

Consequences of Charge Control Baskets



February 2015

1. Introduction

The use of baskets within a charge control is designed to give the regulated business a degree of freedom to rebalance individual charges or make discretionary pricing decisions, while remaining compliant with the overall control. The broader the basket, the more freedom is afforded. In cases of larger baskets containing multiple services additional protection measures are often put in place in the form of individual service pricing caps which restrict the absolute pricing movement allowed on individual products (to discourage one product bearing the price change load for entire basket while at the same time helping to avoid product specific price shocks for consumers). Preferential pricing may be seen as a valuable way of giving appropriate pricing signals to the market, for example by discouraging the purchase of legacy products over newer products within the same basket, with basket pricing flexibility providing a mechanism to incentivise the purchase of the newer generation of a product.

However, basket flexibility can also provide a means for the regulated business to favour its own consumption patterns against those of its downstream competitors or to act in a way that discourages investment in competing infrastructure by lowering returns of one set of products, offset by higher pricing elsewhere in the basket. Baskets may also present a practical obstacle in the introducing of other features that refine the application of the charge control, such as mid-term volume error correction mechanisms, which are more problematic to implement where a larger multi-product basket has been adopted.

The question that this paper seeks to address is: are the benefits of baskets more than outweighed by their drawbacks?

2. The Pros and Cons of Baskets

Historically too much credence has been placed on the idea that BT might use basket pricing freedom in a welfare enhancing manner when in fact there is little evidence to suggest this is the case. In theory basket price flexibility could hypothetically be used in a welfare enhancing way by BT recovering differing amounts of common costs from products to increase demand and allocative efficiency (ie. Ramsey pricing - recovering more common cost from low elasticity products). This pricing approach can also increase profits. However the degree to which this might happen in practice is limited.

BT is a rational business that supplies SMP products to the market. It will always act to serve its own shareholder interests in the first instance and will not feel compelled to use basket flexibility to maximise welfare benefits for consumers.

The gaming of pricing on prior/current weights is a comparatively straightforward task and risk free for BT, as the parameters of the charge control are known from the outset and BT can respond with a compliant pricing strategy that seeks to maximise profit with no wider consumer welfare benefit.

Gaming can be extended by using the allowed flexibility on the price of individual products. BT can increase its profit by flexing pricing in two ways, both of which are anti-competitive and welfare harming:

1. by raising prices on products that are more in demand externally than internally; and/or,
2. raising prices on less competitive products and lowering prices on more competitive products

It is comparatively easy for BT to implement these pricing strategies since it is simple to identify which products are purchased more internally or what products are subject to more competition.

The potential increase in both profit and efficiency from Ramsey pricing can be low since (a) the differences in elasticities amongst products in the same basket is often minimal, with demand for SMP products frequently determined by other factors like technology shifts and the ease of migrations (for example WES to EAD: while WES was

Consequences of Charge Control Baskets



February 2015

withdrawn for new supply, the legacy base is problematic to move regardless of the price as issues around individual customer migrations need to be overcome and are a far greater influence on overall demand than price alone).

BT is far more likely to focus the use of basket flexibility on anti-competitive tactics (e.g. increasing the price of externally used products) which is both easy to do and highly profitable rather than Ramsey pricing, which is difficult to do and results in limited additional profit.

3. Charge control Volume Error Correction & Baskets

Existing charge control methodology sets out a glide path to a target set three years in advance; making it vulnerable to volume forecast error. The means that charge control derived pricing could be consistently above (or below) the underlying cost level for a number of years, giving rise to long-run windfall gains or losses. A simple correction method could be incorporated within the initial charge control design to eliminate over- or under-recovery, adjusting the glide path to a pre-determined level based on actual volumes, ensuring an accurate target was met in the third year of the control.¹

The application of this “glide path shift” can easily be applied to single regulated products, however while it can also be applied to a baskets of services it is more complicated to implement because a mechanism has to be incorporated to deal with variations on volumes within baskets. The benefits of volume error correction and its ability to reduce or even eliminate windfall over-recovery but yet preserve the efficiency incentives of the control, while at the same maintaining certainty are more quantifiable than any benefits derived from the existence of baskets, which offer limited welfare gains, offset by price gaming opportunities. If the presences of baskets was also felt a deterrent towards the introduction of volume error correction it would likely lead to a charge control outcome that didn't maximise consumer welfare, with any restricted benefits that baskets provide completely overshadowed by the negative behaviour they encourage coupled with the limitations they place on more welfare enhancing remedies such as volume error correction.

At the very least basket groupings made up of homogenous services, with similar underlying costs should be utilised to assist with the introduction of error correction. Products that are near substitutes with similar cost bases (and cost volume relationships) could share a basket and co-exist happily with an error correction remedy. Where products that are not homogeneous and have different underlying costs share a basket then volume error correction is considerably harder to implement. In the case of EAD10 and EAD 100, the products themselves are similar, as are the underlying cost bases and the cost volume relationship, making them ideal partners to co-exist in a basket. It is even more important to ensure that higher bandwidth services over 1Gbit/s are placed in appropriate baskets with homogeneous services that have similar cost profiles, as the gulf between underlying costs and price is at its greatest on these services, leaving them vulnerable to over-recovery. Volume uncertainties in this growing higher bandwidth area mean these services would benefit considerably from error correction in the next BCMR charge control.

4. Conclusion

With Cost Orientation removed there is no longer a back stop remedy to ensure that individual prices reflected the underlying cost of provision. Charge controls therefore should be tighter with smaller baskets and have more extensive use of sub-caps. These additional charge control design features significantly water down the very flexibility that is supposed to be delivered through baskets.

When the existence of baskets then acts as a barrier towards the introduction of a sensible welfare enhancing error correction mechanism, which would prevent consumers overpaying and limits meritless over-recovery on regulated

¹ See Vodafone Paper 'Suggested approach to charge control volume forecast error correction' February 2015

Consequences of Charge Control Baskets



February 2015

products, it seriously calls into question the value of the role that baskets play, particularly on the key high volume services which account for the bulk of SMP revenues within a charge control.

The continuation of baskets within the BCMR charge control needs to be backed up with a stronger analysis of the benefits that they can bring, set against the more negative aspects of their existence (such as price gaming). Future charge control design must focus on enhancing overall welfare through maximising features such as volume error correction by using fewer baskets, or modifying their design to focus basket groupings on homogeneous services, with similar underlying cost profiles in order to co-exist with error correction.