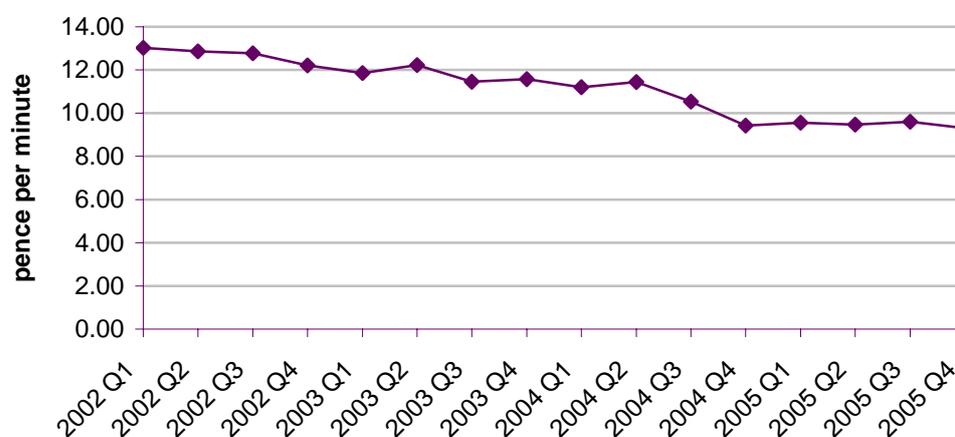


Source: Ofcom / BT

Figure 10 - Residential international average call revenues (pence per minute)



Source: Ofcom / BT

Figure 11 - Residential fixed-to-mobile average call revenues (pence per minute)

Source: Ofcom / BT

- 4.26 In summary, from 2002Q3 to 2005Q4 there has been a steady decline in the average revenue per minute for all call types.
- 4.27 Ofcom acknowledges that residential call services continue to be markets in which BT generates significant returns. However, call prices are declining significantly, suggesting competitive pressure, for example through CPS operators.

Other relevant developments

VoIP

- 4.28 The March Consultation outlined a series of developments that have started to make a significant impact on the UK communications markets. One of the services referred to was Voice over IP (VoIP) services²⁷. Although VoIP services are relatively new they would seem to offer real benefits, through lower prices and increase in competition, thereby giving consumers the opportunity to take advantage of new, cheaper and innovative services.
- 4.29 VoIP services come in a number of different forms, they can be accessed via a computer (that allow calls to another computer), and there are also secondary line services and other services that are retailed as being replacements for traditional PSTN-based call services.
- 4.30 In 2005, just over half (54%) of all UK adults had some awareness of the availability of these services. As knowledge about the services and their associated benefits grows this is likely to drive growth in their take-up. Although, as mentioned above,

²⁷ For more information on VoIP market and regulatory developments, see Ofcom's February consultation, Regulation of VoIP Services, available at <http://www.ofcom.org.uk/consult/condocs/voipregulation/>

these services are currently fairly new, they are likely to represent a significant and increasing competitive challenge in residential retail call markets.

Mergers

- 4.31 The industry has experienced considerable merger activity, leading to the consolidation of many of BT's competitors. In December 2005 - Carphone Warehouse acquired Onetel and Tele2. In their trading statement for Q4 (period ending Dec 31st 2005) they declared 2.6m customers and announced their intention to reach 3.9m customers by March 2009. At this point they had 722,000 WLR customers and 168,000 Broadband customers. By March 2007 they expect 1.35m of these voice only customers to be using WLR.
- 4.32 Caudwell were purchased by the Pipex group in March 2006. In October 2005 Ntl and Telewest merged (and the merged company will also incorporate Virgin Mobile).

LLU

- 4.33 A range of providers have indicated new investment in the provision of telecommunication networks and services. In January AOL, Pipex and Be announced further substantial investments in networks using LLU. In June 2006 Cable & Wireless announced that its Bulldog subsidiary was withdrawing from the retail Broadband market and concentrating on the provision of wholesale services to a range of other providers, in competition with BT. Bulldog's existing customers would continue to be served but it would not be marketing its retail services to new customers.

Bundling and new tariffs

- 4.34 There has been considerable activity in relation to new services and the price of existing services. The following examples are intended to be illustrative and are not an exhaustive list of the changes that have occurred.
- 4.35 In April, Carphone Warehouse announced their 'free broadband deal' linked to its Talk 3 International calling Plan. For a monthly fee of £20.99 (including VAT) customers will receive line rental, unlimited' calls to UK geographic destinations (i.e. excludes mobile, freephone and NTS), 'unlimited' calls to 24 European and 4 other International destinations (USA, Canada, Australia & N. Zealand) and 8MB Broadband (subject to a 40GB per month download limit).
- 4.36 In December 2005 Toucan introduced line rental for £9.99pm. In January 2006 Tesco launched a VoIP pre pay phone package. Ntl and Telewest have also launched a new offer where their 3 for £30 bundle is offered at £15pm for the first 3 months. Wanadoo now provide unlimited off peak VoIP in 2 of their 3 broadband packages.

Conclusion

- 4.37 The markets for fixed narrowband retail services are beginning to experience considerable change. There has been a substantial growth in competition for access and calls as consumers switch to WLR and CPS offerings. Competition will develop further as new offerings based on LLU become more commonplace and as consumers start to explore and take up offerings based on VoIP. BT's market share is in decline in all the relevant markets by both volume and value.

- 4.38 It is the case that BT's returns on calls remain healthy. This does however, need to be contrasted with the loss it makes on its residential fixed line services (although this loss has declined in recent years). Plus, as set out in the March Consultation, prices for all call services have been falling significantly in the last few years.
- 4.39 Research indicates that consumers know that there are alternative suppliers and they are also aware that the switching process is relatively easy. In addition, technological developments continue apace. The availability of VoIP services and their attractiveness to consumers can only grow. As line rental, calls and broadband start to become available from BT's competitors in bundled packages, with consumers being offered lower prices for such bundled services, this will also increase competitive pressure on BT.
- 4.40 Ofcom therefore remains of the view that the markets under consideration are becoming dynamic in new ways, competition is growing and this inevitably necessitates reconsideration of the regulatory remedies that remain necessary to protect consumers. For almost all consumers, there is choice and prices are falling. Consumers are aware of competing suppliers and the majority perceive that switching is easy.
- 4.41 Finally, in the period since the March 2006 consultation, the new market data and introduction of new competitor tariffs support Ofcom's view in the consultation that competitive pressure on BT in fixed narrowband retail markets has been increasing and looks set to continue.

Section 5

Conclusions following the March Consultation

Objectives

- 5.1 In the March Consultation Ofcom explained that it had identified the following objectives as those which seemed to be of particular relevance to consideration of the question of whether to allow the RPC to lapse. These objectives are compatible with the statutory framework of the Act, Framework directive and Ofcom's regulatory principles:
- To operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required;
 - To address retail market SMP and how to facilitate effective retail competition;
 - To mitigate risks to low spending consumers, with recognition that:
 - BT's market power may not be uniform across markets (i.e., it is likely to be stronger in the market for analogue access lines than in the markets for calls);
 - certain groups of low spending consumers may fall outside thresholds for price protection through BT's requirements under its USO; and
 - To achieve the above by the least intrusive regulatory means.
- 5.2 The main concern arising from BT having SMP in these markets would be its potential to set and/or to maintain prices above competitive levels. If intervention is considered necessary, a key objective would be to constrain the firm's ability to set excessive prices to the detriment of consumers.
- 5.3 Another key issue arising from Ofcom's general duties and regulatory principles is that consideration needs to be given to the question of whether certain consumer groups are more exposed to the impact of price rises than others. While certain consumer groups may be protected from high prices through the special tariff scheme offered under BT's USO²⁸, there are low spending consumers (based on expenditure on BT's narrowband access and voice services) who may not be protected through the USO against increases in the prices of BT's basic services (and in particular its exchange line rentals).
- 5.4 Furthermore, these consumers may be less willing or less able to switch, for example as a consequence of them not having a bank account and/or not being eligible for a direct debit payment scheme.

Context

- 5.5 In assessing whether any further regulation is required following the expiry of the RPC, it has been necessary to balance the consequences of BT's SMP with the

²⁸ This is currently the LUS although, as noted below, BT has agreed to the introduction of a new targeted scheme aimed at customers in receipt of state benefits.

extent to which other factors – chiefly competitive pressure and other regulation – may limit BT's pricing freedom. It is necessary therefore to consider both the market developments which have occurred since the RPC was imposed, and the other relevant regulation which remains in place.

Market developments

- 5.6 Section 4 above sets out the significant changes in the extent of competition across all relevant markets since the time of the previous market review. In particular, BT has seen a steady reduction in its market shares across all relevant markets in response to the significant growth of call volumes provided by CPS and the success of WLR in encouraging competition in the market for analogue exchange lines.
- 5.7 In addition, competitive pressure is likely to increase with the growth in services provided via LLU and by the availability of VoIP services.
- 5.8 Whilst overall BT's profits for the markets under consideration might remain above a level consistent with a competitive outcome, prices for all call services have been steadily falling in the face of competition, with increases in access prices reflecting rebalancing.

Other relevant regulation

- 5.9 Following the expiry of the RPC, BT will remain, through its USO, subject to:
- A condition giving protection for vulnerable consumers via a requirement to provide a social telephony tariff (currently BT's Light User Scheme 'LUS' due to be replaced in the course of 2007); and
 - A condition requiring it to price its narrowband services on a uniform basis, irrespective of geographic location, meaning that all residential customers should benefit from price reductions in response to competitive pressures, even if brought to bear in only certain geographic areas²⁹.
- 5.10 Further, BT will remain subject to requirements in respect of (i) no undue discrimination and (ii) price publication since, unlike the RPC, these conditions are not time-limited.
- 5.11 Ofcom has considered all the responses to the March Consultation in the light of these objectives as well as taking full account of the regulatory and market developments outlined in Section 4.

²⁹ It should be noted, however, that with regard to connections (rather than line rental or calls) prices could be varied geographically under certain circumstances. Under the USO BT and Kingston are required to provide a connection upon reasonable request and at uniform prices, irrespective of geographical location. Where the installation of a new line costs £3,400 or less, BT sets a standard charge. Where installation will cost over £3,400, BT requires the customer to pay the excess costs (plus its standard connection charge). Ofcom concluded in its review of Universal Service that it would be clearly justified for BT not to charge uniform prices in these circumstances. Ofcom therefore consented to BT charging non-uniform prices above £3,400 and published guidance which, amongst other things, suggests BT applies the standard charge when costs exceed £3,400 for particularly vulnerable customers. These conclusions were set out in a *Statement Review of the Universal Obligation* published on 14 March 2006:

http://www.ofcom.org.uk/consult/condocs/uso/uso_statement/statement.pdf

Section 3 – Ofcom’s general duties

- 5.12 Section 3(1) of the Act sets out the principal duty of Ofcom. Ofcom is required by this section to carry out its functions in line with this duty. That duty is:
- a) to further the interests of citizens in relation to communications matters; and
 - b) to further the interests of consumers in relevant markets, where appropriate by promoting competition.

Section 4 – European Community requirements for regulation

- 5.13 Section 4 of the Act requires Ofcom to act in accordance with the six European Community requirements for regulation, including the requirement to promote the interests of all persons who are citizens of the European Union.
- 5.14 Ofcom considers that the measures outlined in this statement promote the interests of all persons who are citizens of the European Union by promoting competition in the markets for retail access and calls. Removal of price controls is in response to competition having increased to the extent that consumers have sufficient choice in alternative providers and low barriers to switching. Removal of controls is likely to promote competition leading to further innovation and benefits for consumers.

Ofcom’s decision

- 5.15 In reaching a conclusion concerning the expiry of the RPC, Ofcom has balanced the consequences of BT’s continued market power in these markets with its view of the extent to which other factors – chiefly competitive pressure and other regulation – limits BT’s ability to set excessive prices.
- 5.16 Ofcom considers that allowing expiry of BT’s retail price controls but underpinned by BT’s assurances and supported by an extensive communications campaign meets the requirements set out in Sections 3 and 4 (above). The interests of consumers will be served by their increased awareness of the choices available and with increasing competition engendered by appropriate wholesale regulation. This in turn should lead to new services greater choice for consumers and further reductions in retail prices.

Annex 1

Ofcom's Communications Plan

- A5.1 Publication of this statement on 19 July 2006 will be followed by the commencement of a campaign designed to raise consumer awareness of the fact that regulation, put in place initially in 1984 to control BT's prices, has been removed. The campaign is designed to be neutral in tone and will encourage consumers to approach the choices available in the telcoms market as they would approach their purchasing decisions in any other deregulated market. The advertisements will direct consumers to Ofcom's website where some additional guidance will be provided.
- A5.2 The campaign will be paid for mostly by BT with a contribution from Ofcom. The advertisements have been amended slightly from the versions contained in the March Consultation. Copies of the revised advertisements are at Annex 2. The reference to calling your provider has been removed. The advertisement that starts 'Here in the UK' will be that used for outdoor posters.
- A5.3 The text of the advertisement will also be used in a letter from Ofcom that will go out over a three month bill cycle to all BT residential consumers.
- A5.4 The public information campaign will commence on 20 July with advertisements in national newspapers (including titles in Scotland, Wales and Northern Ireland) as well as outdoor advertising across the UK. Later in the summer, Ofcom will run online advertising on major web portals and news sites as well as further advertisements in regional newspapers. In the early autumn there will be a further national print advertising campaign as well as targeted outdoor advertising.

Annex 2

Ofcom's Communications Plan - Advertisements



From August 1st it's your call.

Here in the UK, customers benefit from some of the lowest phone charges in the world. In fact, because of competition, new technology and regulation, average prices have fallen by around 60 per cent over the last ten years.

For these reasons and others, on August 1st 2006, Ofcom, the UK telecoms regulator, will be ending the formal controls on the cost of phone line rentals and calls from BT. This will leave all phone companies, including BT, free to set their own retail prices for consumers.

We will ensure important safeguards are in place, including those for vulnerable groups. But in future you, not the regulator, will decide whether you think a phone company is good value or not. In much the same way as you buy, say, a TV or a computer, you should choose the right deal for you. Then keep checking it's delivering what you want, at the right price.

So look carefully at all the different options. Take your time to read the small print.

It's your call. You might be surprised by what you find.

The UK communications regulator

Ofcom
OFFICE OF COMMUNICATIONS
www.ofcom.org.uk/itsyourcall

OFCOM6a-POSTER 1.indd 1

26/06/06 11:42:19 am

Here in the UK, customers benefit from some of the lowest  charges in the world.

In fact, because of competition, new technology and regulation, average  have fallen by around  per cent over the last ten years.

For these reasons and others, on August  2006, Ofcom, the UK telecoms regulator, will be ending the formal controls on the cost of  line rentals and calls from BT. This will leave all phone companies, including BT, free to set their own retail  for consumers.

We will ensure important safeguards are in place, including those for vulnerable groups.

But in future you, not the regulator, will decide whether you think a  company is good value or not.

In much the same way as you buy, say, a TV or a computer, you should choose the right deal for . Then keep checking it's delivering what you want, at the right price.

So look carefully at all the different options.

Take your time to read the small print.

It's your call.  might be surprised by what you find.

Annex 3

BT market shares in relevant markets

Figure 12 - Residential fixed lines

BT market share - volume and value

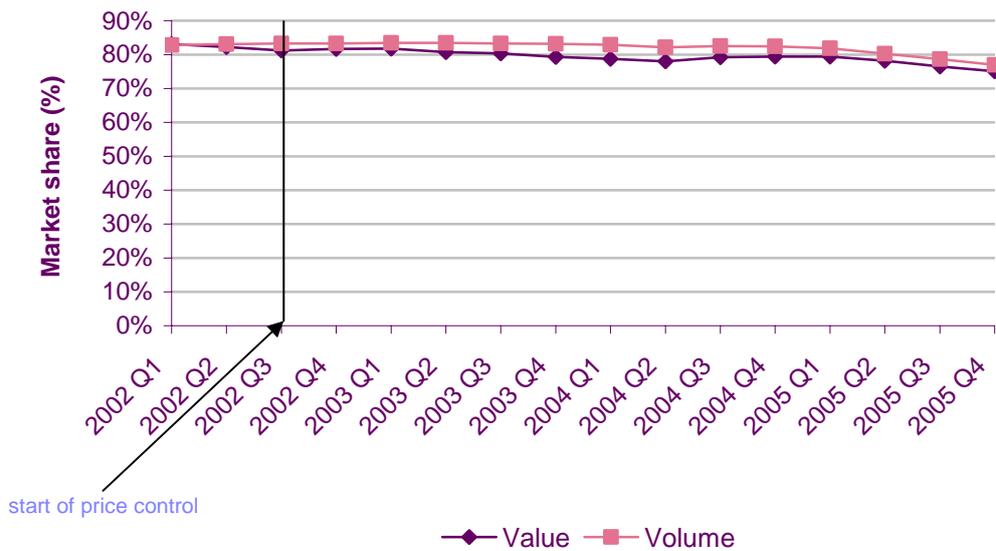


Figure 13 - local calls

BT market share – volume and value

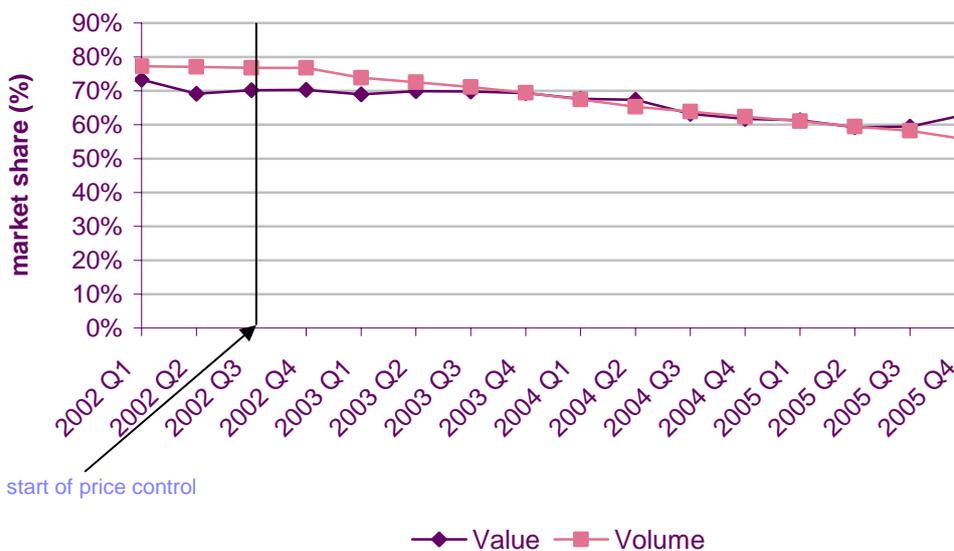


Figure 14 - national calls

BT market share - volume and value

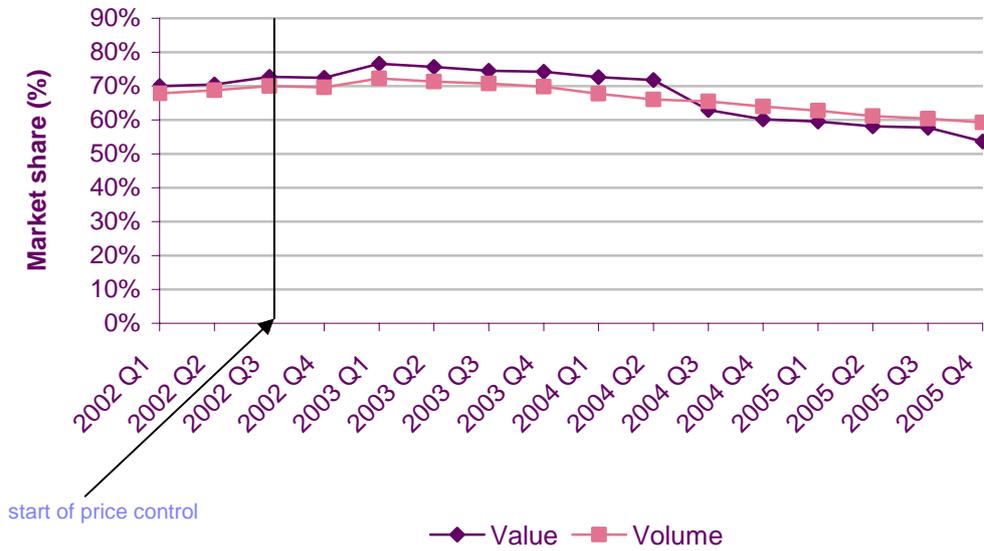


Figure 15 - international calls

BT market share - volume and value

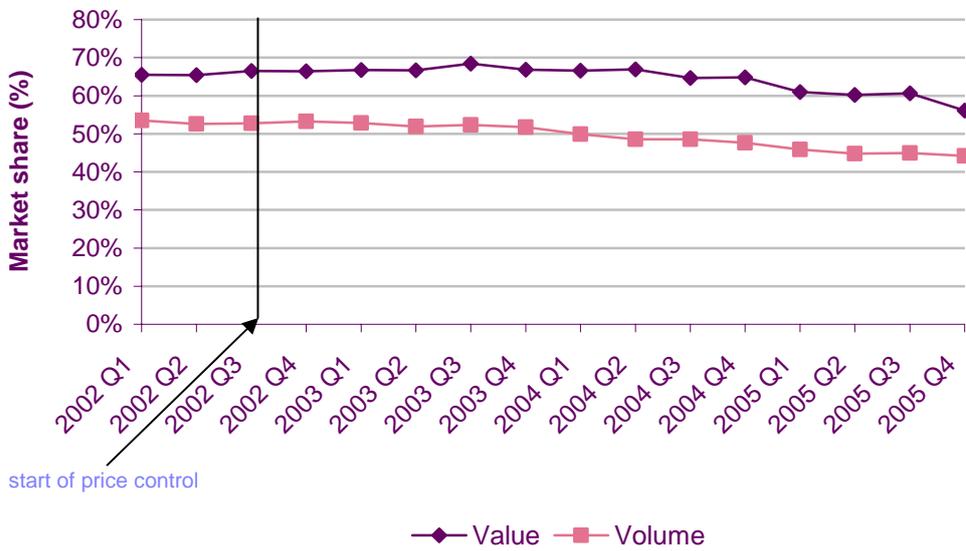
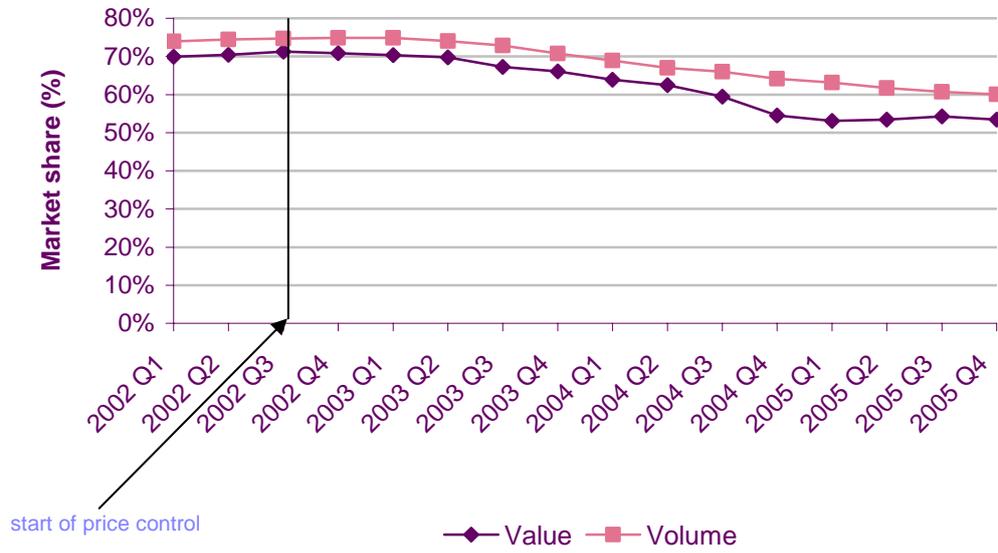


Figure 16 - calls to mobile

BT market share - volume and value



Annex 4

List of respondents to the consultation

Groups representing citizen consumers

Citizens Advice Bureau
Communications Workers Union
Scottish Executive
Welsh Assembly

Individual consumers

Adrian Cox
Barbara Chamberlain
Bill Green
Darren Wolfenden
David Ledger
David Lindsay
Denise Greenslade
Garry Currier
Kevin Kearney
M Roschandel
Neil Asher
Paul Harley
Peter Barnes
Dr R D Feltham
Richard Gurney
3 further respondents asked for their details to be withheld

Industry respondents

BT
Cable & Wireless
Hutchison 3G (UK) Ltd
Ntl
Post Office Ltd
Scottish & Southern Energy
T-Mobile
UKCTA

Annex 5

Impact assessment

- A5.1 The analysis presented in this Annex, when read with the rest of this document, represents an Impact Assessment ('IA'), as defined by section 7 of the Act. This is a further iteration of the IA contained in the March consultation which sought comments on a range of options. This IA assesses Ofcom's decision to proceed with Option 4. For reference each of the proposed options is described in brief.
- A5.2 No comments were received to the IA in the consultation.
- A5.3 IAs provide a valuable way of assessing different options for regulation and show why the preferred option has been chosen. They form part of best practice policy-making and are commonly used by other regulators. This is reflected in section 7 of the Act, which means generally we have to carry out IAs where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. In accordance with section 7 of the Act, in producing the IA in this document, Ofcom has had regard to such general guidance as it considers appropriate, including related Cabinet Office guidance.
- A5.4 This IA is conducted in accordance with the Ofcom publication "Better Policy Making".

Issues consulted on

- A5.5 The June 2002 statement introduced a safeguard cap for a period of four years to 31 July 2006; this is set out in more detail in Section 2. Ofcom is now consulting on the appropriate form of intervention, if any, following the expiry of the existing price controls. Factors Ofcom has considered include:
- The fact that BT retains SMP in the relevant retail markets;
 - Whether competition in these markets is (or is likely to become) sufficiently developed to offer consumers a viable range of alternative products and suppliers;
 - BT's residual control of the wholesale products non-cable providers purchase in order to compete;
 - Whether, in the absence of retail price controls, BT would be likely to significantly increase line rental charges to offset call price reductions it may make in the more competitive calls markets. This could potentially harm low spending consumers not protected by the LUS and its replacement, who depend on their phone line but make few calls.

Policy objectives

Ofcom's statutory duties

- A5.6 Section 3(1) of the Act states that the principle duty of Ofcom is:
- to further the interests of citizens in relation to communications matters, and;

- to further the interests of consumers in relevant markets, where appropriate by promoting competition.

A5.7 Ofcom has identified four objectives (informed by the statutory framework of the Act, Framework Directive and Ofcom's regulatory principles) to inform our thinking on whether there is a need for a further retail price control:

- The desire to operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required;
- The need to address BT's SMP in retail markets and facilitate the development of effective competition in these markets;
- Distributional considerations/consumer protection:
 - market power may not be uniform across markets – i.e. certain consumers may be effectively captive (but in a way that makes market definition on this basis difficult);
 - a number of these consumers may be significantly budget constrained but fall outside the coverage of social telephony services (LUS or its replacement); and
- Finding the least intrusive regulatory mechanisms to achieve these objectives.

Summary of options

A5.8 In light of the significant market and regulatory developments since the last market review, and taking into account its objectives, Ofcom identified a range of options that may be appropriate upon the expiry of the existing price controls on 31 July 2006, in the consultation document "Retail Price Controls: explanatory statement and proposals" published on 21 March 2006:

- Option 1: no regulation in place of RPC – no charge control from 1 August 2006 with no additional consumer protection 'assurances' from BT;
- Option 2: roll-over of the existing charge control – a continuance of the safeguard cap (RPI+0%) on a basket of access and calls for Y% of subscribers by expenditure (currently Y = 80%);
- Option 3: safeguard cap on BT's entry level tariff, BTT1, or any replacement; and
- Option 4: no charge controls from 1 August 2006 but voluntary assurances provided by BT (this was Ofcom's preferred option).

A5.9 Having considered the responses received to the consultation Ofcom has decided to proceed with Option 4 as detailed in this statement.

Assessment of decision

Option 4: No charge controls from 1 August 2006 but voluntary assurances provided by BT

A5.10 Option 4 is considered to meet Ofcom's duties under section 6 of the Act. Ofcom has a duty to ensure that it does not impose or maintain unnecessary regulatory burdens.

Ofcom considers that deregulation obviously fulfils this duty but would not be without risk. Allowing BT complete freedom over all of its retail prices whilst relying solely on social telephony schemes (currently LUS) to protect low income consumers and those with special social needs would not offer sufficient protection for consumers whose spend on calls marginally disqualifies them from membership of the scheme. These consumers may face rises in access prices which, given their low call volumes, cannot be off-set by reductions in the price of calls. However, as competition in access intensifies with the continued uptake of WLR (which is expected to be further encouraged by BT's delivery of EoI in WLR), these consumers should find it easier to switch to alternative providers who charge lower prices than BT.

- A5.11 However, coupled with appropriate assurances from BT, this option also offers adequate protection to those low spending consumers identified to be most at risk.
- A5.12 Whilst there is a risk that by allowing the RPC to expire, BT may raise its prices to the detriment of low spending consumers, Ofcom also recognises the risk of disproportionate regulation which may itself result in perverse results (e.g. reductions in tariffs taken by higher spenders in response to competition for such customers which can be offset within the price control basket with price rises on services/tariffs typically taken by low spending consumers).
- A5.13 Ofcom considers that the growing use of WLR and LLU, along with BT's undertakings given in lieu of a referral to the Competition Commission under the Enterprise Act 2002, together with increasing competition in voice markets driven by growth in CPS, suggest that a formal charge control on BT's retail prices is no longer the most appropriate and proportionate form of regulation. Further, to the extent that BT did choose to take advantage of a relaxation of the controls, this option may encourage new entry and intensify price competition.
- A5.14 BT has provided assurances that will provide protection for low spending consumers falling outside the protections afforded by the social telephony scheme. These include assurances relating to the pricing of line rental and the pass-through in respect of mobile termination rates. The assurances will last until the end of 2007, which will coincide with the anticipated completion of the next review of retail narrowband markets by Ofcom.
- A5.15 Ofcom feels that these assurances, combined with an information campaign to raise consumer awareness of the benefits of thorough research, and given the market and regulatory developments noted above, will be sufficient to protect low spending consumers and represent a proportionate response given existing and expected market conditions and developments. Further, the completion of the market review planned for 2007 will provide Ofcom with an opportunity to reassess the success of such developments in meeting regulatory objectives and to respond accordingly.