Complaint against BT’s pricing of digital cordless phones

Final decision of the Office of Communications ("Ofcom")

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Summary

1. The Office of Communications (‘Ofcom’) has concluded that BT Group plc (‘BT’) has not infringed Section 18 (the ‘Chapter II prohibition’) of the Competition Act 1998 (the ‘Act’) or Article 82 of the EC Treaty (‘Article 82’) in relation to the pricing of its digital cordless telephones.

2. Ofcom’s decision is made following an investigation which was opened on 26 April 2005 following the submission of a complaint on 29 March 2005. The complaint alleged that BT was dominant in the supply of cordless telephones in the UK and that BT had abused its dominant position by predatory pricing behaviour in its supply of digital cordless telephones. The complaint was submitted by Herbert Smith on behalf of Binatone Telecom plc and a co-complainant who wishes to remain anonymous.

3. Ofcom has issued draft non-infringement decisions to the parties in respect of this matter on 20 October 2005 (‘1st draft decision’) and 9 May 2006 (‘2nd draft decision’). Ofcom has considered the comments that were made to it in response to those drafts.

4. During its investigation, Ofcom has considered the available evidence and concluded that the relevant market is for the wholesale distribution of all consumer fixed-line telephone equipment in the UK and that BT is not dominant in the relevant market. Consequently, BT’s conduct is not caught by the Chapter II prohibition or the prohibition in Article 82 and, therefore, there are no grounds for action.

5. In the course of the investigation, Ofcom also considered evidence from BT in relation to its pricing to assess whether, in the event that Ofcom had found BT to be dominant in that market, its conduct could have been considered to be predatory pricing prohibited by Chapter II and Article 82. Ofcom has concluded that even if Ofcom had found BT to have been dominant in that market, it would have then gone on to find that BT was not abusing its dominant position by engaging in predatory pricing. This reinforces Ofcom’s conclusions on dominance since part of the basis of the complainants’ submissions in relation to BT’s alleged dominance was that BT’s adoption of a predatory strategy had raised barriers to entry.
Section 1

Background

Introduction

6. On 26 April 2005, Ofcom opened an investigation following a complaint that BT had infringed Chapter II of the Competition Act 1998 (the ‘Act’) and/or Article 82 of the EC Treaty (‘Article 82’) in its conduct in setting a price for various models of its branded cordless telephones. The complaint was submitted on 29 March 2005 by Herbert Smith on behalf of Binatone Telecom plc (‘Binatone’) and a co-complainant who wishes to remain anonymous (collectively, ‘the complainants’).

7. The Competition Bulletin entry for this investigation can be viewed at: [http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_cases/closed_all/cw_828/](http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_cases/closed_all/cw_828/)

8. On 20 October 2005, Ofcom issued a draft non-infringement decision to the parties in respect of this matter. Comments were received from both the complainants and BT. Ofcom issued a 2nd draft non-infringement decision to the parties in respect of this matter on 9 May 2006. Comments were received by both the complainants and BT. Details of the responses to the draft decisions together with Ofcom’s considerations and reasons for making this decision are set out in Section 3.

Overview of the consumer fixed-line telephone equipment sector

9. Consumer fixed-line telephone equipment includes all equipment complementary to the consumption of fixed-line voice services and includes telephone handsets, including those with answering machines.

10. All telephone handsets enable consumers to make and receive calls, as well as provide basic functions typically including last number redial, mute button, phone number memory, and ringer/handset volume control.

11. However, different types of phones can offer different levels of functionality and quality of service when used in connection with the complementary fixed line voice service. Cordless phones offer greater mobility to the consumer when making or receiving a call. Digital Enhanced Cordless Telephony (‘DECT’) phones potentially offer improved call clarity and greater call range than analogue cordless phones. Some phones include answering machines. Others offer features including polyphonic ring tones, SMS and colour displays. (Further detail on different types of phones and their features is set out in the relevant market section at paragraphs 90-109 below).

12. Figure 1 and Figure 2 below illustrate the relative importance of the product segments. Seven million handsets were sold between August 2003 and July 2004 with fixed phone sales of £299m and DECT phone sales of £214m.
Figure 1 Product segments in the consumer telephone sector (share by volume)

Source: GfK

Figure 2 Product segments in the consumer telephone sector (share by value)

Source: GfK
The supply of fixed-line telephones

13. Wholesale suppliers of fixed-line telephone equipment in the UK are primarily concerned with the design, branding and wholesale supply of telephones. Most suppliers do not have their own manufacturing facilities for fixed-line telephone equipment but sub-contract this activity to manufacturers in the Asia-Pacific region, principally in Hong Kong, South Korea, Taiwan, Thailand, the Philippines and the People’s Republic of China. There is currently no UK-based manufacturing of fixed-line telephone equipment. Figure 3 below sets out the structure of the UK sector and key participants.

14. As illustrated in Figure 3, all major suppliers offer equipment wholesale and offer equipment to retail buyers through a number of supply channels – through wholesale distributors, high street retailers, catalogue based retailers and internet based retailers. In addition BT and Panasonic supply directly via their own websites.¹

Figure 3 Supply chain for fixed-line telephones

¹ Ofcom understands that BT does not supply consumer phones separately through BT retail outlets other than through website sales.
Section 2

The Facts

The undertakings

15. BT Group plc (‘BT’), whose registered office is at 81 Newgate Street, London EC1A 7AJ, is the listed holding company for an integrated telecommunications group that provides voice and data services in the UK and elsewhere. Its principal activities include local, national and international telecommunications services, broadband and internet services, and IT services. BT serves approximately 21 million UK residential and business customers. In the financial year to March 2005, BT had a UK turnover (from continuing activities) of £17.0 billion.\(^2\) BT is an undertaking for the purposes of the Chapter II prohibition and Article 82.

16. Within BT, the BT Retail line of business provides voice telephony to BT’s UK residential and business customers, the leasing of private circuits and other private services, and the sale and rental of customer premises equipment. The Home Communications and High Street Distribution business is the part of BT Retail which sells fixed-line telephone equipment including corded and cordless analogue and DECT telephones to be used by consumers. The BT Home Communications and High Street Distribution business sells only to the UK market, and primarily at the wholesale level to retailers (more than 99% of sales). BT Direct sells directly to consumers via its website.

17. Binatone is an international supplier and manufacturer of telecommunications equipment. It describes itself as the second largest DECT cordless manufacturer in the world.\(^3\) The Binatone Group operates in 10 countries with headquarters in Hong Kong. Binatone has customers in over 30 countries. The Binatone brand was established in the UK in 1958 and the company sells to the UK sector both directly from its Hong Kong operations and through its distribution subsidiary based in the UK.

18. The Binatone complaint was joined by a second complainant who wishes to remain anonymous.

The allegation of predatory pricing

19. In their 29 March 2005 submission to Ofcom, the complainants alleged that BT had engaged, and is engaging, in a highly aggressive pricing strategy, generally, and particularly with low price range models. The complaint alleged that BT targeted particular product lines offered by competitors, notably those in the high volume/low value segment of the sector. In particular, the complainants further submitted that BT is selling a number of BT DECT models below cost:

- BT Freestyle 2100;
- BT XC 100;
- BT Lyric 1100;
- BT Synergy 700 Twin with answering machine; and
- BT Studio 1100.

\(^2\) BT Annual report Note 2 - Segmental analysis
\(^3\) The complainants’ 29 March submission
20. The complainants referred in more detail to the BT Freestyle 2100 promotions conducted by Argos. The complainants submitted that Argos sold that model for £19.75 for the periods 16 February to 15 March 2005, and previously, 22 September to 19 October 2004 and 15 December to 24 December 2004. The complainants further submitted that it was not appropriate to justify the sales of this model at prices it alleged were below cost as write-downs necessary to sell-off old stock. They claimed that the BT Freestyle 2100 is not an out-of-date product, and the complainants expect that BT is continuing to purchase and stock this model.

21. The complainants provided details of each of their equivalent products together with their respective costs. In their view, this analysis establishes that if BT incurs similar costs to those incurred by the complainants, the expected recommended retail price of the BT Freestyle 2100 is less than the cost to BT of offering that equipment for sale. The complainants submitted that, in any event, the cost incurred by BT in respect of the wholesale purchase price is likely to be somewhat higher than the costs that they respectively incur. They also noted their belief that BT’s costs to distribute, market and undertake other related activities would be higher than the complainants’ own costs.

22. The complainants set out their expectation that, in addition to offering the DECT products at significantly reduced wholesale prices, BT is also providing significant marketing funds to retailers to promote BT’s equipment. They submitted that this cost of advertising should be included in an assessment of the costs BT incurs. Likewise, BT's cost of capital should also be included in assessing BT's costs, including the costs that BT must incur through carrying a high volume of stocks.

23. The complainants argued that BT’s competitors are unable to compete with BT at an equivalent price and, as a result of BT’s actions, are steadily losing market share. They provided an independent market report prepared by GfK (“the GfK Report”) covering the period from January 2003 to December 2004, which they say shows the erosion in BT competitors’ market share and a consequent increase in BT’s market share.

24. The complainants claimed that the GfK Report reflects the change in market structure which has occurred as a result of the predation. The key effects alleged are:

- the significant increase in BT’s market share;
- the exit from the market of smaller participants;
- the deterrence of entry to the UK market by European suppliers. The complainants observed that a number of pan-European suppliers, including Alcatel and Sagem, are noticeably absent from the UK; and
- the significant erosion in the market share of long-established participants, such as Binatone.

**The complainants’ submission on BT’s dominance in the relevant market**

25. The complainants made submissions on BT’s dominance in the relevant market in their 29 March complaint. In addition, on 14 September, Ofcom invited the complainants to make a further submission on dominance which the complainants provided on 16 September 2005.
26. In the 29 March 2005 submission, the complainants made various submissions in relation to dominance. In particular, the complainants alleged that BT was dominant, and cited as evidence of this position BT’s high level of its market share for cordless telephones (61% by volume and 60% by value for January 2003 to December 2004 based on GfK data) and the comparatively low level of competitors’ market shares (Binatone with 20% by volume and 15% by value and all other suppliers with a share less than 10% for the same period and also based on GfK data). The complainants also alleged that BT would still be dominant on a narrower market definition of supply of DECT phones, citing BT’s 56% market share by volume and value within that narrower sub-sector.

27. The complainants also submitted that there should be low barriers to entering the UK market for cordless telephones. The requirements include finding a suitable manufacturer in the Asia-Pacific region, design and development work and obtaining British Approvals Board of Telecommunications (BABT)\(^4\) approval. However, the complainants considered that BT’s strategy (which they characterise as being predatory) has resulted in new entrants rapidly leaving the market. The complainants referred in particular to the GfK Report to indicate the exit of key competitors such as Logicom which has a significant presence in France and Spain which has now left the UK market as well as DBTel and Amstrad.

28. On 16 September 2005, the complainants made additional submissions (on the question of whether BT is dominant) in relation to market shares, the strength of the BT brand and other barriers to entry, and BT’s ability to act independently based on its portfolio of products. The complainants’ submissions on these issues are set out in further detail in Section 3 under ‘BT’s Position within the Relevant Market’.

The complainants’ submission on Ofcom’s 1st draft decision

29. On 4 November 2005, the complainants provided Ofcom with comments on the 1st draft decision in relation to barriers to entry and expansion, countervailing buyer power, the value of the BT brand, BT’s market power in a related market, and BT’s behaviour as evidence of dominance.\(^5\) The complainants’ submissions on these issues are set out in further detail in Section 3 under ‘BT’s Position within the Relevant Market’.

30. On 23 February 2006, the complainants provided Ofcom with an additional submission on barriers to entry, retailers’ power and recoupment. The complainants’ submissions are set out in further detail in section 3.

The complainants’ submission on Ofcom’s 2nd draft decision

31. On 7 June 2006, the complainants provided Ofcom with comments on the 2nd draft decision in relation to Ofcom’s analysis, including Ofcom’s market share analysis and its reliance on the Mintel Report and the weight placed by Ofcom on the evidence submitted by other parties that indicates BT’s dominance. The complainants’ submissions on these issues are set out in further detail in Section 3.

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\(^4\) The body in the UK which certifies products and services in the fields of telecommunications, IT and radio.

\(^5\) The complainants also made submissions in relation to the procedures that Ofcom had followed.
32. On 19 June 2006, the complainants’ provided comments on Ofcom’s use of and reliance on the Mintel report in Ofcom’s market share analysis. The complainants’ submissions on these issues are set out in further detail in Section 3.

**BT’s submission on dominance in the relevant market**

33. On 6 September 2005, BT provided a submission on BT’s position in the supply of fixed line telephone equipment arguing that BT does not hold a position of market power. This submission referred to the variations in market share, low barriers to entry, importance to retail purchasers of value for money rather than brand, declining price trends and countervailing buyer power. These submissions are set out in further detail in Section 3 under ‘BT’s Position within the Relevant Market’.

**BT’s submission on Ofcom’s 1st draft decision**

34. On 3 November 2005, BT made comments on Ofcom’s 1st draft decision in relation to the profitability of individual products in a portfolio of products in a competitive market. BT submitted that:
   - Within a portfolio of products it is inevitable that from time to time some products will be launched which do not succeed and that these may not cover their variable costs as defined by Ofcom, even over their entire life.
   - Provided that such episodes are limited in number and duration, having the odd product which fails to cover its costs is fully consistent with a competitive market.
   - A product which fails to cover its variable costs for just part of its life is a phenomenon reasonably to be expected from time to time in any competitive market.

**BT’s submission on Ofcom’s 2nd draft decision**

35. On 7 June 2006, BT provided some minor drafting suggestions which Ofcom has taken into account where appropriate.

36. On 15 June 2006, BT provided comments on the Mintel report. In addition, BT provided comments on the China Sourcing report.

**Ofcom’s Investigation**

37. As detailed in Section 3, Ofcom’s investigation has considered whether BT’s conduct in the pricing of its fixed-line telephones constitutes a breach of the Chapter II prohibition and the prohibition in Article 82. In particular, Ofcom has considered whether BT is dominant in the relevant market, and whether BT’s conduct in setting prices would amount to predation if BT were found to be dominant.

**Evidence collected during the investigation**

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7 Cordless Phones: China sourcing report, January 2006.
38. Following the opening of the investigation on 26 April 2005, Ofcom sought relevant evidence from a number of parties, including BT, Binatone, the anonymous complainant, other suppliers who operate in the UK consumer fixed-line telephone equipment market such as Panasonic, an anonymous competitor and UK retail customers such as Argos and Comet. Specifically, Ofcom used its powers under section 26 of the Act:

i) On 8 June 2005, requiring BT to provide a product profitability of various fixed-line telephone models.

ii) On 28 June 2005, requiring BT to provide a product profitability analysis of various fixed-line telephone models.

iii) On 13 July 2005, requiring BT to provide all internal and external documents relating to BT’s strategy, pricing and purchasing of DECT phones.

iv) On 12 August 2005, requiring BT to provide further financial information related to the costs and profitability of offering fixed-line telephones.

v) On 18 August 2005, requiring Panasonic to provide information on its sales to confirm whether the data sourced from GfK on retail sales represents a fair and accurate estimate of Panasonic’s sales.

vi) On 25 August 2005, requiring Binatone to provide information on its sales to confirm whether the data sourced from GfK on retail sales represents a fair and accurate estimate of Binatone’s sales.

vii) On 25 August 2005, requiring Argos to provide information on influences when making buying decisions, discounting, and information market segmentation within the DECT group.

viii) On 25 August 2005, requiring BT to provide information on its sales to confirm whether the data sourced from GfK on retail sales represents a fair and accurate estimate of BT’s sales.

ix) To require various current and potential suppliers, suppliers who have exited the market, and retailers to provide information on barriers to entry, net margins, negotiating power of the players in the UK market, differences between the UK market and other European markets, and recent prices and price reductions as follows:


- on 20 December 2005 requiring information from Amstrad plc (‘Amstrad’);

- on 4 January 2006 requiring information from Motorola Ltd (‘Motorola’), Binatone, MagicBox, Geemarc Telecom SA (‘Geemarc’).
• On 9 January 2006 requiring information from [anonymous supplier]

• On 13 January 2006 requiring information from Siemens plc ('Siemens').

• On 24 January 2006 requiring information from Alcatel Telecom UK ('Alcatel'),

• On 27 January 2006 requiring information from Sagem Communication UK Ltd. ('Sagem').

x) On 4 January 2006, requiring BT to provide information on marketing and promotional activity and costs, rental telephones, brand, and BT’s wholesale share of facsimile machines.

xi) On 27 January 2006, requiring MagicBox and [anonymous supplier] to provide information in relation to obtaining supplies of cordless phones.

39. Copies of the section 26 Notices that Ofcom issued to require the provision of information are annexed to this decision.

40. Ofcom has also made use of third party market reports in considering the market for DECT phones:

   o “Telephones and Answering Machines Market Intelligence March 2005” – a UK retail market report published by Mintel International Group Ltd ('Mintel report')

   o “Cordless Phones – China Sourcing Report” a report on cordless phones manufacturers in China, Hong Kong And Taiwan published by Global Sources, 2005 ('China sourcing report')

41. During the course of the investigation, Ofcom has also met with both the complainants and BT, in person and in conference calls. In reaching its decision, Ofcom has used additional information supplied voluntarily by BT and the complainants, data in the public domain and analysis undertaken by Ofcom. This evidence is set out further in the decision.

Teleconference with a supplier

42. Ofcom also contacted another DECT phone supplier in the UK market who the complainants alleged was about to exit the market due to BT’s behaviour in the market. This competitor has requested that confidential commercial information in relation to its exit strategy not be included in the decision, and Ofcom has taken the view that it is appropriate to comply with that request.
Section 3

Market Definition

Introduction

43. The Chapter II prohibition and Article 82 prohibit the conduct by one or more undertakings which amounts to the abuse of a dominant position in a market if it may affect trade within the United Kingdom or part of it ("Chapter II") and which may affect trade between Member States ("Article 82").

44. The investigation was conducted under both the Chapter II prohibition and Article 82 of the EC Treaty. Ofcom considers that the nature of the conduct under investigation in this case, namely exclusionary predatory behaviour by a dominant company on the UK market, is capable of having an effect on trade between Member States. European suppliers currently supply the UK market (for example, Siemens and Phillips) and the complainants have alleged that BT’s behaviour is deterring entry from other European suppliers. As noted by the Commission in its Guidelines on the effect on trade concept: "Where an undertaking, which holds a dominant position covering the whole of a Member State, engages in exclusionary abuses, trade between Member States is normally capable of being affected. Such abusive conduct will generally make it more difficult for competitors from other Member States to penetrate the market, in which case patterns of trade are capable of being affected." 8

45. In order to assess whether BT has infringed the Chapter II prohibition and/or Article 82 in this case, Ofcom has considered the following:

   i) The relevant markets and whether BT holds a dominant position in a relevant market; and

   ii) In the event that BT were found to be dominant, whether BT’s conduct would amount to an abuse.

46. In this chapter Ofcom sets out its reasoning on the relevant markets and the issue of whether BT is dominant with respect to that market, and then sets out details of Ofcom’s examination of BT’s prices for cordless phones to determine whether, in the event that BT were to be considered to be dominant, its behaviour would amount to abusive predatory pricing.

Relevant Market and Dominance

47. The European Court of Justice ("ECJ") has defined a dominant position as:

"...a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by giving the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers." 9

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8 Commission Notice Guidelines on the effect on trade concept contained in Articles 81 and 82 of the Treaty 2004/C101/07 at paragraph 93. See also paragraphs 94 – 96.
9 Case 27/76: United Brands v Commission [1978] ECR 207, paragraph 65. See also OFT Guideline 402 The Chapter II Prohibition, paragraph 3.10
48. For the purposes of the Chapter II prohibition, dominance is assessed within a relevant economic market.\textsuperscript{10} A relevant product market comprises all those goods and/or services which are regarded as interchangeable or substitutable by the consumer by reason of the products’ characteristics, prices and intended use.\textsuperscript{11} The relevant market has two dimensions: the relevant goods or services (the product market) and the geographic extent of the market (the geographic market).\textsuperscript{12} A relevant geographic market comprises the area in which the undertakings concerned are involved in the supply or demand of goods or services in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas.\textsuperscript{13}

\textbf{The Relevant Economic Market}

\textbf{The Relevant Product Market}

\textbf{The complainants’ views}

49. The complainants submitted\textsuperscript{14} that the relevant market is the market for the sale of cordless telephones in the UK. While accepting that corded telephones could “broadly” be considered a substitute, the complaint pointed to the significant growth in sales of cordless telephones, and the decreasing sales of corded telephones as indications that (in the complainants’ view) for most consumers, cordless and corded telephones are not substitutable. They further argued that mobile phones fall outside this market. They submitted that DECT telephones could be considered a separate market.

\textbf{BT’s view}

50. BT submitted\textsuperscript{15} that demand and supply-side considerations favour a market including all fixed line equipment. On the demand-side, BT argued that:

- There is a continuous chain of substitution between the different types of fixed line phones. This implies that even if certain phone types are not competing directly with one another, they may still form part of the same product market. This chain of substitution implies that a hypothetical monopolist may be unable to profitably increase prices without control of all fixed line phone segments.

- There also exists a high degree of supply-side substitution since the branding and marketing assets used to supply one product type could readily be used to supply any other. In the event of a 5-10% price increase by a hypothetical monopolist of DECT phones (BT argued), wholesale providers could easily increase their output of DECT phones by devoting more of their branding assets to this segment. From a supply-side perspective, the market would therefore also have to include all telephone receiving equipment.

51. BT further added that these demand and supply-side considerations are supported by price trends over time. If DECT phones formed a separate product

\textsuperscript{10} See OFT Guideline 402 The Chapter II Prohibition, paragraph 3.3.
\textsuperscript{11} See Commission notice on the definition of the relevant market for the purposes of Community competition law 97/C372/03 at paragraph 7.
\textsuperscript{12} Ibid., and OFT Guideline 403 Market Definition, paragraph 2.10.
\textsuperscript{13} Ibid
\textsuperscript{14} March 29 submission
\textsuperscript{15} BT’s 6 September submission
Competition Act 1998 - Complaint against BT relating to pricing of digital cordless phones

market, one might expect to see average DECT prices moving largely independently of average prices for analogue and corded phones. An increase in DECT prices would not lead to an increase in demand and hence prices for analogue and corded phones. However, as evidenced in Figure 4, DECT prices and analogue/corded prices have largely moved in parallel. In fact, the average price series have a correlation coefficient of 0.93. BT submitted that this is fully consistent with the conclusion that the relevant market includes all fixed line telephone receiving equipment.

Figure 4 Correlation between DECT and analogue/corded prices

![Figure 4](image)

Source: GfK

Oftel's view in April 2001

In 2001, Oftel, as part of its review of BT's pricing of fixed line telephone equipment, reached the following conclusions in relation to market definition:16

- Fixed voice telephone equipment and network provided voicemail services in the UK, including DECT, corded and analogue cordless phones, were comprised within the same market. That conclusion was reached on the basis of an analysis of both demand side and supply side chains of substitution.17

- Supply side substitutability was an important factor supporting that market definition, given that chains of substitution were likely to be asymmetric on the demand side.18

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17 Respondents agreed that there was a chain of substitution between corded and cordless phones, and telephone/telephone answering machines. With regard to certain specification and quality, certain analogue and cordless products were comparable with DECT products. Similar specifications overlaps could be seen between higher value corded phones and cordless phones.
18 Ofcom recognised that DECT phones were of a higher quality and specification than corded or analogue cordless phones, and that while the prices of the latter could constrain DECT prices, the same
• There were separate markets for fax machines and mobile phones.

• The geographic market comprised the UK.

Ofcom’s approach

53. Market boundaries are determined by identifying constraints on the price-setting behaviour of firms. There are two main competitive constraints to consider: how far it is possible for customers to substitute other products or services for those in question (demand-side substitution); and how far suppliers could switch, or increase, production to supply the relevant products or services (supply-side substitution) following a price increase.

54. Importantly, Ofcom considers that the results of the chain of substitution analysis in the retail market apply to the relevant wholesale market. There are two reasons why this analysis carries across to the wholesale market. First, demand in the wholesale market is derived from demand in the retail market. That is, products are only bought and sold in the wholesale market between wholesale suppliers and retailers in order to meet end-user demand in the retail market. Hence product demand in retail and wholesale markets are directly linked. Second, the wholesale price represents a significant proportion of the retail price - at least 60%.19 The magnitude of this proportion implies similar chains of substitution between products groups in the wholesale market as in the retail market. Accordingly, Ofcom considers the ‘chains of substitution’ analysis to apply equally to the wholesale product market.

Chains of demand-side substitution

55. Ofcom has assessed the functionality of different telephone handsets to establish:

• the premiums paid/savings accepted for differences in specified product functionality; and

• by drawing on customer survey data on the likelihood of switching, whether (in response to a price increase) the availability of near-substitutes would make the price increase unprofitable.

56. Ofcom’s functionality analysis was undertaken to establish whether a chain of substitution could be established between closely related consumer telephone products, within the overall set of products which are complementary to fixed line Public-Switched Telephone Network (PSTN) communications services.20

57. Ofcom first considered the following distinct product groupings for telephone handsets:

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19 Based on review of supply contracts and agreed gross margins between BT, Binatone and their respective retail buyers.

20 Ofcom did not undertake this analysis for consumer telephone equipment that is complementary to voice communications services using non-PSTN networks.
• DECT
• Analogue cordless
• Analogue corded
• DECT with answering machine
• Analogue cordless with answering machine
• Analogue corded with answering machine

58. These groups were considered because they represent products complementary to the consumption of fixed line telephony services for the end consumer (i.e. voice communication services that use the PSTN only).

Mobile handsets

59. There are two issues to consider in respect of mobile handsets. First, does the availability of mobile services (including handsets) provide a competitive constraint on the market for the supply of fixed line services (or complementary goods such as fixed line handsets), such that a hypothetical monopolist of fixed line handsets would be required to respond to competition from mobile operators? Second, for purchasers of a fixed line access service, are mobile handsets substitutable products such that the prices of fixed handsets would be constrained by the availability of mobile handsets?

60. In relation to the competitive interaction between fixed services and mobile services, Ofcom’s published market data reveals that the price of mobile calls has fallen against fixed line prices, but still lies at a significant premium to fixed line calls. Most customers view having PSTN access as an addition to mobile access since while customers may substitute between calls on PSTN based and mobile based communications services, they still require both types of service and hence for the period of the investigation Ofcom considers mobile phones and tariff plans are not substitutable for fixed line telephone equipment and associated service costs.

61. Ofcom has considered substitutability between fixed and mobile services in Phase 2 of the Telecommunications Strategic Review. In the review, Ofcom found that “there is strong evidence of the increasing displacement of fixed services by mobile networks. But for substitution to develop to the level where mobile companies exert competitive pressure on BT’s pricing and vice versa, it would be necessary for the relative difference in prices of voice calls on fixed and mobile networks to decline to a much greater degree.”

62. In relation to the question of substitutability of handsets, purchasers of fixed line telephone equipment are not, generally, able to purchase equipment designed for use with a mobile network and use that equipment with a fixed line service (that is, on a ‘cordless’ rather than ‘mobile’ basis). Ofcom notes the existence of BT Fusion, a recently introduced product designed to roam from fixed cordless to mobile operation, but even that service is offered on a tied basis with a particular line rental service and is not available separately (for example, customers of a hypothetical monopolist of fixed line cordless telephone equipment would not be able to purchase BT Fusion handsets direct from BT). Consequently, while Ofcom acknowledges that future technological developments may lead to future

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21 Strategic Review of Telecommunications Phase 2 consultation document, page 84, paragraph 8.32.
http://www.ofcom.org.uk/static/telecoms_review/condoc_phase2.htm
interoperability between fixed and mobile handsets, the current market conditions are such that the handsets are sold in separate markets.

**Non PSTN telephony services**

63. Ofcom also considered the likelihood that products complementing non-PSTN telephony services for end consumers (e.g. VoIP, and WiFi) could provide substitution possibilities away from fixed line consumer telephone equipment.

64. VoIP services remain in their infancy. Providers of VoIP communications services include Vonage and Skype (recently acquired by eBay). These services are anticipated to cost substantially less than the cost of a fixed line call. Providers of VoIP equipment i.e. telephones for use with VoIP communications services include Cyberphone and Alcatel.

65. However, the perceived technical difficulties in setting up a VoIP service, the requirement to have broadband and supporting computer equipment and the limited extent of VoIP phones available on the market all suggest that VoIP telephony equipment would not provide a competitive constraint to the mass voice communications services market during the period addressed during this investigation. In Ofcom’s view, any competition from such services would not have been material in the period being assessed.

66. Accordingly Ofcom does not consider VoIP equipment/communications services as a sufficient constraint on pricing of fixed line equipment/communications services to include it within the relevant product market.

**Facsimile machines**

67. Ofcom has also considered facsimile machines as part of its investigation. Ofcom considers it unlikely that a 10% SSNIP in the price of consumer phones would result in a sufficient proportion of customers to switch to purchasing facsimile machines to make the price increase unprofitable. Ofcom considers demand side substitution is likely to be limited and would tend to place facsimile machines in a separate market to consumer phones (functionality differences between voice and data communications underscore this lack in demand side substitution). For instance, consumer phones facilitate real time voice communications, whereas a facsimile machine only facilitates a written communication (i.e. a facsimile transmission). Given the relative price of facsimile machines (e.g. between approximately £60 and £150\(^{22}\)) and differences in functionality, facsimile machines are unlikely to constrain price increases. On the supply side, Ofcom considers that a 10% SSNIP in the price of consumer phones could result in some limited substitution to consumer phones from facsimile machines. However, Ofcom considers that the design and functionality differences would mean that switching supply would not be costless, and that it would be unlikely to result in a sufficient proportion of suppliers switching so as to make the price increase unprofitable. This suggests some very limited supply side substitution.

68. Ofcom also recognises BT’s share of the facsimile sector is considerably lower than for the consumer phone equipment market generally (4% in first half of 2005 compared to around 50% in the consumer phone market), which further suggests

\(^{22}\) Prices taken from a range of 7 models sold through Argos at [www.argos.com.uk](http://www.argos.com.uk) in February 2006
competitive conditions are significantly different between the two separate sectors.

**Rental phones**

69. Ofcom has also considered whether rental phones are part of the relevant market.

70. Ofcom understands that BT has historically been the largest supplier of rental phones. The following table identifies supplier shares of rental phones in 2002 in the UK.

*Table 1* Supplier shares of rental phone equipment in the UK, 2002

<table>
<thead>
<tr>
<th>Supplier</th>
<th>October 2002 Volume share</th>
</tr>
</thead>
<tbody>
<tr>
<td>BT</td>
<td>98.9%</td>
</tr>
<tr>
<td>ntl</td>
<td>&lt;0.1%</td>
</tr>
<tr>
<td>Kingston</td>
<td>1%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

*Source: (Ofcom historic data)*

71. Under a rental contract, ownership of the equipment remains with the supplier (e.g. BT) throughout the contract. The contractual responsibility to maintain the rental phone equipment (e.g. repair faulty equipment) rests with the supplier. If a customer wishes to upgrade its telephone equipment, it must wait 18 months or alternatively enter into a new rental contract.

72. Ofcom considers that the wholesale consumer phone market does not include rental phones, since the rental sector provides no direct horizontal competitive constraint on wholesale phone equipment prices. Corded rental phones are almost exclusively self-supplied by BT and retailed through BT Direct. Given this feature of the rental sector, a 10% SSNIP in the price of wholesale purchase phones is not unlikely to be constrained by the wholesale element of the rental sector (e.g. through BT at the wholesale level switching phone equipment produced for rental into the purchase sector).

73. For completeness, Ofcom has also considered whether, at the retail level, corded rental phones are in the retail purchase phone sector. As at March 2005, BT had [X] cordless rental customers and [X] million retail rental corded customers.

74. The number of customers on rental phones has fallen from 6 million (March 2000) to just over [a significant fall] as at March 2005. This sector is declining and Ofcom would not expect it to provide any effective constraint on pricing in the relevant market. Ofcom notes that major sales channels (including Argos, Dixons and Comet) do not on a regular basis offer rental terms to purchase customers. Since major retailers do not offer rental packages, customers would need to rent these phones directly from BT (either by calling BT or ordering over the internet) which could also limit the competitive constraint on the purchased phone sector. Ofcom considers that the lack of rental terms on offer more generally in the marketplace reflects an absence of demand for these contracts among customers in the relevant market.
75. Ofcom notes that in 2004, there were approximately 7 million handsets purchased, compared to \( [\times] \) new rentals recorded by BT during 2004/05 (comprising both completely new rentals and upgrades to existing renters). Accordingly rental phones would not appear to offer a competitive constraint to the pricing of purchase phones.\(^{24}\)

76. BT does not offer DECT phones under rental contracts. Ofcom considers the number of cordless phone rentals to be insignificant (\textit{de minimis}) relative to the overall market and therefore does not consider these phones further in its analysis. Were Ofcom to include these, they would have no material bearing on its finding on the relevant market or dominance assessment.

77. Ofcom has considered whether, in response to a 10% increase in the average price of corded phones for purchase, a sufficient proportion of customers would instead choose to rent a corded phone such that the price increase would be unprofitable.

78. Ofcom has taken the average corded purchase price of (approximately) £21\(^{25}\) as at July 2005.\(^{26}\) Ofcom has added warranty charges to the corded phone price, to reflect the warranty policies that offer product replacement for faults and or accidental breakage available through large retailers. Ofcom has included this additional charge to ensure a more like with like comparison with service element of rental contracts. The resulting prices inclusive of warranty charges are between £25.99 and £32.99.\(^{27}\) Ofcom has applied a SSNIP to this price range. A 10% SSNIP in the average purchase price of a corded phone results in a post SSNIP price of between £28.59 and £36.29.

79. Ofcom has compared this price range against possible quarterly rental charges offered by BT for corded phones.\(^{28}\) The minimum present value of the rental charges for a customer who rents the phone for 3 years (a conservative estimate of the life of a phone) is £43.51 (£3.41 per quarter discounted at 3.5% over 3 years).\(^{29,30}\) Accordingly, a customer switching to the cheapest rental phone on

\(^{23}\) BT submission of 7 February 2006.

\(^{24}\) Although there are over \( [\times] \) rental customers, these customers appear inert and when sampled do not report an overwhelmingly conscious decision for choosing to rent. Customers who are likely to switch from purchasing to renting a consumer phone are likely to have different demand preferences to these customers, and we would expect potential new rental customers to make a conscious price or service based decision if they were to switch in the event a SSNIP of 10% applied to the price of purchased corded phones. Ofcom considers the estimate of \( [\times] \) customers (i.e. new rentals per year) represents a more accurate illustration of the numbers that could be expected to switch from purchase to rental phones (in contrast to the installed base of \( [\times] \), which is not illustrative for the reasons mentioned above).

\(^{25}\) The average price represents a simple average of the prices for 24 non-decorative phone models listed on the Argos website in February 2006.

\(^{26}\) Corded phone purchase prices fell 37% from £27 in January 2002 to £17 in May 2005. Over roughly the same period, minimum rental charges increased 12% (from £3 to £3.41 per quarter).

\(^{27}\) For instance, Argos offers a 3 year warranty for £4.99 which covers breakdown of the phone, including where due to an accident, for up to 3 years from the date of purchase (inclusive of any manufacturer's guarantee). Once a phone has been replaced the policy ends. Comet offer 3 year warranties on corded products of up to £39.99 for £11.99. The phone must be faulty or have developed a fault within the three year period, but Comet will replace the phone as many times as necessary over the 3 year policy period.

\(^{28}\) While Ofcom does not have more recent data on shares within the rental sector, the overall decline in volumes in this sector, and the lack of observed entry into the rental sector suggests that BT rental prices remain an appropriate benchmark price against which to undertake the SSNIP test.

\(^{29}\) BT rental prices as at February 2006. Rental prices exist for 6 corded models and range from £3.41 to £6.11 each quarter.
offer would be paying between 20% and 52% more. In this analysis, the customer would be sacrificing a corded model with features including speakerphone and answering machine functionality for the least expensive corded rental phone (with minimal features). To rent an equivalent high functionality corded phone would cost £6.11 per quarter or a present value over 3 years of £77.96.

80. This analysis suggests there is little incentive available to stimulate a sufficient proportion of customers to switch to rental contracts to make such a price increase profitable.

81. In any case, Ofcom would not necessarily expect a sufficient proportion of customers to switch from purchase phones to rental phones even if savings were available. While the functional characteristics of rented and purchase phones are identical, consumers who rent phones typically do so because of non-price factors (e.g. risk aversion, inertia, or lack of price sensitivity). These characteristics are not necessarily shared by customers who purchase phones.

82. Under a rental agreement, ownership never passes to the customer. Accordingly the provision of a rented telephone is a service, rather than a sale of goods. In particular, BT remains responsible for the maintenance of rented telephone equipment throughout the rental period. In contrast, BT only guarantees purchased telephone equipment for a limited period against faults due to faulty design or manufacture. It is possible that more risk-averse customers may prefer to rent as a form of insurance.

83. Customer characteristics also distinguish typical rental customers from typical purchasers. According to Oftel’s Second Consumer Survey31, the most common positive reasons for renting were maintenance-related (19%): 17% valued the prompt replacement or repair of faulty rental equipment, while 3% mentioned the cost of replacing faulty purchased equipment. However, 18% of all residential customers did not know why they rented their telephone handsets. A further 23% appeared not to have made a conscious decision to rent rather than buy: 17% said that buying had not occurred to them, while 6% said they had moved into a house with a rented telephone handset. Finally, a further 30% said either that it was more convenient/easier to rent (17%) or too much hassle to buy (14%), without providing a positive reason for renting. Therefore, consistent with the findings of the First Consumer Survey32, it appears that between 55% and 70% of residential rental customers rent largely out of habit or are otherwise unresponsive (in other words, inert). The reason for giving a range is that the ‘more convenient/easier to rent’ response would, in some circumstances, represent a positive reason for renting. It is worth noting that the possibility of asymmetric retail sectors. Whilst rental phones do not constrain prices of corded purchase phones (see paragraph 75), purchase phone prices may constrain rental prices (in response to a 10% SSNIP in rental prices). For instance, the large decline in the rental sector (from 6 million in 2000 to [×] in March 2005) could reflect falling purchase phone prices which are acting to constrain rental prices. This could suggests that the SSNIP test which shows rental prices do not constrain purchase prices might only apply in one direction.

30 The Social Time Preference Rate (STPR) of 3.5% is used for discounting future rental charges (see the HM Treasury green book at http://greenbook.treasury.gov.uk/annex06.htm#social). It is the discount rate at which individuals discount future consumption over present consumption.

31 MORI sample of United Kingdom residential customers, commissioned by Oftel in July 2002.

32 IPSOS sample of United Kingdom residential customers, commissioned by Oftel in August 2002.
84. Ofcom has not carried out a further SSNIP test to establish substitution from rental phones to purchase phones for two reasons. First, Ofcom considers that the investigation is presently to determine whether rental phones are part of the relevant market and not whether purchase phones are in the rental sector. Accordingly, Ofcom considers that the most relevant test is whether in response to a 10% increase in purchase phones, sufficient customers would switch from rental phones to make the purchase phone price increase unprofitable. Ofcom has shown a break in this possible link (see paragraph 66) such that rental phones are not sufficient substitutes to place them in the retail purchase phone sector. Second, and moreover, Ofcom considers that it has demonstrated that rental phones cannot be part of the relevant market (i.e. the wholesale market) since the price of wholesale purchase phones would not be constrained by the wholesale element of the rental sector (e.g. through BT at the wholesale level switching phone equipment produced for rental into the purchase sector).

85. In summary, Ofcom considers that on the basis of its analysis of the characteristics of rental customers and the SSNIP test discussed below, the relevant market excludes rental phones.

Product groups defined by three key features

86. This section explains the product groups within the overall set of products complementary to the consumption of fixed line telephony services.

Cordless equipment

87. Cordless handsets provide a product feature that commands a premium over handsets that are fixed to a specific location (i.e. ‘corded’). Accordingly, Ofcom has considered the extent to which purchasers are prepared to pay more for a cordless than a corded telephone (the ‘premium’), since these premiums reflect the implied price consumers are willing to pay for flexibility in use of their handset separate from its other features.

Analogue and digital

88. Although both analogue and digital cordless phones are used to make calls over fixed PSTN lines, there are differences in the quality of voice communications depending on which technology is used. Firstly, digital receiver technology tends to provide for a better call quality, primarily due to lower levels of interference. Secondly, digital technology enables cordless phones to be used at a greater distance from the phone base station than an analogue cordless phone. Thirdly, digital phones provide better security than analogue phones.

Answering machines

89. A third product group includes answering machines. In survey information gathered for BT by market research company Drummond Madell, one third of all the respondents who purchased a telephone with an answering machine (just under 50% of the total) indicated that an answering machine was an important consideration when purchasing a fixed line telephone. Accordingly Ofcom has considered the premium for this feature. Importantly, telephones without an

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34 The survey consists of a sample size of 1246 respondents. The methodology used was face to face interviews in people’s homes.
answering machine (but which permit the consumer to make use of network services such as BT’s voicemail 1571 service) represent a very close substitute for purchasing a phone with an answering machine.

**Product market definition analysis**

90. Ofcom’s analysis of products in the retail sector suggests that the relevant market is a wholesale consumer telephone market which is complementary to fixed line PSTN communications services (i.e., consumer phones designed to be used on fixed lines). That market includes corded, analogue cordless and DECT consumer phones (with or without answering machines), but excludes mobile handsets and fax machines. Ofcom’s reasons for concluding that corded, analogue cordless and DECT phones are all comprised within the same market are discussed further below.

Within product group analysis

91. Within the DECT group, for example, phones tend to have four price ranges. First, “entry level” phones provide basic functionality with a small phone book (i.e. up to 20 number memory) and last number redial. These phones typically retail from about £18 to about £29. Secondly “Step-Up” phones have a greater number memory, speakerphone and possibly backlit LCD display. These phones typically retail between approximately £23 and £39. Thirdly, “Mid-priced” phones offer a larger phonebook, speakerphone capability a backlit LCD display and a backlit key pad. Some phones in this range may also feature polyphonic ringtones and SMS text messaging facility. These phones typically retail between about £35 and £60. Fourthly “Top end/Premium” phones usually feature 100+ number memory, speakerphone, backlit LCD display, backlit keypad, polyphonic ringtones, SMS text messaging and possibly a SIM card reader. These phones typically retail from £50 up to £150. The four price ranges are illustrated in Figure 5 below.

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35 Wholesale demand is derived from the retail market. Since wholesale costs represent at least 60% or total costs, the magnitude of this proportion suggests the demand side substitution found at the retail level will also be found at the wholesale level (see paragraph 79).
Between product group analysis

92. Ofcom took two approaches to considering whether demand side chains of substitution existed between product groups and between degrees of functional specification (proxied by price ranges).

93. First, Ofcom attempted to conduct a SSNIP test by comparing estimated price elasticities of demand for each product segment against critical loss values (which were based on observed margins for these product groups). Ofcom’s proposed approach was to show whether or not a 10% SSNIP in the price of DECT telephones would be unprofitable for a hypothetical monopolist by identifying whether the estimate elasticity was greater than the critical loss value.

94. However, due to weaknesses in the reliability of the data, Ofcom has not relied on the results of the analysis to assess market definition.

95. A particular concern was that price data for each product group was derived as the revenue for that product group in a given month divided by the total number of units sold. Because the mix of products sold (e.g. ranging from high to low priced units) could change from month to month the derived average price could change due to both changes in demand and changes in product mix. This derivation produced a relatively volatile price series that made it difficult to estimate a robust demand curve for each product.

96. Second, Ofcom considered an approach that did not directly incorporate a SSNIP test, but could present an indicative view of the possible markets.
97. In particular, Ofcom has considered the range of DECT products between the lowest priced entry-level phone and the highest priced top-end phone. Given the proliferation of phone models available that offer consumers a variety of mixes and graduations in the level of functionality and design aspect between the extremes of the price, functionality and quality spectrum, this suggests a chain of demand side substitution between entry-level and top end phones.

98. Ofcom also considers that chains of substitution appear to exist between the key product segments DECT, analogue cordless and analogue corded (see paragraphs 100 to 109). An analogue phone with speaker-phone facilities, for example, will generally be priced at a significant discount to a DECT phone with otherwise similar features. This suggests that analogue prices are constrained by DECT prices, and possibly vice versa. Accordingly, if a sufficient number of consumers would be prepared to accept the disadvantages of analogue equipment in exchange for a small but significant increase in the ‘saving’ represented by the difference in price between analogue and digital phones that were in all other respects very similar, this would support a conclusion that analogue and DECT cordless phones were in the same market.

99. Ofcom has therefore sought to identify DECT phones and analogue cordless phones with similar features to one another, so as to compare their prices. Ofcom has confined its analysis to entry and step up level phones since very few popular consumer phones offer levels of functionality above those of step up level phones, and it is difficult to identify appropriate comparators among high end products. There are, for example, few analogue phones that offer a higher level of functionality to step up level DECT phones, which is perhaps unsurprising given that, in relation to multi-feature consumer products, at a certain level of price or overall functionality, certain features are expected by consumers to come as standard (e.g., in the case of a cordless phone, a reasonably large number memory capacity, a mute function, speaker facility, and/or digital receiver technology).

**Comparing entry level DECT and Analogue cordless**

100. Ofcom has compared prices for DECT and analogue phones that have similar characteristics. Specifically, Ofcom has compared the analogue cordless Binatone Icarus 9 phone (£14.75) and the DECT Binatone E800 (£17.95). Both phones share many functional aspects including: up to 20 number memory and up to 7 hours talk time and 70-80 hours standby time; and last number redial. The analogue model represents an 18% saving on the DECT model. Ofcom considers that a 10% SSNIP in the price of DECT phones in this section of the market would be likely to increase the price premium for DECT to attract a sufficient proportion of DECT customers toward purchasing analogue cordless phones so as to reduce the profitability of the price increase.

**Comparing step-up level DECT and Analogue cordless**

101. Ofcom has compared prices for DECT and analogue phones that have similar features. Specifically, Ofcom has compared the analogue cordless Freestyle 60 phone (£24.95) and the DECT Onetel Circle BB Single (£29.95). Both phones share many features including up to 30 number memory storage and up to 120

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36 Note that this price is offered under a WOW! promotion with Argos, and hence is likely to understate the long run entry level DECT price. Both are advertised on the Argos website in September 2005.

37 Both models advertised on Comet website in September 2005.
hours standby time. The analogue cordless model is 17% cheaper than the DECT model. Ofcom considers that a 10% SSNIP in the price of DECT phones in this section of the market would be likely to increase the price premium for DECT sufficiently to attract a significant proportion of DECT customers toward purchasing analogue cordless phones so as to reduce the profitability of the price increase. It is worth noting that the possibility of asymmetric markets - whilst DECT phones might constrain prices of cordless analogue phones, cordless analogue phone prices may not constrain DECT prices if customers are not willing to accept any loss in functionality (e.g. digital functionality) in response to a 10% SSNIP in DECT prices). This suggests that there may be a chain of substitution linking analogue cordless and DECT phones in both directions or that this chain of substitution might only apply in one direction i.e. DECT constrains cordless analogue but not the other way around.

Comparing entry level analogue cordless and analogue corded

102. Ofcom has compared the analogue cordless Binatone Icarus 9 phone (£14.75) with the analogue corded phone Binatone Avon 111 (£9.99). Both these models have up to 13 number memory storage and last number redial. The analogue corded model is £4.80 (33%) cheaper. Ofcom considers that at this entry-level functionality analogue corded phones may be in the same market as analogue cordless phones since a 10% SSNIP in the price of cordless phones would be likely to increase the price premium for cordless sufficiently to attract a significant proportion of analogue cordless customers toward purchasing analogue corded phones so as to reduce the profitability of the price increase.

Comparing step-up level analogue cordless and analogue corded

103. Ofcom has compared the analogue cordless BT Freestyle 60 phone (£24.99) and the analogue corded Binatone Caprice 600 (£17.95)\(^{38}\). The analogue corded model is £7 or 28% cheaper. Ofcom considers that at this step-up level functionality analogue corded and cordless phones may be in the same market since a 10% SSNIP in the price of cordless phones would be likely to increase the price premium for cordless to attract a sufficient proportion of analogue cordless customers toward purchasing analogue corded phones so as to reduce the profitability of the price increase.

104. Ofcom considers that a chain of substitution may exist between analogue corded and analogue cordless. However, it is worth noting that the possibility of asymmetric segments - whilst cordless analogue phones might constrain prices of corded phones, corded phone prices may not constrain analogue cordless prices if customers are not willing to accept any loss in functionality (e.g. mobility benefits) in response to a 10% SSNIP in cordless prices). This suggests that there may be a chain of substitution linking corded and cordless analogue phones in both directions or that this chain of substitution might only apply in one direction i.e. cordless constrains corded but not the other way around.

105. When combined with the chain between analogue cordless and DECT, the analysis suggests that all these products may be in the same relevant market retail sector and by implication the same wholesale market.

Answering machines and the relevant market

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\(^{38}\) Comet website, September 2005.
106. The Drummond Madell customer research survey suggested that, on average, consumers were willing to pay £12 more for an equivalent phone model with an answering machine.

107. Ofcom analysis suggests that in many cases, equivalent phone models with an answering machine can be purchased for around an additional £5-£15. For example, in the entry level DECT product segment, upgrading from the Binatone E800 (£17.95) to the Binatone MDTAM (£24.99) represents a £7.04 price premium – below the willingness of consumers to pay for this extra functionality. Thus when faced with a 10% SSNIP in the cost of products falling within one of those groups (i.e. with, or alternatively without, answering machine) a significant proportion of consumers would be likely to switch to a product from the other group, indicating that these two types of product are in the same market.

108. Ofcom also considers that the use of either analogue or digital phones (that do not have answering machines) together with the voicemail services offered as part of line rental services (for example, BT’s free 1571 voice mail service) is a substitute for having a phone with an answering machine. This further supports the view that there is a chain of substitution between answering machines and phones with answering machines which therefore places both in the same market.

109. Ofcom therefore concludes that phones with answering machines are in the same product market as a similar phone without an answering machine. Figure 6 illustrates the demand side chains of substitution suggested by the analysis in paragraphs 100-109. In figure 6, the arrows point in the direction that the SSNIP test is undertaken. (e.g., the first SSNIP is to determine whether analogue prices constraint the ability of a hypothetical monopolist to raise DECT prices 10%).

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39 Ibid footnote
40 However to record a personalised greeting message using the 1571 service costs £1.50 per month
110. Ofcom has also considered whether demand side substitution is asymmetric across product groups, given that DECT phones are generally of a higher quality and have a higher functional specification than corded and cordless phones. While it may be the case that DECT prices constrain prices of analogue cordless and corded phones, it does not necessarily follow that the prices of corded and cordless analogue phones constrain DECT prices. For instance, consumers may not be willing to give up the mobility benefits of cordless as opposed to corded phones in response to a 10% SSNIP in DECT prices.

111. In summary, the complainants have argued that the relevant market is the cordless phone (or possibly the DECT) sectors in the UK. Ofcom's analysis suggests the presence of demand side substitution between top end and entry level phones, and between different product segments (corded, cordless analogue and DECT). This finding is supportive of a broad consumer phone market.

112. To put it another way, the data suggests that consumers looking to purchase a telephone for use on a fixed line look at a broad range of factors when deciding which phone to purchase. Those factors are likely to include price, features and style. In balancing these factors, individual consumers are bound to differ from one another in the value they ascribe to particular features (such as speaker function, number memory capacity, cordless mobility and digital reception). For some consumers, cordless mobility and/or digital transmission may perhaps have greater value than other features. Looked at overall, however, the range of available consumer phones offers prospective purchasers a great variation in possible combinations of styles, features and prices, and there is an approximate correlation between the feature set of particular consumer phones and their retail prices. In Ofcom's assessment, although certain consumer phones may have particular features (e.g. digital reception) which may be 'must have' or 'highly
desirable’ features for some (though not all) consumers does not, in the light of the available evidence, lead to the conclusion that those phones are in a separate market from other consumer phones.

113. In that regard, Ofcom notes that the consumer phone market is now largely comprised of DECT phones (80%). The fall in DECT phone prices between January 2002 and May 2005 of 48% (see price trends in Figure 4) has roughly coincided with the growth in DECT sales to the extent that DECT sales have comprehensively overtaken sales of cordless analogue and corded phones (see Figures 1 and 2). It appears, therefore, that the fall in DECT prices has led to large numbers of consumers buying a DECT phone who would otherwise have bought a corded or analogue cordless phone. The evidence provided by actual consumer behaviour therefore appears to support the conclusion that cordless analogue, DECT and corded phones are part of the same product market.

114. However, Ofcom has also recognised the possibility that there may be asymmetric demand substitutability, which could act to narrow the product market definition and has therefore also considered supply side substitutability.

Supply side substitution

Complainants’ views

115. The complainants have not directly commented on supply side substitutability. They have suggested, however, that, although in principle there should be low entry barriers to the UK wholesale market, BT’s alleged strategy of predatory pricing has effectively raised barriers to entry:

“There should be low barriers to entering the UK market for cordless telephones. The requirements include finding a suitable manufacturer in Asia, design and development work and obtaining BABT approval. However, BT’s strategy, and in recent months, its predation has resulted in new entrants rapidly exiting the market.”41

BT’s views

116. Ofcom has been provided with statements by BT which claim there is supply-side substitution between the wholesale of phone products. For instance, BT have commented that:

“There […] exists a high degree of supply-side substitution since branding and marketing assets used to supply one product type could readily be used to supply another. In the event of a 5-10% increase by a hypothetical monopolist of DECT phones, wholesale providers could easily increase their output of DECT phones by devoting more of their branding assets to this segment.”42

117. BT also stated that:

42 BT submission of 6 September 2005.
“While less relevant to market definition in supply, even at the manufacturing level most producers, capable of supplying one phone can produce the others as well implying the supply side substitution is also high at this level of the supply chain.”

118. In discussions with retailers, it has been suggested that factories in the Asia Pacific Region produce all electronic circuitry required for DECT and other product types, which suggests a capacity to substitute between product types with relative ease at the manufacturing level. For instance, Ofcom notes that firms presently supplying the UK market (e.g. Vtech) produce DECT, corded and cordless phones, and operate factories which produce circuitry for DECT analogue and corded phones. This suggests that at least some manufacturers can readily substitute production in-house from one product to another. Where manufacturers do not produce all circuitry in-house, it is likely that circuitry can be bought in from other manufacturers, given the standardisation of circuitry present in phones produced for the UK market.

119. Ofcom also recognises that contractual relationships between wholesalers and retailers, including commitments related to branding and marketing allow for some flexibility for wholesalers to apply branding and marketing costs depending on the popularity of various product models as agreed with retailers. This suggests marketing and branding assets can be relatively easily applied to different product groups.

Ofcom analysis

120. Ofcom notes that there are over 110 manufacturers of consumer phones in China (including Taiwan and Hong Kong). Some of these manufacturers (e.g. Vtech and BBK) make more than one type of phone (i.e. not only corded, analogue cordless or DECT, but two, or even all, of these types of phone). Furthermore, these manufacturers have considerable excess capacity which they could use to rapidly respond to an increase in demand (whether from the UK or elsewhere in the world) for consumer phones of any one of those types. Ofcom recognises that not all of these are able to supply to the level of quality and quantity needed for the UK market, however, the evidence does not suggest that a supplier is or was unable to obtain the manufacture of phones for the wholesale supply to the UK consumer phones market.

121. For instance, the manufacturer Vtech produces DECT, cordless analogue and corded phones and supplies UK compatible phones to BT for sale in the UK market. Vtech, along with many other manufacturers were reported to have excess capacity in 2005. Another manufacturer, BBK Communications, has 14 production lines for corded phones and 9 for cordless phones with excess capacity. It appears that Vtech, BBK Communications and many other SE Asian manufacturers produce DECT, cordless and corded phone models. It also appears that most manufacturers operate well under full capacity. Of the manufacturers interviewed in a recent business survey and operating in

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43 BT submission of 6 September 2005
44 Informal discussions with retailers and wholesalers during July 2005
46 Ibid., page 100.
47 Ibid., page 19. Vtech operated at 83% of capacity in 2005, with an output of 20 million units (maximum capacity was reported as 24 million units of output).
48 Ibid., page 58.
Mainland China, 80% operated at least 50% of capacity. In Hong Kong, more than 40% of firms operated at a maximum of 50% capacity.\textsuperscript{50}

122. Some manufacturing facilities are vertically integrated. For instance, VTech performs a full range of commercial activities in-house, from R&D, cosmetic design, mould making, plastic injection moulding, surface mounting, PCB sub-assembly, final assembly and quality control. Every process from design, manufacturing and assembly is implemented at the facility. Accordingly, some manufacturers can readily substitute production of one type of phone for another, by substituting inputs produced internally to the firm.

123. Ofcom considers it likely that non-vertically integrated manufacturing companies would also be able to source components from different suppliers and therefore be readily able to substitute production of one type of phone for another. This suggests that firms need not source components necessarily in-house, but can procure components from upstream manufacturers (e.g. a manufacturer could readily buy in DECT electronic circuitry in the event of a price rise in DECT phones).

124. In the light of these facts, Ofcom considers that wholesale suppliers of non-DECT phones would be able to respond rapidly to any price changes in a hypothetically monopolised DECT segment and undermine the profitability of a SSNIP. Those suppliers would, for example, have little difficulty in finding a manufacturer of consumer phones in the Asia-Pacific region who was willing to meet that wholesaler’s demand for DECT phones, whether by making use of excess capacity to increase production of DECT phones, or even by diversifying production from the manufacture of non-DECT to DECT phones. These considerations suggest a wholesale market broader than DECT phones.\textsuperscript{51}

125. It is important to distinguish the factors present in this case from those present elsewhere in communications sectors.\textsuperscript{52} Ofcom notes that as part of its ongoing market reviews, Ofcom has considered that supply side substitution is primarily informed by whether or not new entry would be likely in a 12 month period in response to a price rise in a relevant market, and not by whether existing companies who are present in both the relevant and adjacent markets could expand output in the relevant market. In particular, where a very small number of firms have similar shares in both markets, a price increase in the relevant market may not provide incentives for the same supplier to switch production from the adjacent to the relevant market, since this could lower profits for its product sold in the relevant market.

126. In this investigation Ofcom is considering a market with many wholesalers all competing across DECT, corded and cordless, and where there is considerable excess capacity in manufacture with shares that vary between the market

\textsuperscript{50} Ibid., page 19
\textsuperscript{51} If there was no excess capacity, it would be likely that there would be a delay in the ability of potential competitors to respond to the price rise due to the need to establish new manufacturing capacity and therefore a hypothetical monopolist of DECT might be able to raise prices profitably at least over the short term (up to one year).
\textsuperscript{52} It is important to note that the supply side substitution argument that supports a broader product market than DECT relies on the ability of many firms to take advantage of excess capacity in production, and where firms present in the production of DECT, cordless and corded have shares that vary between the products. It is reasonable to expect that at least some firms will have lower shares in say DECT than other products such that an increase in the DECT price will provide an unambiguous incentive for the supplier to switch its own production from corded or cordless to DECT, thereby lowering the DECT price and profitability of the DECT price rise.
segments. These differences allow for price rises in product segments to provide incentives for existing firms to expand output and the information on excess capacity suggests that output expansion would be feasible.

Summary

127. Ofcom considers that the evidence on both demand and supply side substitution is indicative of a wholesale market for fixed voice telephone equipment, given the observed spectrum of prices, functionality and quality. In summary, the reasons are as follows.

128. First, Ofcom's analysis shows that the proliferation of models and pricing points of DECT phones suggests that entry level and top end DECT phones are linked by chains of substitution. Therefore Ofcom does not consider the product market is defined narrowly by entry level, step up, mid or top end priced models. Ofcom suggests that this chain also exists within analogue and corded phones (between lowest and highest priced phone models).

129. Secondly, Ofcom considers that there is sufficient evidence of demand and supply side chains of substitution between product groups (eg between DECT, analogue cordless and corded phones) (see paragraphs 91 to 109) to support the conclusion that all of those product groups are within the same market.

130. With regard to demand side substitution, Ofcom notes that DECT phones now represent 80% of the consumer phone market by sales revenue. The decline in the sales of non-DECT consumer phones as a proportion of the total number of consumer phones sold has coincided with a fall in the price of DECT consumer phones (see Figures 1, 2 and 4). This suggests that large numbers of customers who would previously have purchased an analogue cordless or corded phone have been persuaded to 'trade up' to a DECT phone because of the lowering of DECT phone prices. Indeed, in the future, as a result of the likely continued decline in the corded and analogue cordless segments of the consumer phone market, a future consumer phone market could potentially be comprised almost exclusively of DECT phones.

131. With regard to supply side substitution, on the basis of the matters considered at paragraphs 115 to 126 above, Ofcom notes that wholesale suppliers of corded and cordless analogue phones, such as BT and Binatone, also supply DECT phones. Existing wholesale suppliers of consumer phones could therefore be expected to respond to a 10% SSNIP in the price of DECT phones by increasing their purchases of DECT phones from manufacturers in the Asia-Pacific region. Ofcom considers there to be little or nothing to constrain existing manufacturers of corded and/or analogue cordless phones from responding to increased demand for DECT phones by increasing or commencing DECT phone production.

132. Indeed, given the large number of manufacturers of consumer phones worldwide, Ofcom considers that the larger wholesale customers of DECT phones (e.g. Argos and other large retailers of consumer phones) would be reasonably able to respond to a 10% SSNIP in DECT phone prices by bypassing wholesale suppliers, sourcing phones directly from manufacturers in the Asia-Pacific region. This has been illustrated by Argos, which has recently begun to source phones directly from a South Eastern Asian manufacturer, those phones being marketed...
to consumers under a brand name which Argos has been licensed to use for that purpose.

133. Taking all these considerations together, Ofcom is therefore of the view that all consumer telephone handsets intended for use for voice calls over fixed lines appear to be in the same product market.

134. Nevertheless, Ofcom recognises that its analysis is not necessarily conclusive and that Ofcom’s indicative market definition is broader than that suggested by the complainants. Accordingly, Ofcom has considered whether alternative market definitions could result in a different conclusion on dominance. In particular, Ofcom has considered an alternative (narrower) market definition based on DECT as part of its dominance assessment (Ofcom has chosen to look at DECT particularly given the similarity between the cordless and DECT segments of which DECT accounts for at least 90% in value terms).

135. Ofcom considers that this narrower market definition would not alter Ofcom’s conclusion on dominance. Ofcom notes, in that regard, that around 80% of consumer phones sold in the UK are now DECT phones, and that Ofcom’s analyses of levels and changes in market share,\(^{53}\) countervailing buyer power, pricing analysis and barriers to entry, exit and expansion, would not be significantly affected by a market definition that comprised only DECT, or only cordless, phones. Accordingly, Ofcom has not considered it necessary to undertake further work to enable itself to reach firm conclusions on which of these possible definitions of the relevant product market is correct. Whichever is correct, Ofcom’s conclusion on whether or not BT was dominant on that market would be the same.

**The relevant Geographic Market**

**Complainants’ views**

136. The complainants suggest that the geographic market is the UK. In particular, they argue that, “while there are no regulatory barriers to the supply of fixed line telephones to the UK from continental Europe, or indeed elsewhere, the pricing strategy of BT has in effect insulated the market from external competition by the large European suppliers”\(^{54}\).

**BT’s views**

137. BT submitted that the relevant market may be limited to the UK as conditions of competition appeared to be appreciably different between the UK and other European countries for the following reasons in particular:

- Unlike the UK, some countries have greater investment in richer telephone equipment features.

- Fixed-line platform service is less sophisticated in the UK than in the rest of Europe, for example multi-media messaging (‘MMS’) is available on fixed-lines in some parts of Europe. An MMS-enabled phone from elsewhere in Europe would not function in the UK.

\(^{53}\) While it is the case that BT’s share of the DECT market is lower than for the overall consumer phone market, Ofcom does not consider this would alter its dominance finding.

\(^{54}\) Complainants’ letter to Ofcom of 29 March 2005
• Differences in consumer tastes have lead to differences in phone design and features such that a phone developed for the marketplace in Germany may not necessarily appeal in the UK.  

Ofcom’s analysis

138. To determine whether the market is limited to the UK or whether it may be larger (e.g. including the rest of Europe or a world-wide market) it is relevant to test whether retailers would consider purchasing phones from wholesalers abroad or direct from the manufacturers in response to a 10% rise in UK fixed line wholesale consumer telephones prices. Ofcom also considered supply-side opportunities for wholesalers overseas to supply phones to the UK market.

139. However, all phones currently supplied in the UK are manufactured overseas, predominantly in the Asia-Pacific region, to the technical specifications required by UK customers. Whilst it would be possible for manufacturers in any country worldwide to supply the UK market, they would need to manufacture the phone to the technical specifications and to the consumer preferences required in the UK.

140. There is some evidence to suggest that there are some upfront costs in producing a version of a DECT phone suitable for the UK market, compared to the rest of Europe. In particular, Ofcom has spoken to one supplier who has indicated that slightly different phone standards apply between the UK and some countries in the rest of Europe, such that some phones may not be fully compatible with the UK fixed-line network. However, the costs to a manufacturer to configure a phone for the UK market are small.

141. The basic telephone marketed in Europe (including the UK) appears the same irrespective of destination market. Packaging, instructions power and telephone cable are, however, country specific. One supplier claims set-up cost arising from these set up costs should not exceed £2 per unit.

142. Another estimate suggests the cost of adaptations to the plug to be around $0.50 per unit. Another supplier estimated EUR0.15 for adapting the power supply and EUR0.15 for adapting the plug. One supplier argues that only the cost of changes to the plug/adapter would be material costs of switching production to the UK market.

143. This suggests that the substituting production from phones intended for the Continental European market to UK compatible phones may not be costly. This could suggest that a 10% SSNIP increase in the price of UK compatible phones could reasonably be expected to result in a shift in production to UK compatible phones, such that the price increase in producing UK compatible phones is not profitable. This would then suggest a chain in the supply side substitution between production of UK compatible phones with production of Continental European compatible phones.

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55 BT Submission, 6 September 2005.
56 [supplier], S26 response [date].
57 [supplier], S26 response [date].
58 [supplier], S26 response [date], paragraph 2.
144. Ofcom notes that most suppliers (although not BT) sell the same model of phone across Western Europe. For example, the Panasonic TCD200 model is available in France, UK, Germany, Spain, Poland, and Czech Republic amongst others.\(^6\) Similarly Phillips and Binatone also offer the same model in the UK and other European countries.

145. Ofcom recognises that there is an argument in support of a wider market definition: for example, international wholesale distribution of fixed-line consumer telephones. Indeed, as already noted above, [a retailer] has demonstrated the existence of the possibility of UK retailers bypassing their existing suppliers and sourcing phones directly from manufacturers in the Far East. This would appear to suggest that opportunities exist for UK retailers to directly source phones from any one of a large number of phone manufacturers around the world.

146. If the relevant market were not limited to the UK, BT’s share of that market would be very small. Estimated DECT phone production from China, Hong Kong and Taiwan in 2005 is 115 million units.\(^6\) Assuming other countries contribute a further 10 million units implies a worldwide production of 125m. BT’s market share in the worldwide DECT ‘market’ is therefore less than 2%.

147. Another estimate\(^6\) which put worldwide production at 130 million in 2003 estimated that 90% of these units were sold within western Europe. Again this would indicate that BT’s share of the wholesale DECT phone ‘market’ in western Europe was less than 2%.

148. However, Ofcom notes the representations made by the complainants that the market is limited to the UK. Ofcom believes that there is some force in the observations of the parties that the characteristics of actual competition in the market would (leaving aside Argos’ recent ‘self-supply’ activities) appear to suggest a UK market, given that the identities of the key players in that market and their market shares are distinct to the UK. Accordingly, Ofcom has, for the purpose of its analysis, taken the view that the market is restricted to the UK, i.e. the narrowest reasonable geographic market.

149. That does not, of course, render irrelevant the demonstrated ability of certain purchasers in that market to source supplies from suppliers outside the UK who were not previously engaged in direct supply to UK retailers. Ease of entry to the UK market from suppliers worldwide has been considered in the section on barriers to entry below.

**Conclusion on Relevant Market**

150. Ofcom has taken as the relevant market, for the purpose of its analysis of BT’s competitive position, the market for the wholesale supply within the UK of all consumer telephones that are complementary to the consumption of fixed line voice communications services or the wholesale supply of DECT telephones within the UK (i.e. the wholesale market for consumer phones sold in the UK and designed to be used for voice calls over fixed lines (“consumer phones”)).

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\(^6\) [https://secreg.globalsources.com](https://secreg.globalsources.com)

\(^6\) [http://www.dectweb.org](http://www.dectweb.org)
Dominance Assessment

BT's Position within the Relevant Market

151. As already noted at paragraph 47 above, the legal test for dominance is: "the dominant position thus referred to by Article [82] relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers".

152. Ofcom has therefore considered a number of factors in assessing BT’s market position in terms of whether it has the power to behave to an appreciable extent independently of its competitors, customers and/or consumers. The factors that Ofcom has considered have included evidence on market shares over time (of BT and its competitors), as well as evidence concerning countervailing buyer power, barriers to entry and historical price trends in the relevant market, all of which might potentially be relevant to the extent to which BT is constrained by its competitors, customers and consumers.

Market Shares

153. As a starting point, Ofcom has considered market shares over time of BT and its competitors.

154. In its guideline Assessment of Market Power, the OFT notes: “There are no market share thresholds for defining dominance under Article 82 or the Chapter II prohibition. An undertaking’s market share is an important factor in assessing dominance but does not determine on its own whether an undertaking is dominant”.

155. The ECJ has given indications about market share thresholds in the context of Article 82. However market shares will always be considered alongside other factors to assess market power:

- In Hoffmann-La Roche, the ECJ said: “...Furthermore although the importance of the market shares may vary from one market to another the view may legitimately been taken that very large market shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position. An undertaking which has a very large market share and holds it for some time… is by virtue of that share in a position of strength.”

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• In *Hoffmann-La Roche*, market shares over a three year period of between 75%-87% were held by the ECJ to be so large that "they are in themselves evidence of a dominant position".66

• In *AKZO*, the ECJ found that dominance was to be presumed in absence of contrary evidence if an undertaking has a market share persistently above 50%.67

• In *Hoffmann-La Roche* the ECJ overturned the Commission’s finding of dominance in relation to the vitamin B3 market where Roche’s market share was 43% but where the Commission had not provided evidence of sufficient additional factors to evidence dominance. Equally, in *United Brands*, a market share of between 40% and almost 45% was found not to permit an automatic conclusion that the undertaking concerned controlled the market. The ECJ noted, however that in the circumstances of that case United Brands was dominant, in particular due to the fact that its market share was several times greater than its closest competitor. It said: "This fact together with the others to which attention has already been drawn may be regarded as a factor which affords evidence of UBC’s preponderant strength."68

• The OFT states that it considers it unlikely that an individual undertaking would be dominant with a market share of below 40% but it acknowledges that, if other factors are present such as the weak position of competitors in the relevant market, dominance could be established even with market shares below 40%.69 In *Virgin/British Airways*70, the Commission found that BA was dominant in the UK air travel agency services market with a market share of 39.7%. The CFI upheld the finding of dominance on appeal.

Complainants’ submissions on market shares

156. The complainants submit that BT’s market shares demonstrate its dominant position. They allege that BT has a very high share of DECT supply, digital cordless telephone supply and fixed line telephone supply in the UK. In respect of DECT, which the complainants submit is the only area for growth in the UK, the GfK data indicate that BT’s market share is increasing and, when measured in terms of value has consistently been above 48% in the last twelve months, and when measured in terms of volume, rarely below 46%.

157. The complainants alleged that the GfK data significantly underestimates BT’s market share for the following reasons:71 (i) omission of BT’s direct sales which the complainants expect to increase BT’s share by 5%; (ii) omission of coverage of sales made by smaller retailers who are supplied by wholesalers such as ECD, inclusion of which would increase BT’s market share by a further 2%. Accordingly, the complainants argue that the market share estimate set out in GfK data should be considered an under-estimate of BT’s true market position. The complainants suggested that a further 7% should be added to the estimate of BT’s market share.

66 Ibid, paragraph 56.
67 Case C62/86 [1991] ECR 1-335
69 Assessment of Market Power, paragraph 2.12
71 Also set out in Binatone’s response of 5 September to Ofcom’s Section 26 Notice.
158. Further, the complainants submitted that BT’s ability to act independently of suppliers is further seen in its ability to increase its market share at will through its behaviour. The complainants note that the most important period for suppliers of fixed line telephones and in particular DECT, is the pre-Christmas period. The complainants’ commercial judgement is that in November and December, 40% of the annual value of sales of DECT phones to consumers is obtained. They note from the GfK data, that BT’s market share increases substantially in this period, for example, in December 2004, BT’s share in terms of DECT was 56.4% (value) and 55.3% (volume).

159. The complainants claim that BT is increasing its already high market share in periods of high volume by "playing its portfolio", for example by moving into the low value segment of the market in the pre Christmas period. The complainants allege that in the pre-Christmas period BT will sell its fixed line telephones at very low prices that "B" brands cannot meet. The complainants allege that as a result, in the pre-Christmas period in 2004, BT had a 67% share of sales of fixed line telephones sold below £30.00.

160. The complainants query whether Ofcom’s market share analysis is complete, arguing that Ofcom should include BT’s share of supply via its rental business. The complainants consider that BT is supplying a significant number of new telephones to its existing rental base pursuant to its rental maintenance obligation. The complainants estimate that 300,000 telephones per year are supplied by BT to its rental customers. The complainants argue that if these customers were unable to gain access to a replacement BT phone, these customers would be available to other suppliers. Accordingly the complainants argue that the supply of phones to these customers should be included in BT’s share of the consumer fixed line telephone market.

**BT’s comments on market shares**

161. BT submitted that since 2000, BT’s revenue share of the market for all fixed line telephone receiving equipment has ranged between 41% and 51%, while its volume share has ranged between 33% and 44%. BT believes that BT’s higher share in value terms is explained by the fact that most of the phones supplied by Binatone, its largest competitor, are in the lower priced segments of the market. As a result, Binatone’s volume share was 29% in 2004, while its share in terms of value was only 18% that year. Given Binatone’s focus on the lower-price segments of the market, market shares by value will generally overstate BT’s position in the market as a whole.

162. BT added that given the degree of innovation and the low entry barriers present in the industry, individual market shares will provide a poor indicator of market power.

163. BT alleges that the market share history since 2000 shows evidence of both new entry and market share volatility with market shares of all players in the industry exhibiting considerable fluctuations. BT gave the example of Philips which has gone from being the “undisputed number two” in the DECT segment in 2000-2001 to fourth place in 2004-2005, with both Panasonic and Binatone moving ahead of Philips in the market. BT’s annual share of the DECT segment by value has been as low as 37% and as high as 49%, with year-on-year fluctuations of as much as 7%.
Ofcom's view

164. Ofcom had been provided with market data from BT, Binatone and Panasonic. The data provided by both BT and Binatone is from GfK, and BT, Binatone and Panasonic have provided additional in-house data on sales. Subsequent to its 1st draft decision, Ofcom also obtained market share data from Mintel.72

165. GfK is a market research company (based in Germany), and provides widely used market share data. Both BT and Binatone subscribe to GfK’s service which tracks sales of consumer telephone equipment in the UK by retailers to consumers and provides the information in the form of monthly sales including by product types, model types, and wholesale supplier. GfK is also widely used by retailers and wholesalers.

166. Both BT and Panasonic have indicated that in their view the GfK data is a fair and accurate reflection of their respective sales in the retail consumer telephone sector.73 As demand in the wholesale market is derived from demand in the retail sector, Ofcom considers this source to be a reliable starting point for estimating for market shares in the wholesale market. Ofcom notes two possible difficulties in using the GfK retail market shares as a proxy for the wholesale market shares:

- incomplete data; and
- timing differences

Incomplete wholesale market data

167. While the complainants have provided GfK data to Ofcom in support of their allegation that BT’s market shares suggest BT is likely to be dominant, as noted above, the complainants have argued that the data represents an underestimate of BT’s underlying market share because the GfK data omits sales via:

- direct sales to consumers (both BT and Panasonic supply direct, e.g. via their websites); and
- smaller retailers through distributors such as East Central Distributors (a customer of BT) and Rocom.

168. The GfK data is compiled from sales at the retail level. GfK obtains this data from all significant retailers of fixed line telephones in the UK. GfK does not monitor the sales of smaller and less significant retailers, or those made direct by BT through BT Direct (see below). While the sample population collected by GfK each month will differ, GfK claims that it captures approximately 90% of retail sales of fixed line telephones made within the UK.

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73 BT stated the following “BT considers that the GfK data is representative of its sales to consumers of telephone equipment, other than sales made through BT’s “direct” channels which, as Ofcom will note from the data provided by BT on 19th of August 2005, amounted for the year 2004/2005 to only [x%] units (approximately [x%] of total telephone equipment volumes).” Panasonic states in relation to GfK data “Taking the volume figures over the whole period [January 2002 – May 2005], the GfK data is consistent with our data, showing sales in at approx 10% greater level than sales out, which would be accounted for by stock holding and distribution time lag. Accordingly we would confirm that the [GfK] data represents a fair and accurate estimate of our sales of the relevant product.”
169. A limitation of the GfK data set is that it excludes direct sales, such as sales made by a supplier through the Internet. Ofcom notes that BT provides a direct retail service to consumers as does Panasonic, whilst other suppliers (such as Binatone) operate solely through distributors or retailers. There is a risk therefore that excluding these sales would understate BT’s share of the relevant market. BT has provided Ofcom with details of its direct sales which amount to less than [0-5]% of its total sales and, where appropriate, Ofcom has adjusted GfK data to include this additional market share. Ofcom has also obtained additional data from Panasonic to ensure that all relevant sales are included in the market share data analysis.

170. Arguably, because the relevant market considered in this complaint is the wholesale distribution market, direct sales should be excluded in any event. However, Ofcom has included direct sales within its dominance assessment because Ofcom does not consider that inclusion or exclusion of these sales alters its dominance assessment.

171. The retail sector not included in GfK data arises from sales made by small retailers typically supplied by electrical wholesalers. The complainants’ argument that BT has a disproportionately high share of one particular distributor’s sales does not mean that it has a disproportionately high share of all the retail outlets not covered by the GfK data. In Ofcom’s view, the evidence does not suggest that BT’s market share of the retail sales not included in the GfK data is materially different to that of the retail sales included in the GfK data. For completeness, however, Ofcom has sought sales data relating to East Central Distributors. This data indicates the proportion of BT phones sold through ECD’s is not significantly different to BT’s share of retail sales among major retailers.74

Timing differences

172. The retail GfK data reports “sales out” at the retail point of sale on the date the consumer buys the phone. However, the relevant date for the wholesale market is the date the sale of the phone from the supplier to the retailer is invoiced to the retailer (which may be significantly earlier).

173. In a volatile market it is possible that these timing differences could lead to material, but temporary, differences in market shares at the wholesale and retail level. Over time, however, any differences should even out as underlying shifts in market shares at the wholesale level take effect at the retail level.

174. BT, Binatone and Panasonic have indicated that the presence of time lags and warranty returns make reconciliation of the GfK data and in-house data difficult. For instance BT states that:

- “The data BT has provided covers sales to BT’s own customers, whereas the GfK data covers sales by those customers to the consumer end user. There can be a time lag of anywhere between 1 and 6 months for products sold in to retailers to be subsequently sold on to consumers. It is impossible for BT to know when a product sold to the retailer has been sold on by that retailer.”; and

74 Data relating to ECD sales provided by BT (email dated 6 October 2005).
• “Warranty returns are also an issue in reconciling the different sets of data.” [75]

175. Panasonic has also made a similar observation:

• "As far as the reliability of the GfK data is concerned, neither volume nor value can be readily reconciled on a monthly basis. In respect of volume, the time between our sales in to retailers and their sales out to end users is variable, dependant both on the retailer concerned and general market conditions."[76]

176. Finally, Binatone states:

• “Binatone’s data records sales at a different level of the market to the sales recorded by GfK. Accordingly, any comparison between the data would be of limited value.”[77]

177. Notwithstanding these limitations, Ofcom considers that:

• Overall, BT and Panasonic consider that the GfK data is reliable and accurate for the purposes of estimating market shares in the retail consumer telephone market, and is therefore a reliable estimate for upstream shares in the derived wholesale market; and

• the complainants have relied on the use of GfK ‘retail’ data in support of their allegation of high market shares in the wholesale market, and have identified omitted sales figures that could lead to the GfK data underestimating BT’s share of the wholesale market. Ofcom has considered these potential omissions in assessing the market share position as already set out above.

Market share analysis

178. Figure 7 and Figure 8 illustrate suppliers’ market shares in the fixed line communications equipment market from January 2000 to May 2005.
Source: GfK, BT

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78 For the period June 2005 to November 2005, data on market shares was available for Binatone, BT, Cable and Wireless ntl, Onetel, Panasonic, Philips, and other category only. The other category does not include named suppliers referred to in the legend to the figure.

79 The BT share (including direct sales) is adjusted (between April 2002 and May 2005 to provide an indicative share inclusive of sales through BT direct. Ofcom only has data on volumes sold through BT Direct and has therefore used percentage of volume sales as a proxy for additional revenues earned through BT Direct sales.
179. The complainants argue that Ofcom should re-consider sales made through the following sales channels: via BT.com, sales made via telephone purchases, new rentals, sales to staff, supply of phones to maintain the installed rental base, internal supply (i.e. within the BT Group), and sales made via direct promotion and co-promotion (e.g. advertisements in communications with fixed line telephony customers, responses to telephone enquiries, newspaper and other promotions).\textsuperscript{80}

180. Ofcom notes that the GfK sales data on all consumer phones include the following:

- Retail sales of corded, analogue cordless, and DECT phones
- Sales of phones with and without answering machines
This incorporates approximately 90\% of retail sales in the UK.

181. Ofcom notes that the GfK data does not include the following;

- rental sales
- self supplied volumes by BT (i.e. internet sales through BT Direct)
- self supplied volumes from any other supplier
- internal sales

182. The Mintel sales data include the following:

- Manufacturer sales of corded, analogue cordless and DECT phones
- Sales of phones with and without answering machines

183. The Mintel sales data do not include the following:

- rental sales

184. Ofcom has assessed market shares using GfK data derived from point of sale figures effectively measuring wholesale market shares via retail sales. We have also considered the Mintel data shares and methodology (see paragraph 170).

185. Ofcom has included the following additional sales (to the extent covered by BT Direct sales) in its market share analysis:

- via BT.com, and
- sales made via telephone purchases.

186. Ofcom has not included the following additional sales within its analysis of market shares:

- new rentals,
- supply of phones to maintain the installed rental base,
- sales to staff,
- internal supply (i.e. within the BT Group), and
- sales made via direct promotion and co-promotion.

\textsuperscript{80} Complainants’ 7 June 2006 letter, page 3, paragraph 13.
187. Ofcom has considered the complainants’ argument that sales of new phones to existing and new rental customers be included within the estimate of BT’s market share.

188. Ofcom has analysed the rental segment and considers that rental phones are not within the relevant wholesale market and therefore does not consider them further within its market share analysis (see paragraphs 69 to 85).

189. Ofcom has also considered the complainants’ argument that sales to staff, internal supply and sales made by direct promotion and co-promotion should be included in market share estimates (to the extent that they represent additional sales to that measured by the GfK data)\(^{81}\). Ofcom does not consider these additional sales further on the grounds that the relevant market considered in this complaint is the wholesale distribution market, and that the sales suggested by Binatone appear largely to fall outside this group.

Analysis of market share

190. BT has been the largest single supplier in the relevant market throughout the period January 2000 to January 2005. During this period, BT’s volume share was as low as 29% at January 2000 and as high as 56% at December 2004. BT’s average market share for the period December 2003 to November 2004 was 44% and for the period December 2004 to November 2005 was 44%.

191. BT’s market share measured by value is higher than that when measured by volume. BT’s market share by value exceeded 50% in December 2001 (52%), July 2002 (52%) and December 2003 (51%). BT’s share was consistently above 50% from June 2004 to May 2005, peaking again in December 2004 (59%). Binatone have claimed that BT has “played its portfolio” over this period, by lowering prices of its sub £30 phones to gain share. Ofcom notes that BT’s share is higher during pre-Christmas periods than in other months, reflecting its better sales performance during this period. The evidence also suggests that BT’s share of the sub £30 phone segment is higher at this time (67% as at December 2004)\(^{82}\). However, this share is not sufficiently above its share of this segment at other months to suggest a significant shift in its sales portfolio at the pre-Christmas period (e.g. BT’s share of the £20-£29.99 segment was only slightly less at July 2004 (63%)\(^{83}\).

192. Ofcom notes BT’s claim that shares measured by value will tend to overstate BT’s market share in volume terms, since Binatone’s portfolio of lower priced phones lowers Binatone’s value share for the market as a whole, which must therefore necessarily raise BT’s relative value share. Ofcom has not been able to substantiate whether in fact BT’s portfolio of products has remained stable over time, or whether the mix of products has changed toward lower priced products over the period, which would negate the possible overstatement of market share effect suggested by BT. However, BT’s high share of the sub-£30 segment of the market suggests that BT may have gained an increasing presence in the entry level segment, in which case BT’s claim that the value share overstates its market share could be less convincing.

\(^{81}\) Complainants’ 7 June 2006 letter, page 3, paragraph 13
\(^{82}\) Source: GfK data provided to Ofcom by Binatone.
\(^{83}\) Source: GfK data provided to Ofcom by BT. Note that this estimate excludes phones in the £0-£19.99 ranges.
193. Since December 2004 (BT’s highest recorded monthly share) data shows that BT’s share has declined in both value and volume share measures. In terms of volumes BT’s share has fallen from 49% to 41% (as at November 2005) and in terms of value, from 59% to 45% (as at November 2005). BT’s average market share for the period December 2003 to November 2004 was 49.8% and for the period December 2004 to November 2005 was 50.2%.

194. Accordingly Ofcom has considered both value and volume share measures, and therefore incorporates the higher measure of market shares within its dominance assessment (i.e. value based share measures).

195. As this case is specifically concerned with BT’s pricing of DECT phones, Ofcom has also considered BT’s market share for this particular product. Figure 9 shows BT’s share by volume of the DECT phone sales.

Figure 9 Shares by volume, DECT, 2000-2005

Source: GfK, BT

196. Figure 9 highlights the significant fluctuations in volume share that are evidenced in the growing DECT segment of the market. For example, Philips was in some months in early 2000 the largest supplier in the segment (39% in April 2000). Since than, Philips’ brand share fell to a low of 4% in August 2004, and then recovered to 8% in November 2005. Binatone, who started as third or fourth largest in the segment are now the second largest supplier in the segment. Notwithstanding this movement in shares, BT has been the largest supplier in the segment since mid 2001 and the trend in BT’s shares has been upward during this period. Figure 10 illustrates a similar picture for DECT shares by value.

197. In Figure 9, in contrast to Binatone’s decline in value share (from 21.6% in January 2004 to 13.2% in November 2005), it appears that competitors Panasonic, Philips and Onetel, have made material gains in market share. Over

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84 BT share is inclusive of sales volumes through BT Direct.
the same period, Panasonic increased its share from 11.4% to 16.2%, Philips from 8.5% to 10.1% and Onetel from 0% to 4.6%. At November 2005, Panasonic had overtaken Binatone as the second largest supplier (by value share) in the DECT segment.

**Figure 10** Shares by value, DECT, 2000-2005

Source: GfK, BT

198. Ofcom has also considered market share data published by Mintel International Group Ltd (Mintel). The Mintel data on brand shares is collated through trade interviews and discussions with industry participants. The interviews and discussions are held primarily with consumer phone manufacturers (note that this approach contrasts with that taken by GfK, where market share estimates are based on data supplied by retailers).

199. The Mintel survey is undertaken every two years, with the most recent survey published in March 2005. For this report, data was collated in autumn 2004. Ofcom understands that estimates of brand shares in 2004 reflect a combination of actual data, depending on manufacturer between 6 and 9 months, with the remaining months estimates based on forecast sales. Prior to publication, the data is collated, and Mintel submit the results to the manufacturers who participated in the survey for confirmation and final check of the brand share estimates.

200. In their 19 June 2006 submission, the complainants have criticised Ofcom’s use of the Mintel report which they consider to be "a badly written, poor researched
and inaccurate report”. The complainants comment that “the basis on which the Mintel market shares are calculated are not totally clear” and yet they note that Ofcom considers the estimation method “a reasonable method for estimating market share.”

201. In contrast, BT made the following comments on the Mintel report:

- It is produced by a well respected international marketing intelligence organisation operating across a range of industry sectors, whose reports are industry recognised and widely used;
- It appears to be very comprehensive, and is transparent about the methodology used which suggests that the authors are confident of the validity of their findings;
- the confidence levels stated are high and suggest that the findings are representative;
- some of the market size data is sourced from GfK itself.

202. Ofcom notes that, contrary to the complainants’ allegation, Ofcom has not heavily relied on the Mintel report, but simply used it as an additional source of perspective on the market. Ofcom notes the complainants’ comment that the Mintel data does not sufficiently capture the effect of predatory activity on monthly market shares and therefore is deficient for the purpose of this investigation. Ofcom considers that although the annual data does not cover the entire period of the alleged abuse, it does provide insights into BT’s share in 2004, which does fall within the relevant period for the investigation and will reflect an average of monthly market shares over this period of the investigation.

203. The following figures illustrate the Mintel estimates of supplier market share in the cordless telephone segment (note the cordless segment of the market represents 92% of the value of the overall market). In Figure 11 below, BT’s market share by value increases slightly over the period 2000-2004 from 40% to 42%.

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87 The complainants submitted, in their 19 June 2006 letter, that the Mintel report contains a number of errors, including:
- The reference to Betacom having a large market share and the reference to the growth in Betacom’s market share from 4-11% in 2004. The complainants strongly doubt that this is correct;
- Figure 21 shows BT’s market value at retail as £102.2 million. The complainants believe this is wrong and that BT was achieving this level in terms of trade value, not retail value in 2004/2005;
- the reference to entry by newcomers Sagem, Doro, and Siemens indicates the author was not aware of market developments. The complainants submitted that all these suppliers have been unsuccessful and withdrew following pressure placed by BT.

Ofcom notes the complainants’ specific points of detail. However, as set out at paragraph 202, Ofcom has simply used the report as an additional perspective on market shares. Ofcom has considered the complainants’ comments in relation to BT’s retail market sales and notes that these reflect product groupings, timing and methodology used by Mintel to size the market. In Ofcom’s view, the most useful measure from the Mintel market analysis is the relative market share rather than the absolute value.

Further, Ofcom notes that the complainants submitted that the Alba group (who brands telephones under ntl, Cable and Wireless and Betacom) has or is intending to exit the market. In this regard, Ofcom has been informed by Alba plc (Alba) that it is not exiting the consumer phones market (4 July 2006 telephone conversation between Tanya Rofani and [Alba]). In addition, Ofcom notes that Doro is still active in the consumer telephones market.

89 Email from BT to Ofcom dated 15 June 2006.
90 Complainants’ 7 June 2006 letter, paragraphs 11-12.
91 Mintel report, figure 13, page 27.
The Mintel data suggest that Binatone’s share of the cordless segment has increased over the same period from 14% to 23% (£22.1 million to £56.1 million).93

**Figure 11** Share by value, cordless, 2000-2004

Source: Mintel

204. The annualised Mintel market share estimates also suggests a degree of volatility in competitor market shares over the period 2000-04 (for example, Binatone’s market share increased 9 percentage points between 2000-04, whereas Philips lost 9 percentage points over the same period).

205. Typically, the market share data published by Mintel suggests a lower market share for BT and a higher share for Binatone than that published by GfK. Mintel have suggested that as the retail survey conducted by GfK excludes some retailers, it may inflate BT’s share.

206. Ofcom considers the method of estimation (through trade interviews and discussions with industry participants) to be a reasonable method for estimating market shares. Therefore, Ofcom considers that the Mintel report provides a useful secondary source of information regarding market shares which provide a different perspective on market shares from that provided by GfK data alone. In Ofcom’s view, it is likely that BT’s true market share lies somewhere between the range suggested by the higher GfK market share estimate and the lower Mintel market share estimate. Nevertheless Mintel’s estimates of market BT’s market shares for BT are lower than those derived from GfK data. However, Ofcom’s

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92 The market share estimates for corded phones suggest a slightly lower market share estimate for BT, with BT’s share of the corded market increasing over the same period from 28% to 30% (£9.8 million to £4.8 million).

93 In contrast, Binatone’s share of the corded segment of the market has fallen over the same period from 26% to 14% (£9.1 million to £2.2 million). It is worth noting that the value of corded segment has fallen from approximately £35 million to £16 million over the period 2000-04, representing a 54% reduction in the size of that market segment.
dominance assessment has not relied on either the lower Mintel figure or a figure between the Mintel and GfK figures – rather the higher GfK market share has primarily been used.

Conclusion on market share

207. The complainants have suggested that BT’s market shares support a finding that BT is dominant. The complainants argue that:

- BT’s value and volume shares are substantially larger than any other supplier.

- BT’s market share is consistently above 50% from June 2004 to May 2005 and it reached 59% in December 2004.

- A market share of 50% or more results in a presumption of dominance in the absence of exceptional circumstances for which the burden of proof rests with the undertaking. The complainants argue that no such exceptional circumstances have been demonstrated in this case.

208. Ofcom agrees with Binatone that (as shown by the GfK and Mintel data) BT’s market share is substantially higher than that of any other supplier, and that its value share of all consumer phones exceeded 50% for most months between June 2004 and May 2005. However, Ofcom considers the evidence that BT’s market share is persistently in excess of 50% to be more mixed than suggested by the complainants.

209. Ofcom accepts that BT’s market share based on GfK value share data was at least 50% for the period June 2004 to May 2005 (12 months). However BT’s GfK value share was below 50% between January 2003 and May 2004 (excluding December 03, when it was 51%) and fell below 50% in the four months August 2005- November 2005. The Mintel value data shows that BT’s value share of cordless phones was around 41% in 2002 and 42% in 2004. Ofcom notes that Mintel’s estimates of BT’s market shares for BT are lower than those derived from GfK data. However, Ofcom’s dominance assessment has primarily used the higher GfK market share.

210. Further, GfK data indicates BT’s market share by volume exceeded 50% only in one month (December 2004), during the period January 2000 – December 2005... The data indicates some variation in market shares, suggesting that there are opportunities to grow and expand in this market, as well as contract. Analysis conducted since June 2005 suggests BT has lost market share by value for all consumer phones. Accordingly, it appears the upward trend in BT’s market share in 2004/05 has reversed. Ofcom also notes that in the DECT segment, Panasonic have overtaken Binatone during 2005 to become the second largest supplier in that segment (by value share). This suggests competitors have been able to expand in the market. This further suggests that BT cannot necessarily maintain its market share at previous levels. Ofcom considers that this is a factor counting against the argument that the market share evidence points to dominance for BT.

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95 Letter from complainants, 4 November 2005, paragraph 9, page 2.
96 Ibid, paragraph 10 – 12, pages 2-3.
97 2004 figure is an estimate, based on 6-9 months actual, 3-6 months forecast.
211. Ofcom has considered other factors in the market (set out from paragraph 213 onwards) including pricing behaviour, barriers to entry, expansion and exit, and countervailing buyer power in order to assess BT’s market power. These factors collectively demonstrate, in Ofcom’s view, that BT cannot act independently of competitors, customers or consumers.

212. In Ofcom’s view, the conclusions on market share are not affected by consideration of BT’s share of the narrower cordless or DECT segments. In that regard, Ofcom notes that BT’s shares of the cordless and DECT segments are broadly in line with its share of the relevant market as a whole. BT’s share of the DECT segment by value is generally lower than for all consumer telephones, and in the case of volume shares, BT’s share of DECT is similar to BT’s share of all consumer phones. The broad similarity between BT’s market share and its share of the DECT segment is unsurprising given that DECT phones now account for around 80% of all consumer phone sales.

Pricing

213. Ofcom has also considered pricing data to establish whether BT has been able to price independently of the market over time.

214. The ability of a firm to behave independently of its competitors can often be observed by the firm’s ability to command a higher price (and margin) from the same or similar products as competitors. This could be, for example, because the firm has a superior brand or superior technology.

Complainants’ views

215. The complainants have submitted that BT is engaging in predatory pricing and that this behaviour is, in itself, evidence of its dominant position. The complainants have not submitted any evidence of BT having commanded a higher price in the market.

216. The complainants have submitted that the fact that BT’s prices have not moved independently from those of other suppliers or the market average only provides evidence that BT has not yet exercised market power to elevate prices, despite its market share.

BT’s views

217. BT submitted GfK average price data and the monthly average prices for the major DECT brands from 2000-2005, as well as the average price across all DECT brands. The data shows the average price of BT’s DECT phones over the past five years. BT submitted that it is clear from the data that in general DECT prices have been in decline and argued that BT’s prices have not moved independently of this downward trend, or in any other way behaved in a manner inconsistent with a fully competitive market. As a consequence, BT argued that the GfK pricing data suggests that BT is subject to the same market trends and competitive pressures as its rivals.
218. BT has submitted that its prices have not moved independently from those of other suppliers or the market average because BT has no power to behave independently since it is not dominant.

**Ofcom’s analysis**

219. Figure 12 illustrates average monthly DECT prices for products supplied by major wholesalers. It is important to note that this illustrates BT’s average price in relation to the market average excluding BT, as this is the relevant average price against which to benchmark BT’s price level. (For clarity, the data is reproduced at Figure 13 for only BT’s average price, the total average market price and the total market average excluding BT).

**Figure 12 Average DECT prices by brand: January 2000 – July 2005**

![Graph showing average DECT prices by brand from January 2000 to July 2005](source: GfK)
220. While this average price data across a range of phone models may reflect changes in mix as well as changes in price, BT has indicated to Ofcom that the price/model mix within the DECT group has not changed significantly over this period and therefore BT’s price is not driven by a switch to selling cheaper models over time. Ofcom has not been able to verify independently whether or not BT’s product mix has changed over the period with the data made available to Ofcom.

221. Figure 13 indicates:

- the evidence available to Ofcom does not suggest that BT has priced independently of the market; and
- BT’s price reductions have been in line with those of the market as a whole, the trend in prices of DECT cordless phones having been broadly downward from 2002 onwards, resulting in lower prices for both retailers and end-consumers.

222. Furthermore, the evidence available to Ofcom does not suggest that BT is leading the price reductions in the market. Ofcom has reviewed BT’s internal documents relating to pricing decisions and found that decisions to reduce prices were typically led by a need to respond to competitive pressures or to meet legitimate commercial needs (e.g. to sell off remaining supplies of old lines). The evidence in these documents does not suggest that there was a strategy to increase market share by predatory price reductions. On the contrary, the documents illustrate a concern on the part of BT to maintain substantial margins despite the pressures of a market in which competition is keen and prices have been falling (see paragraphs 650 onwards). In addition, whilst there is anecdotal evidence that BT can earn a premium over less well known brands98 or brands

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98 [a retailer] [date] S26 response
associated with lower priced products, the evidence suggests that there are a number of suppliers that are able to earn such a premium and the evidence does not suggest that BT's ability to earn a brand-based premium is unique.

**Barriers to entry, expansion and exit**

223. Barriers to entry or expansion are features of a market that prevent or deter firms from entering or expanding in that market. In addition, barriers to exit could arise that could further deter entry to a market. Barriers to entry, expansion and exit can arise for legal, economic or strategic reasons.

224. Legal barriers are laws or other legal restrictions that prevent firms from entering markets and competing. Such barriers arise by way of governmental regulation. A common form of legal barrier is licensing.

225. Economic barriers are barriers linked to production or proprietary technology, scale or scope economies, product differentiation or branding. Such barriers could impose cost disadvantages to new entrant undertakings since they may have trouble matching established undertakings in the market. This form includes sunk costs of entry and switching costs.

226. Strategic barriers are barriers created or strengthened by an undertaking in order to deter entry of new firms into the market. These are exclusionary practices by undertaking to restrict conditions of competition on the market. This may involve the threat to engage in a price war or to expand output in response to a new entry or excessive investments in product range or advertising.

227. The following section considers economic and strategic barriers. The complainants have not alleged that there are any significant legal barriers to entering the market.

**Complainants' comments on barriers to entry**

228. As already noted, the complainants argued that BT gains additional market power through the consumer recognition associated with the "BT" brand. They allege that while a few other suppliers of fixed line telephones have strong brands (such as Panasonic), no other provider has the same degree of recognition and reputation that BT enjoys in respect of telephone products. The complainants allege that this strength of brand makes BT an "obligatory trading partner" for all retailers of fixed line telephones in the UK.

229. The complainants added that BT's market power in the fixed line telephone market(s) is further increased by BT's "super-dominance" in the fixed line telephony markets. BT's fixed line telephone business gains considerable advantage from being part of the incumbent fixed line telephony provider which holds super-dominance in related markets. In particular, the complainants alleged that BT's access to direct mail sent to millions of UK households as part of BT's fixed line telephony bills provides BT with a marketing advantage which other competitors do not have.

230. All of those factors, the complainants suggest, would tend to deter new market entry.

231. The complainants also alleged that there exist three further barriers to entry:
(i) the need to establish a relationship with key customers (in particular Argos, Dixons and Comet) whom they allege will only contract with suppliers with an established track record in the supply of DECT;

(ii) the need to establish a relationship with suppliers, predominantly located in the Asia-Pacific region (in that regard, the complainants’ alleged that BT had put pressure on its suppliers not to supply phones destined for the UK retail market to BT’s competitors in the UK wholesale market, including new market entrants); and

(iii) that BT’s pricing behaviour has itself created a barrier to entry (since new entrants would be unable to match BT’s prices while still making a profit) and has deterred new entry from Europe and resulted in market exit. The complainants referred, in that regard, to the absence of key European consumer phone wholesale suppliers such as Alcatel and Sagem.

232. The complainants also disagreed with Ofcom’s analysis of barriers to entry in its 1st draft decision. In particular, the complainants submitted that:

- Ofcom had misinterpreted the complainants’ submissions regarding barriers to entry. Ofcom’s reliance on the statement of a departing supplier that its exit “was not in any way related to any behaviour by BT” was naive and demonstrated a lack of understanding of the relationship between many fixed telephone equipment suppliers and BT. Given this direct conflict in evidence between the complainants’ submissions and the evidence provided by the departing supplier, Ofcom should not place any weight on the response submitted by that supplier.99

- Ofcom failed to consider the differences between UK and European wholesale markets – why were pan-European providers absent from the UK market and/or exiting from it?

- Binatone was informed that three other suppliers of fixed line telephone equipment (one of whom is a significant supplier in France) had exited the UK market during the period since BT’s conduct commenced. The complainants’ suggested that the failure of these suppliers to gain even a small market share in the UK market had been caused by BT’s predatory strategy.

- The only evidence of market entry that Ofcom appears to have relied upon was that of MagicBox. Although Ofcom had also identified three other recent market entrants, two of these were brands that were in fact supplied through MagicBox (Onetel and Motorola). The only other entrant, NTL, entered prior to the period of alleged abuse and had not been able to sustain any significant presence in the market.

- It was not appropriate for Ofcom to have cited MagicBox as an example of the possibility of new entry into this market since that entrant was an exceptional case since it was run by former BT executives. If MagicBox was the only new entrant Ofcom could rely on, this proved the point that BT’s behaviour had created a barrier to entry.

99 Letter from complainants, 4 November 2005, paragraph 17, 18.
• The existence of small suppliers was not inconsistent with there being barriers to entry - even the most dominant companies can tolerate small suppliers provided that they do not have any real impact on the market.

233. The complainants made additional arguments in respect of barriers to entry following from conversations with Ofcom subsequent to their comment on the first draft decision.

• It is highly unlikely that most manufacturers of fixed line telephone equipment located in the Asia-Pacific region would have the necessary skills and experience to establish and operate a business to successfully sell direct to the UK retailers and even less likely that a manufacturer, should it actually hold or obtain the necessary skills, be interested in doing so. Factors leading to this view include:
  
  o Lack of manufacturer experience with dealing with retailers
  o Reluctance of manufacturers to deal with UK retailers
  o BT conduct deters manufacturers from entering market
  o Unsuccessful entry by manufacturer as evidence of UK retailer power (e.g. DBTel)
  o UK retailers reluctance to obtain supplies direct from manufacturers due to greater degree of technical network specification

• While there are no regulatory or technical barriers to entering the UK market, the absence of such suppliers in the UK market and the history of unsuccessful attempts by Continental European suppliers to enter the UK market.

234. The complainants have argued that the following quotes - made by competitors – provide support for its contention that suppliers face significant barriers to becoming sustainable and effective competitors:

“The retail market in the UK is much more concentrated than other situations in Europe. Regarding cordless telephones, we can consider that a large amount of the market is detained by 3-4 main players and a significant part by one actor: Argos. The buying power of these retailers is therefore very strong and allow them to impose very sever conditions to small players or new entrants such as Sagem.”

“To be listed by retail groups, e.g. Argos, Comet, DSG etc is of most importance.”

“However pricing expectations from all major retailers (i.e. DSG Group, Comet and Argos, Phones 4U and distribution difficult to meet for Siemens during this period.” As Siemens was in the process of entering the retail market directly, we had to adjust our pricing, especially on the entry level phones, to gain listings with the main retailers.”

“Less dominant market position of BT” and “fair prices for suppliers and retailers” are cited as factors that would be important to Siemens in determining whether to enter the UK market. Also noted is the following “In this suspect, Siemens would like to enter the market, however, the current market situation does not provide the basis for a profitable business case.”

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100 Letter from complainants, 23 February 2006.
101 Complainants letter to Ofcom, 7 June 2006, page 5, paragraph 20.
102 Sagem s26 response to Ofcom, 30 January 2006.
103 Siemens s26 Response to Ofcom, 1 February 2006.
235. The complainants also cited the high Herfindahl-Hirschman Indexes (HHIs) (a commonly accepted measure of market concentration), in the Mintel report as demonstrating the competitive problems of the market. The complainants argued that a market with a four firm concentration ratio of 86% (for cordless telephones) and 75% (for corded telephones) is clearly highly concentrated and will in most circumstances be considered indicative of barriers to entry.

**BT’s submissions on barriers to entry**

236. BT submitted that even a firm with a substantial market share would be unable to exercise significant market power in industries where the barriers to entry were low. In such industries, any attempt to exercise market power (for example through price increases) would be likely to trigger new entry that would prevent the firm from sustaining prices at uncompetitive levels. This was particularly so where powerful retailers were in a position to encourage and sustain new entrants or, indeed, enter the market with their own brands.

237. There were several reasons why entry barriers to the supply of cordless telephones should be regarded as being low, the most significant being ready access to suppliers. With manufacturing outsourced, a new entrant into the wholesale supply of fixed line phones would not need to incur the costs of large-scale capital investment. Instead, a new entrant would need only to secure supply from one of the many South Eastern Asian manufacturers. Access to those producers was relatively straightforward, being hindered neither by exclusive supply agreements nor capacity constraints. None of the relevant South Eastern Asian producers faced binding capacity constraints that would prevent them from catering to the output requirements of a new entrant into the UK market for the wholesale supply of fixed line consumer phones.

238. Furthermore, while it was true that BT was an established brand, it had to compete in the wholesale consumer phones market with other established brand names such as Panasonic, Philips and Motorola. Cordless phones were largely commoditised, in particular due to the DECT standard which had reduced the degree of differentiation between different brands of consumer phones. In BT’s view, purchasing decisions by customers were based primarily on a phone’s perceived value for money.

239. BT added that its argument that barriers to entry were low was supported by the existence of direct evidence of successful new entry and expansion. NTL, for example, had entered the DECT segment in mid-2001 and had been able to sustain a market share in DECT sales of between 5% and 8% by value since then.

240. Similarly, the Onetel brand had entered the market in mid-2004 and had since grown its market share to 4% (for the period January – July 2005). Onetel entry had been pioneered through Magicbox by a group of former BT executives with considerable experience in the branding of cordless telephony. BT therefore expected that Onetel would experience further growth.

241. Panasonic was an example of expansion by an established player. BT noted that Panasonic was only a modest player in the market in 2000 and 2001 but had subsequently doubled its DECT share between 2001 and 2002, and had since sustained a share of between 10% and 12% by value (8-9% by volume).
242. BT submitted that while Samsung provided an example of market exit, this was entirely consistent with an effectively functioning competitive marketplace in which less efficient firms were exiting as prices were driven down towards the costs of the more efficient firms.

243. BT expected that there would be further entry to the market and cited the example of Motorola which announced the launch of its first DECT phones for the European market in December 2004 and was planning a range of DECT products for launch in 2005. BT noted that ownership of the Motorola brand in the UK had been transferred from ECD to Magic Box, which as already noted was acting as wholesale provider for Onetel and Southwestern Bell phones (a brand licensed to Argos by Southwestern Bell in the US). BT considers that with this transfer of ownership to the experienced Magic Box team and an already well established brand name in the UK in connection with the supply of mobile phone handsets, the Motorola brand was likely to gain rapid brand recognition and market share in the fixed line consumer phone market as well.

**Ofcom Analysis**

244. Ofcom has considered the commercial relationships new entrants must establish with buyers (retailers) and sellers (manufacturers/suppliers) if they are to enter to enter the wholesale fixed-line consumer telephone handset market. Access to the market, including the ability to enter into contracts for supply and sale with suppliers and buyers will be an important factor in assessing whether barriers to entry, expansion and exit exist in this market.

**Relationships with buyers**

245. The fixed-line consumer phones market is a mature market and is characterised by a number of established household and electronic goods or communications brands, including BT, Binatone, Panasonic, Motorola, Siemens, Cable & Wireless, Southwestern Bell, ntl, Onetel and Philips.

246. All these brands/suppliers have product listings with major retailer catalogues for products across a range of different prices. Indeed, a requirement for effecting successful entry into the market on a significant scale is the establishment of a relationship with at least one of the major retailers.

247. [a major retailer] indicated to Ofcom, however, that it was looking to reduce the number of its suppliers for products across all product ranges and that a supplier’s ability to provide profitable products across a range of different pricing points was becoming increasingly important. Ofcom has taken this point into account in its analysis, which would appear, on the face of it, to suggest that it might be becoming more difficult for new entrants to obtaining listing, at least with that particular retailer.

248. Another requirement of the major UK retailers is that suppliers must be in a position to rapidly meet buyer demand, including by having sufficient stock on hand to meet any urgent demand. This effectively requires suppliers to have warehousing facilities and stocks in the UK.

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104 See Motorola news release at [http://www.prnewswire.co.uk/cgi/news/release?id=136419](http://www.prnewswire.co.uk/cgi/news/release?id=136419)
249. Accordingly, a prospective entrant into the wholesale market is likely to have to demonstrate to potential major buyers that it has.\footnote{S26 Response from [retailer] to Ofcom, [date].}:

- a reputable brand (whether its own or one that had been licensed to it);
- an ability to supply stock on demand; and
- the ability to provide an attractive (i.e. profitable to the retailer) range of products at different price points.

250. Ofcom considers that these requirements would not constitute a barrier for an entrant with ambitions and capacity to gain entry to the mass consumer market by establishing a relationship with one or more of the larger retailers. In that regard, Ofcom notes that the potential large retail outlets for the sale of consumer phones are no longer limited to Argos, Dixons and Comet, but now extend to non-dedicated retailers of household and electric goods, such as the large supermarket chains. For instance, Ofcom understands that Asda and Tesco are the two largest customers of [supplier] after Argos.

251. In Ofcom's view it is realistic to expect that an efficient supplier with a known and reputable brand (in consumer electrical, mobile phones or another related retail sector), and which could offer a range of consumer phone products and be able to guarantee meeting the retailers supply conditions, would be able to establish itself in the UK market within a 12 month period.

252. Furthermore, it would appear possible even for a supplier without an existing reputable brand to obtain at least some of the benefits of such a brand by contracting for a licence to market phones in the UK under a brand with an established trading reputation in the UK and/or internationally. Indeed, even a supplier without the ability to trade under an existing brand might be able to achieve effective market entry on a significant scale, though this would probably require them, at least in the first instance, to find a customer from among the ‘high volume / low prices’ retailers, such as one of the large supermarket chains.

253. While it is certainly the case that potential market entrants without the financial resources to be able to meet the supply demands of the major UK retail multiples (e.g. in terms of stock availability or product range) would be unlikely to be able to secure catalogue listings or floor space with such retailers, Ofcom considers that this is no different from many other markets. Furthermore, Ofcom considers that alternative sales channels exist through which such potential market entrants could profitably sell their products, including wholesale distributors, independent electrical specialists and telecommunications specialist retail outlets.

254. In Ofcom’s view, the ability of a new entrant, Magic Box\footnote{http://www.magicboxproducts.co.uk} (which, as already noted, was established by a team of former BT managers) to enter the market and to establish a presence and secure catalogue space with Argos within just 1 year provides evidence that competitive entry is feasible. MagicBox’s strategy of supplying phones under the Onetel and Motorola brands demonstrates a strategy which appears to have proven successful for effecting large-scale entry to the UK consumer phones market and meeting the advantage held by certain existing market players (such as BT) in terms of having a recognised brand name. Furthermore, Ofcom notes that MagicBox has recently started to sell non-entry level phones under their own brand name. This again suggests a potentially
profitable strategy whereby a relatively new market entrant may be able to establish its brand as a quality supplier which might ultimately be able to command a premium for its branded products.

255. [retailer] has a [×] licence to use the [×] brand in the UK and sources phones directly from manufacturers in the Asia Pacific Region which [retailer] then brands. Therefore [retailer] is aware of the possibility of purchasing directly from manufacturers and could do so relatively easily (directly or via an intermediary). Other large electrical retailers can be expected to be aware of this possibility.107

256. Ofcom considers the example of [the above retailer] suggests that neither retailers nor manufacturers are necessarily reluctant to deal directly with each other, as suggested by the complainants. (see paragraph 233).

Relationships with upstream suppliers

257. With very few exceptions, consumer phone wholesale suppliers in the UK outsource the manufacture of the phones that they sell to overseas suppliers, the vast majority of whom are in the far East. Discussions with retailers and suppliers indicate that there is no shortage of manufacturing capacity globally. The presence of a large and flexible manufacturing base to which suppliers can subcontract manufacturing indicates that the up-front investment required to enter the market will be relatively small. For example, there are 110 cordless phone makers in mainland China, Taiwan and Hong Kong108, supplying a wide range of brand names including Phillips, Toshiba, Motorola, Sanyo, and NEC.

258. The information available to Ofcom does not suggest that there are any capacity constraints on manufacturers in the relevant market. Ofcom understands that suppliers to the wholesale consumer phones market generally have several months' notice of likely product demand from retailers and can accordingly adjust production requirements. In addition Ofcom understands that the only constraint on the ability of a manufacturer to raise output significantly in the short term would be a 3-4 month period required to order components, which would not prevent output expansion on a quarter by quarter basis.

259. All of these facts would tend to suggest that potential new entrants to the relevant market (and, indeed, existing market players) have ready access to competitively-priced supplies of consumer phones from manufacturers in the Asia-Pacific region. The complainants have argued that there are less than 10 manufacturers in the Asia-Pacific region who are credible suppliers of DECT. Further, the complainants argue, the largest are tied to BT and are outside the pool of potential manufacturers to UK suppliers due to their unwillingness to risk this relationship. [×]109

260. [×]

261. [×]

107 The complainants alleged in the 7 June 2006 letter that Argos intends to withdraw the Southwestern Bell brand.
109 Complainants’ letter to Ofcom on 23 February 2006.
As noted above, there are over 100 cordless phone manufacturers in greater China alone, but BT sources 90% of its DECT phones from two manufacturers. Furthermore, Ofcom notes that it appears that most manufacturers in the Far East operate well under full capacity.  

Ofcom has approached a number of suppliers, including suppliers that have previously entered the market (and ‘suppliers’ who do not presently operate in the market, but had considered entering it). Ofcom requested each supplier identify the reasons why they entered (or intended to enter) the market, including whether any barriers to entry, expansion or exit were factors considered in their commercial decision.

One such supplier, [supplier], operated only in the UK and supplied phones under its own brand name as well as other brands under licence. The supplier considered that it has a “well established brand for its own entry-level products, as well as supplying premium branded phones under licence”. The supplier suggested that not having a well established or premium brand would make it harder for a potential new entrant to enter the market (unless that entrant could aggressively compete on price).

Responding to the first draft decision, the complainants argued that Ofcom had relied only on the entry of MagicBox as evidence of entry into the market, and that Onetel and Motorola should not be considered as separate entrants, since MagicBox currently sells these brands under licence.

Ofcom accepts that a distinction must be drawn between market entry by an undertaking and new ‘brand entry’ to the market. It is plainly the case, for example, that certain potential barriers to entry that might stand in the way of an undertaking entering a market in which it had no existing presence might not be relevant to the entry of brands (which could be achieved by licensing the brand to an existing market player, for example). Nevertheless, one of the points which has been strongly and repeatedly made to Ofcom by the complainants is that the strength of BT’s brand is itself both a barrier to entry and a significant source of market power. The demonstrated ability of brands which had not hitherto been part of the UK consumer phones wholesale and retail sectors to effect significant entry to that market is therefore far from being irrelevant, in particular where that has been achieved via a wholesale supplier that is itself a new market entrant.

Ofcom notes that market share data for licensed brands with MagicBox suggests that new entrants can take market share from BT and that at least in respect of some licensed brands, there has been a degree of market penetration (e.g. Onetel raised its market share from 0% to 4.6% in the DECT product segment between January 2004 and December 2005 – see paragraph 197).

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110 Cordless Phones: China sourcing report: January 2006. In its 15 June 2006 submission, BT submitted that this report appears to be extensive with a considerable amount of information sourced from a large number of suppliers. Although not all of the well-known Asian manufacturers are included, the report does demonstrate the vast number of factories and sources (and therefore capacity) available for different brands to source their telephone equipment from, and lends support to Ofcom's supply side analysis in this case.

111 S26 response from the [supplier] [date].

112 The complainants made these comments again in their letter to Ofcom of 7 June 2006, page 6, paragraph 23.
269. Ofcom also notes the recent entry by Lazerbuilt. Lazerbuilt entered the DECT segment of the market in October 2004, and currently their largest retail buyer is Tesco\textsuperscript{113}. Ofcom considers this provides further evidence of entry into the consumer phones market.

270. The complainants have submitted, however, that all of this evidence of recent market entry must be seen in the context of evidence of recent market exit (which the complainants allege to have been attributable to BT having a position of dominance). Ofcom has therefore considered the relevant examples of recent market exit in an effort to identify the causes of that exit.

\textit{Evidence of market exit and/or non-entry}

271. The complainants claimed\textsuperscript{114} that the absence of Alcatel and Sagem from the UK market, and the expected exit in the coming months of another supplier from the market, provided evidence that BT was deterring entry and speeding up exit from the market through a predatory pricing strategy. The complainants subsequently claimed that another supplier, [supplier] was also likely to exit the market, and that this provided evidence of the effects of BT’s alleged predation.\textsuperscript{115}

272. In order to investigate these allegations, Ofcom contacted a number of suppliers (including European suppliers) which had exited the market, or who intended to exit the market, in order to establish whether they considered their decision to exit to be the result of anti-competitive conduct by BT.\textsuperscript{116} Accordingly, Ofcom requested that each of those suppliers identify the reasons why it had decided to exit the market, including whether any barriers to entry, expansion or exit were factors in that commercial decision.

273. The complainants further claimed\textsuperscript{117} that Alba (with ntl, Cable and Wireless and Betacom brands) was about to exit the market. However, Ofcom contacted Alba and was informed that the company is not exiting the consumer telephones market.\textsuperscript{118}

274. Ofcom has considered in particular detail the case of [supplier], a wholesale supplier of consumer phones in the UK that was cited by the complainants as an example of an existing market player that was intending to withdraw from the UK market. There has not yet been any public announcement of this supplier’s planned exit.

275. Ofcom was informed by that supplier that it had chosen to exit the market for commercial reasons, relating primarily to its cost structure compared to that of other competitors operating in the UK.\textsuperscript{119} The supplier subsequently provided further information relating to its decision to exit the market. In particular, [supplier] provided Ofcom with a document setting out [supplier] reasons for

\textsuperscript{113} Email from Lazerbuilt, 25 July 2006
\textsuperscript{114} The 29 March complaint
\textsuperscript{115} The complainants’ 4 November submission
\textsuperscript{116} Ofcom issued a section 26 information request to [supplier], a supplier based in [X]. However, despite following up on the request by Ofcom, [supplier] has not responded to the request. Ofcom has chosen not to pursue [supplier] in this regard since it has gathered considerable data from other sources in relation to market entry and exit.
\textsuperscript{117} Complainants’ 19 June 2006 letter.
\textsuperscript{118} Telephone conversation of 4 July 2004 between Tanya Rofani and [X] Alba [X].
\textsuperscript{119} [X]
The document lists 6 main reasons for exiting the market. They include:

1. **Overall UK business case “deep” red. Higher volumes do not alter this result and only drive a larger negative EBIT**
2. **Market is shrinking by 12% per year in value (highest decline in Europe)**
3. **Even Binatone is losing market share**
4. **Dealer margin up to [40%-50%]**
5. **Service – Buyer remorse concept very expensive**
6. **[<] doesn’t see to turn around the business within the next 1-3 years.”**

276. The list suggests that the supplier made losses while active in the UK market. These losses appear to have been exacerbated by higher sales volumes, in the context of a market that has been shrinking in value terms. This result supports [supplier] claims that its cost structure was too high for it to operate in the UK market profitably. Ofcom notes that retailer margins were considered a factor in the exit decision. [supplier] state that there were very high margin expectations from suppliers (with price structures and terms and conditions that did not vary significantly between retailers) as well as upfront and revenue independent marketing support requested.

277. [supplier] also identified the retailing culture of “no customer remorse” as being expensive. Ofcom understands that this refers to the policy adopted by most retailers under which suppliers must accept product returns where customers are not happy with the product and wish to return it (even where no fault exists with the product). Ofcom notes that this particular policy has been singled out as a feature that makes the UK market a more difficult wholesaling proposition than Continental Europe (see paragraphs 381 to 385).

278. [supplier] also identified high price erosion mainly triggered by BT as another factor influencing [supplier] decision to exit the market. Ofcom considers the issue of price reductions in the market at paragraphs 213 to 222. We note, in that regard, that price erosion is not necessarily inconsistent with a competitive market, and that price erosion in a competitive market might be expected to lead to market exit by ‘less efficient’ operators who could not, or did not wish to, accept lower margins. Ofcom has examined whether BT’s pricing behaviour could be regarded as predatory (assuming that BT were dominant), and concluded that BT was not charging predatory prices, at least during the time period to which the complainants’ referred. In addition, Ofcom has also reviewed BT internal documents to understand the reasons for BT’s pricing decisions and has concluded that price reductions were made in response to retailers’ demands and market conditions. (Ofcom’s examination of BT’s pricing behaviour is discussed later in this decision, beginning at paragraph 430.)

279. Another supplier that Ofcom contacted, [supplier], exited the market prior to Ofcom’s investigation. That supplier stated that the main reasons for its having exited the market at that time were:

   1. market dominated by large retailers,
   2. fierce price competition from other manufacturers, and
   3. the high cost associated with brand awareness and promotion etc.”

280. The same supplier has suggested that it was not willing to pay the quoted marketing costs associated with catalogue listings and therefore left the market.

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120 [Supplier] S26 response [date]
However, the same supplier also indicated that with the commoditisation of consumer phone technology, and falling prices, brands may be less important than they were 5 years ago.

281. One supplier [supplier] which has a presence in the UK and is supplying cordless phones to other EU Member States suggested the following, as an explanation for key differences between the UK and the Continental European markets.

“The absence of the “money back if not absolutely delighted” culture on the continent is probably the biggest single factor enabling manufacturers to operate with a higher level of profit in continental markets.”

and

“It would appear that price competition is significantly greater in the UK than most EU markets.”

282. The additional costs arising from the returns policy includes the costs to suppliers of repackaging and reselling phones second hand, as well as additional costs relating to managing stocks, including warehouse costs. The same supplier [supplier] also suggested that the market power of retailers who could constantly demand lower prices and monetary assistance to promote products in the retail sector placed:

“….considerable and sustained pressure for [supplier] to remain competitive with other brands.”

283. Another supplier [supplier] put forward a similar argument:

“The main difference between UK and continental Europe market is that end user is unable to return the goods unless it is faulty. For example, it’s about 70%-75% of return goods from Argos to [supplier] are NFF (no fault found) units. It therefore costs [supplier] a huge amount to handle this level of returns. This is a key problem as far as [supplier] is concerned.”

284. A second supplier [supplier] cited by the complainants who has exited the market, was asked to identify any particular conditions that enabled it to operate profitably in other markets but which were absent in the UK. The supplier listed the following 2 factors:

“1. Diversity of retail actors
2. Cost of returns and after sale in general”

285. Importantly, BT’s position in the wholesale market is not mentioned. Factors including customer friendly returns policy and retail market conditions are cited as the key reasons why this supplier participates in Continental Europe but not the UK market.

286. Ofcom recognises that consumer returns policies and pressure from retailers to contribute to marketing expenditure could be perceived as a barrier to entry to wholesale suppliers. Ofcom is of the view, however, that these buyer demands,

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121 [Supplier] S26 response [date].
122 [Supplier] S26 response [date]
123 [Supplier] S26 response [date].
while they might deter entry by certain potential competitors, would be unlikely to
deter entry by efficient new competitors who were willing and able to meet
demand side expectations in a market where, largely as a result of buyer
expectations, suppliers' per product profit margins are under pressure and
competition between them was very keen.

287. In that regard, Ofcom notes that the additional costs associated with having to
accept product returns from retailers (such as additional warehousing space and
repacking) would not in themselves be likely to raise a significant barrier to entry
to a new entrant. In relation to warehousing, Ofcom considers that warehouse
space could be purchased on short term contract or through subletting
arrangements, neither of which imply any sunk costs for the supplier. In relation
to repackaging, Ofcom considers that suppliers could easily procure packaging
services without any significant expenditure on capital equipment or premises.
Alternatively, the phones can be sold as ‘seconds’ or ‘returns’ on the secondary
market through outlets such as dectcordlessphones.co.uk

288. Furthermore, existing commercial arrangements between retailers and suppliers
which Ofcom has come across during its examination of this market appear to
suggest that it may be possible for suppliers to negotiate with their retailer
customers to remove or limit product returns obligations. For example, [a
supplier] supplies phones direct from the manufacturers in the Asia-Pacific region
to retailers on a no returns unless faulty basis. While Ofcom notes that any new
entrant supplier who sought to negotiate its way out of standard product return
obligations would normally be expected to reflect that exception by way of a price
reduction, this possibility also illustrates that product return obligations should not
necessarily be regarded differently in barrier to entry terms from the
discouragement to entry that a potential new entrant to any competitive market
would face in terms of having to be confident that it could be a sufficiently efficient
market player to price its products competitively while still making a profit.

289. Ofcom considers that the reasons stated for exiting the market after 2004 are not
dissimilar to reasons stated by suppliers exiting the market before 2004. One
supplier [supplier] stated that they left the cordless telephone market in 2000, and
closed down that part of their business.

290. The supplier stated that only two models were introduced to the UK, with only
[×] sales recorded. The phones sold in the UK were considered as part of a
market acceptance test. In particular, the supplier stated124:

“From what we at the time could understand the UK market was as competitive and no
different from any of the other markets when considering price levels or any other
market conditions. The main reason [to leave the cordless market] was a decision to
focus our resources entirely on mobile phones. After this decision, no more phones
were sold in any other markets, including the UK.”

291. Another supplier stated that they were only briefly active in the market for
cordless phones, their presence was only minor and that their participation in and
exit from the market was not recent (possibly as early as the mid 1990s). The
supplier stated that125.

124 [Supplier] [date] S26 response.
125 [Supplier] [date] S26 response
“...the main barriers to entry did not relate to technical or competitive barriers but rather to the following factors. First the market was considered to be very devalued, with products increasingly being sold through mass merchants (e.g. Argos) and cheaper brands (e.g. Binatone) dominating. In other words there was no premium to be earned by [supplier]. Secondly the limited research we did pointed to the likelihood of mobile phones being the way forward.”

292. In summary, therefore, whilst low prices were one factor in wholesale suppliers’ decisions to exit or not to enter the market, the tough market conditions appear to have been regarded by most of those suppliers as arising, at least primarily, from the demands of UK retailers and on ‘no fault found’ returns policies, than on any particular pricing strategy adopted by BT.

293. Ofcom does not consider that consumer returns policies and pressure from retailers to contribute to marketing expenditure present barriers to exit (and therefore barriers to entry) to suppliers since costs associated with these polices/practices are not sunk costs which would otherwise influence the decision into exit. For instance, the additional costs associated with having to accept product returns from retailers include additional warehousing space and repacking. In relation to warehousing, Ofcom considers that warehouse space could be purchased on short term contract or through subletting arrangements, neither of which imply any sunk costs for the supplier. In relation to repackaging, Ofcom considers that suppliers could easily procure packaging services without any significant expenditure on capital equipment or premises. As noted outlets such as dectcordlessphones.co.uk provide packaging services.

294. Ofcom has also considered all the evidence, including individually and in the aggregate, and finds that there are no significant barriers to entry or exit in this market.

295. Having taken all of the above information into account, Ofcom considers that the evidence on exit is, on balance, more supportive of the view that exit has been driven primarily by legitimate competition between different consumer phone wholesalers and brands, as well as by the pressures on retailers caused by the buyer power of retailers (such as pressure to support ‘no fault found’ returns policies, as well as to lower prices/contribute to marketing and advertising). Ofcom considers the evidence does not indicate that exit was due to the pricing behaviour of BT.

**BT’s position in related markets**

296. The complainants have made a number of allegations regarding how BT’s position in the fixed line voice telephony sector affects both BT’s position and behaviour in the wholesale consumer phone market.

297. These allegations can be grouped into two separate types of allegations. The first type of allegation made by the complainants is that BT’s dominance in exchange lines confers dominance to its downstream wholesale consumer phone business.

298. The second type of allegation argues that an abuse in the phone market is feasible even where BT is not dominant in the wholesale consumer phone market (i.e. where it is dominant or has a significant presence in a related market).

Does BT’s position in fixed line confer dominance in the consumer phone market?
299. Ofcom has carefully considered whether BT’s SMP in the fixed line telephony market has conferred advantages on BT in the wholesale consumer telephone market, through branding and marketing.

300. First, through its fixed line telephony business, BT has access to a customer base of approximately 19.8 million UK households.\textsuperscript{126} BT can and does market its consumer telephones through marketing literature inserted into quarterly bills to these customers, thereby taking advantage of BT’s large fixed customer base and considerable economies of scope in billing/mailing which act to lower BT’s consumer telephone business’s allocated unit marketing costs.

301. Ofcom considers the relevant consideration for this investigation is whether the large fixed line customer base and economies of scope arising between billing and marketing of cordless phones through fixed line bills constitutes a barrier to entry, expansion or exit in the wholesale consumer telephone market.

302. Second, the BT brand value associated with BT’s provision of fixed line services could carry across to BT’s activities in other markets, including the wholesale consumer telephones market. Ofcom considers whether the brand value can be leveraged and whether this constitutes a barrier to entry, expansion or exit in the wholesale consumer telephone market.

303. Ofcom requested information from BT on all consumer phone marketing literature that was included in consumers’ fixed line telephony bills from January 2004 to September 2005. BT provided Ofcom with a table setting out promotional campaigns by month, as well as copies of the marketing literature. The table provided by BT to Ofcom is reproduced below.

Table 2 Telephones advertised between January 2004 and September 2005

\textsuperscript{126} Based on 25 million UK household, where 92% have a fixed line, and where BT’s share of households with a fixed line is 80%.}
<table>
<thead>
<tr>
<th>Date of Issue</th>
<th>Nature of advertising</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2004</td>
<td>Advertises the</td>
</tr>
<tr>
<td></td>
<td>▪ BT Décor 310 – corded style</td>
</tr>
<tr>
<td></td>
<td>▪ BT Diverse 5000 solo</td>
</tr>
<tr>
<td></td>
<td>▪ BT Diverse 5210</td>
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<tr>
<td>February 2004</td>
<td>Advertises the</td>
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<tr>
<td></td>
<td>▪ BT Décor 500</td>
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<tr>
<td></td>
<td>▪ BT Diverse 5000 solo</td>
</tr>
<tr>
<td></td>
<td>▪ BT Diverse 5210</td>
</tr>
<tr>
<td>March 2004</td>
<td>Advertises the</td>
</tr>
<tr>
<td></td>
<td>▪ BT Décor 500</td>
</tr>
<tr>
<td></td>
<td>▪ BT Diverse 5000 solo</td>
</tr>
<tr>
<td></td>
<td>▪ BT Diverse 5210</td>
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<tr>
<td>April 2004</td>
<td>N/A</td>
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<tr>
<td>May 2004</td>
<td>N/A</td>
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<tr>
<td>June 2004</td>
<td>N/A</td>
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<tr>
<td>July 2004</td>
<td>N/A</td>
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<tr>
<td>August 2004</td>
<td>Advertises the</td>
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<tr>
<td></td>
<td>▪ BT Diverse X10 Twin</td>
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<td></td>
<td>▪ BT Relate SMS</td>
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<tr>
<td>September 2004</td>
<td>Advertises the</td>
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<tr>
<td></td>
<td>▪ BT Equinox 1200</td>
</tr>
<tr>
<td></td>
<td>▪ BT Relate SMS</td>
</tr>
<tr>
<td>October 2004</td>
<td>Advertises the</td>
</tr>
<tr>
<td></td>
<td>▪ BT Equinox 1200</td>
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<tr>
<td></td>
<td>▪ BT Relate SMS</td>
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<tr>
<td>November 2004</td>
<td>Advertises the</td>
</tr>
<tr>
<td></td>
<td>▪ BT Equinox 1200</td>
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<tr>
<td></td>
<td>▪ BT Relate SMS</td>
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<tr>
<td>December 2004</td>
<td>N/A</td>
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<tr>
<td>January 2005</td>
<td>N/A</td>
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<tr>
<td>February 2005</td>
<td>Advertises the</td>
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<tr>
<td></td>
<td>▪ BT Equinox 1200</td>
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<td></td>
<td>▪ BT Paragon 500</td>
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<tr>
<td>March 2005</td>
<td>Advertises the</td>
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<tr>
<td></td>
<td>▪ BT Equinox 1200</td>
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<td>▪ BT Paragon 500</td>
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<td>April 2005</td>
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<tr>
<td>August 2005</td>
<td>Advertises the</td>
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<tr>
<td></td>
<td>▪ BT Text enabled phone</td>
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<tr>
<td>September 2005</td>
<td>Advertises the</td>
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<tr>
<td></td>
<td>▪ BT Text enabled phone</td>
</tr>
<tr>
<td></td>
<td>▪ BT Relate corded phone with SMS text</td>
</tr>
<tr>
<td></td>
<td>▪ BT Freestyle 4500 trio</td>
</tr>
<tr>
<td></td>
<td>▪ BT Calypso 120 Twin</td>
</tr>
</tbody>
</table>

*Source: BT*

304. The table shows that in 2004, BT advertised either 2 or 3 phone models during 7 months of the year. Some of the models advertised are those which were best sellers (Equinox and Décor) whereas others include phones with new functionality (e.g. BT Relate SMS, with SMS functionality). A typical promotion consisted of a page containing a colour photo of the models and a description of
the offer. Between January 2005 and September 2005, BT phones were advertised for four months.

305. The information provided by BT demonstrates that BT advertises its consumer phones on a regular basis though marketing literature inserted into quarterly fixed line telephony bills. This suggests that BT’s consumer telephone business may benefit from a competitive advantage, arising from the inherited incumbent position within the fixed line market, namely, the large fixed line customer base to which BT has a well established provider-consumer relationship.

306. This advantage is also enjoyed through the sizeable economies of scope that exist between mass mail-outs of billing statements and promotion of consumer phone products through leaflets. The additional cost to BT’s consumer phone division of seeking to include an additional page within an existing leaflet would seem low compared to mailing out its promotional material on a stand-alone basis (for example, the cost of postage is a cost that would have to be incurred for billing regardless of whether marketing leaflets were included).

307. Ofcom has also considered BT’s method of allocating marketing costs between its fixed line and fixed equipment businesses to determine the potential degree of competitive advantage. The promotional and marketing campaigns associated with corded and cordless phones and answering machines are identified by BT, and the costs of these campaigns are then spread across the relevant products by revenue. BT argues that since publicity drives sales, it is appropriate to apportion those additional leaflet costs on a revenue basis.

308. Clearly BT’s consumer telephone division enjoys benefits arising from lower unit costs of utilising BT’s fixed line billing mail out after costs are allocated to its consumer phone business.

309. Ofcom has considered whether these competitive advantages enjoyed by BT’s consumer phones division can be viewed as barriers to entry, expansion or exit in those markets.

310. For instance, Ofcom has considered two ways in which equally efficient operators could potentially compete with BT in respect of marketing mail outs.

311. Suppliers who supply both fixed line telephony services and wholesale consumer telephone equipment can potentially use their fixed line customer base to market their consumer phones, although not to the degree undertaken by BT. For example, both ntl and Onetel have fixed line subscribers who could be targeted in a marketing campaign through their customer’s fixed telephony bills. Clearly, the fixed line customer base for Onetel (1.55 million at December 2005) and residential broadband customer base for ntl of 3.3 million are substantially smaller than that of BT 19.8 million households. This suggests that BT does have a competitive advantage to direct marketing through bills to its fixed line customers.

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127 For instance, are costs allocated on an incremental or standalone basis? If so, would an equally efficient operator face these same costs if entering the market?
128 Onetel website
312. Suppliers who do not supply fixed line telephony services have the option of competing with BT mail outs through third parties, including other utility operators (possibly in other sectors including water and energy suppliers) as well as mail shot companies (e.g. Letterbox Distribution\textsuperscript{130}) who offer a fee-for-service charge for mail out of promotional leaflets. For instance, Letterbox Distribution quote a mail out charge of £50 per 1000 mail outs (5p per mail out). Clearly, there will also be a cost to produce and print marketing literature. However, when comparing the 5p pure cost of mail out with Letterbox Distribution against the marginal cost to BT of direct marketing through mail out to fixed line telephony service customers, 5p does not appear to place competitors at a significant cost disadvantage to BT.

313. Ofcom does not have direct evidence on the effectiveness of direct marketing through quarterly bills, and therefore the degree of competitive advantage is difficult to assess. Ofcom notes that BT does not directly advertise entry level phones, but rather mid level top-top end phones in mail outs to fixed line customers. This contrasts with the allegation made by the complainants which suggests the alleged predation tends to occur among lower value phone products (although not exclusively lower value phones).

314. For instance, prices for advertised DECT phone models include:

- BT Diverse 5000 £44.95 (January 2004)
- BT Diverse 5210 £69.99 (January 2004)
- BT Diverse XT Twin £119.99 (August 2004)
- BT Equinox 1200 £89.99 (November 2004)
- BT Equinox 1200 £79.99 (March 2005)
- BT Paragon 500 £49.99 (March 2005)\textsuperscript{131}

315. Ofcom recognises that advertising of these higher-priced DECT phones may raise the profile of entry level and other BT branded DECT phones among BT’s fixed line customers, thereby producing a barrier to entry and expansion. However Ofcom considers it material that no entry level DECT phones were directly marketed through this channel. That fact provides evidence that, in respect of the specific allegation, the competitive advantage has not necessarily been used to an extent that the marketing restricted entry or expansion in the market.

316. Furthermore, direct mail is not the only channel for marketing phones to consumers. Other channels (such as the Argos catalogue, in-store promotions and newspaper advertising) represent popular alternative ways in which consumer phones are marketed, and there is little evidence to suggest that BT's competitors lack sufficient access to promotional channels to enable them to effectively promote their products to consumers in competition with BT.

317. Ofcom also recognises that BT’s Significant Market Power (“SMP”) in fixed line telephony provides it with a strong brand association with fixed line communications and related markets more generally. Ofcom has considered at paragraphs 402 to 414 below the extent to which BT’s brand may provide it, in the wholesale consumer phones market, with the ability to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers. For the reasons set out in those paragraphs, Ofcom has

\textsuperscript{130} \url{http://www.letterboxdistribution.com/leaflet-distribution-costs.html}
\textsuperscript{131} BT email submission of 4 January 2006 to Ofcom.
concluded that BT’s brand does not provide it with that ability. In that regard, the example cited within those paragraphs of the domestic facsimile machine wholesale market suggests that BT’s SMP in fixed line telephony has not translated into a high market share on all products that are used over fixed lines (though Ofcom also accepts that the differing customer profiles of typical domestic fax, as compared with consumer phone, may create a different competitive dynamic as between the two types of product).

318. Taking all the circumstances together, Ofcom does not consider that BT’s SMP in the fixed line market has either ‘conferred’ dominance on it in the wholesale consumer phone market, or given rise to a significant barrier to entry, expansion or exit in that market.

Reputational barriers to entry through predation in consumer phones

319. Although this was not the complainants’ main allegation, Ofcom has briefly considered whether BT has used its position in the fixed line market for the purpose of excluding competitors in the consumer phone markets through predation. Ofcom has therefore examined whether BT’s pricing in consumer phones could be predatory (see below). In particular, Ofcom has had regard to whether BT’s position in related markets may enable it to access deep pockets through which it can cross subsidise its wholesale consumer phones business.

320. Ofcom has also considered whether BT has attempted to signal any readiness to use deep pockets in the fixed line voice market to raise barriers and exclude competition in the wholesale consumer phone markets.

321. The OFT states in regard to reputational effects:

*Predatory pricing may be pursued in one sector (or market) in order to protect profits or share of sales in another, perhaps through establishing a reputation likely to deter other would-be entrants.*

322. Similarly, Ofcom considers that firms can establish reputational barriers to entry through past or present behaviour that communicates a strategy to competitors that if they do enter (or expand), then the incumbent firm will react by lowering prices post entry (or expansion) to eliminate competitors. In this way, a credible threat is made (eg through lowering prices for a short period) such that although there may be no ex ante barriers present, firms will experience ex post barriers upon entry (or expansion) in the market, since entry or expansion will trigger predatory price cuts from the incumbent firm.

323. Ofcom has shown, as part of its price-cost tests (from paragraph 447) that BT did not engage in predatory pricing in the period under examination. This price-cost test shows that overall, BT’s DECT phones recovered their average variable costs and fully allocated costs during the period of the alleged abuse. There were two phone models that did not cover their fully allocated costs. However, Ofcom considers that this can be attributed to the sale of obsolete stock at discount prices (in the case of Lyric 1100) and the exclusive offering in which BT did not bear the risk of returns on the discounted product (XC 1000). Ofcom considers that based on its analysis it cannot be argued that BT has signalled to competitors during the period of the alleged abuse that it can predate and make

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losses in a feasible way. Accordingly, Ofcom does not consider that there is evidence of reputational barriers to entry or expansion in the relevant market.

324. Ofcom has concluded that BT has not sought to leverage its SMP in fixed line telephony into the reference market through predatory pricing in consumer phones.

_Sunk costs as a barrier to entry_

325. The wholesale consumer fixed line telephone equipment business requires relatively few upfront or sunk costs. In particular there is no need to invest in manufacturing equipment or facilities. New designs typically can be manufactured within a six month time period. The initial set up costs relating to product design etc are very small compared to the overall costs of the business. Ofcom analysis of entry, including that of Magic Box, and of exit (e.g. DBTel) suggests that set up costs are negligible. The supply business is essentially one of distribution, in which the set up costs would include office and warehousing facilities, which could be easily subcontracted. Ofcom therefore considers that there are little or no sunk costs which would represent a barrier to entry.

_Barriers to expansion_

326. Ofcom has identified variability in market shares in both the consumer phone market and the DECT segment (paragraphs 190 to 212) which are suggestive of low barriers to expansion, given the observed growth in the size of competitors during the period of the alleged abuse. Additionally, Ofcom has, as part of its market definition analysis (paragraphs 115 to 126), considered supply side substitution, which is suggestive of few manufacturing capacity constraints.

327. Furthermore Ofcom has considered the expansion of 3 key competitors, namely Panasonic, Philips and Onetel, in the consumer phone market and the DECT segment. Since January 2004, Panasonic increased its value share from 8.3% to 13.3%, Philips from 6.1% to 8.2% and Onetel from 0% to 4%. The increase in share is also reflected in the DECT segment, where Panasonic increased its share from 11.4% to 16.2% over the same period, overtaking Binatone to become the second largest supplier in that segment by November 2005. Ofcom considers that these suppliers provide additional evidence that over the period of the investigation competing suppliers realised opportunities for expansion.

328. Ofcom has also requested suppliers to comment on opportunities to expand in the market. One supplier has indicated that it had opportunities to expand and grow in the consumer telephone market from 2004 onwards:

“[supplier] managed to sustain market share in 2004 and grow its share during 2005. [supplier]’s strategy has been to introduce high-end features (e.g. telephone answering capability, large phone book) into mid and lower-end models, and this has been well received by retailers and consumers.”

329. Therefore, Ofcom considers that there are few if any barriers to expansion.

_Concentration ratios, Herfindahl-Hirschman Index and barriers to entry_

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133 [supplier] S26 response [date].
330. The complainants have also raised the following in support of evidence of barriers to entry:

“The high HHIs reported in the [Mintel] Report also demonstrate the competitive problems of the market. A market with a four firm concentration ratio of 86% (for cordless telephones) and 75% (for corded telephones) is clearly highly concentrated and will in most circumstances be considered indicative of barriers to entry.”

331. Concentration ratios measure the combined market share of leading firms in a market. They are absolute measures of concentration, and do not take account of differences in the relative size of the firms that make up the leading group. The Herfindahl-Hirschman Index (HHI) measures total market concentration inclusive of all firms, but unlike concentration ratios, takes account of the differences in the size of the market participants. The HHI is calculated by summing the squares of the market shares of all the firms engaged in the market.

332. The OFT uses markets shares, concentration ratios and HHI’s in its merger analysis. In OFT guidance it states that:

“The OFT is likely to regard any market with a post merger HHI in excess of 1800 as highly concentrated, and any market with a post merger HHI in excess of 1000 as concentrated. In a highly concentrated market, a merger with a delta in excess of 50 may give rise to potential competition concerns. In a concentrated market, a merger with a delta in excess of 100 may give rise to potential competition concerns. Where it is not possible to calculate HHI for the entire market (e.g. because not all participants’ shares are known), the OFT will generally use other concentration measures or may, where appropriate, calculate only the incremental delta.”

333. Importantly, the OFT also state that:

“Each of these measures [market share, concentration ratios and HHI] may be used as an initial indicator of potential competition concerns, but will not give rise to a presumption that a merger may be expected to lessen competition substantially. In other words, further investigation is always required to determine whether a merger will substantially lessen competition.”

Oftcom analysis

334. Ofcom has considered both concentration ratios and HHIs based on the Mintel and GfK data. In relation to the concentration ratios, Ofcom notes that the Mintel data suggests a four firm concentration ratios to be 81% (for cordless telephones) and 75% (for corded phones) in 2004.

335. Ofcom has also looked at the four firm concetration ratio and HHIs for the period 2000-2005 for DECT phones using GfK value share data. The following table lists the results:

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134 Letter from complainant to Ofcom, 19 June 2005.
136 Similar concentration ratios are evident for 2000 and 2002.
137 Herfindahlt-Hirschman Index (HHI). The HHI measures market concentration, but takes account of the differences in the size of the market participants. The HHI is calculated by summing the squares of the market shares of all the firms engaged in the market. In a perfectly competitive market, the HHI will tend to zero, with the maximum possible HHI score of 10,000 reflecting a monopolist with 100% share of the market.
Table 3 Four firm concentration and HHI for DECT phones

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>C4 ratio</td>
<td>83</td>
<td>84</td>
<td>85</td>
<td>85</td>
<td>85</td>
<td>83</td>
</tr>
<tr>
<td>HHI</td>
<td>2399</td>
<td>3156</td>
<td>2591</td>
<td>2452</td>
<td>2938</td>
<td>2549</td>
</tr>
</tbody>
</table>

(Source: Mintel, GfK)

336. The table shows that the four firm concentration based on the GfK data is higher than for Mintel and suggests a stable ratio of between 83% and 85%. This share suggests four firm concentration is high. However, the measure does not indicate whether this arises from stable high underlying shares of the four leading firms or whether there are changes in the size of the leading four firms that could be masking underlying competitive processes in the market.

337. For instance, Ofcom notes in paragraphs 196-197 that cross over points arise over the period. In particular, we note that BT’s share (the largest firm share) of DECT by value broadly falls from December 2004, while Panasonic and Philips increase their shares, with Panasonic overtaking Binatone as the second largest firm by size by November 2005. This variation in the relative size of the four largest competitors suggests that firms must compete in order to maintain their own share of the market, and that opportunities for expansion by competitors exist. Ofcom also notes that entry by Magic Box, Onetel, Motorola and Lazerbult is observed over the period in which high concentration ratios are observed (see paragraphs 266-268).

338. Unlike concentration ratios, the HHI measure bears out relative share movements because it measures the relative size of all competitors in the market. Table 3 illustrates that the level of the HHI is relatively high. The measure does exhibit some movement with peaks in the HHI being observed in 2001 and 2004. The HHI is higher in 2004 reflecting the increased BT share over this period.

339. The OFT’s merger guideline suggests that for merger analysis an HHI of over 1800 is indicative of a highly concentrated market. The HHIs in DECT phones exceed 1800 throughout the period. However, the guideline also recognises that whilst measures of concentration, including HHIs, may provide an initial indication of potential competition concerns, they do not give rise to a presumption and further investigation is always required.

340. The complainants have argued that high concentration will in most circumstances be considered indicative of barriers to entry. However, in Ofcom’s view, in the circumstances of this investigation, it is more appropriate for the assessment of barriers to entry and expansion to rely on more direct evidence of these factors. This is preferable to relying on an indication from measures of concentration, which omit or fail to fully capture all of the relevant considerations, such as those referred to in the next paragraph.

Ofcom’s conclusions on barriers to entry, expansion and exit

138 Note that an HHI based on the GfK data will overstate the level of the HHI since smaller supplier shares are aggregated and hence the square of this aggregate figure will necessarily be greater than the square of the underlying small individual suppliers.
341. Having carefully examined the market and taken account of the information and evidence gathered from suppliers, Ofcom considers that there are few barriers to entry (paragraphs 244-270) and that there are few barriers to expansion (see paragraphs 326-329). In addition, Ofcom has considered outcomes in the market that are suggestive of a competitive market. These include falling prices (see paragraphs 219-222), relatively few upfront or sunk costs and numerous manufacturers, in particular in Asia, with excess capacity (see paragraphs 257-263) The relevant circumstances of the market lead to the conclusion that barriers to entry, exit and expansion are low.

**Retailer customer and end-consumer constraints on BT’s pricing behaviour**

342. Ofcom has considered whether the behaviour of end-consumers, customers and competitors in the market appear to be constraining the pricing behaviour of BT in the wholesale consumer phone market. As a result of that consideration, Ofcom has concluded that there are readily observable constraints to BT’s ability to raise its prices (whether on consumer phones generally, or any significant product segment or value segment within the consumer phones market), and that BT’s commercial decisions also demonstrate that BT is subject to such constraints.

**Complainants’ views**

343. The complainants claim that BT is an "obligatory trading partner for all retailers of fixed line telephones", essentially because the strength of the BT brand means that a degree of customer demand exists specifically for BT branded products to be carried by retailers that does not exist in relation to competitor brands. As a result, the complainants argue, retailers will not remove BT brands altogether, a prospect which is real for other suppliers, and it follows that BT has considerable bargaining power in its relationships with retailers that other suppliers do not also enjoy.

344. The complainants also made the following additional points in response to Ofcom’s 1st draft non-infringement decision on 20 October 2005:

- market power held by a small number of retailers (in reality only Argos and Dixons) does not provide a sufficient constraint on BT’s dominance in the wholesale market. In *Irish Sugar* the ECJ held that the presence of 2 large customers did not constrain the dominance of Irish Sugar
- the strength of the BT brand means that retailers are less likely to reduce listings of BT phones
- retailers have a vested interest in down-playing the importance of BT’s brand, since they have an interest in sharing in the benefits of BT’s marketing spend and lower prices.
- Price reductions are rarely unilateral and are usually made by a supplier and a retailer jointly. While price reductions may have been sought by retailers, BT was an active participant in the price initiatives. BT knew or at the very least ought to have known that its competitors would not have been able to sustain the price reductions.
• to the extent that retailers do hold market power, BT has taken advantage of that market power and used it in conjunction with its own, to the detriment of other suppliers. BT has done this by focussing price cuts on competitors’ main product lines over the Christmas sales period

• to use the existence of a degree of market power on the part of a few key retailers to displace the obligations that rest on BT is misconceived. A company holding a dominant position has a special responsibility not to allow its conduct to impair undistorted competition. BT’s special responsibility in this market is not to loss lead with key retailers since such conduct has the effect of adding their market power to its own resulting in the squeezing of competitors. BT clearly has the market power to resist the price requests from retailers which other suppliers do not.

345. In their 23 February submission, the complainants made additional arguments in respect of buyer power.139

• BT is an obligatory trading partner for all major UK retailers in the UK. As one of the most recognised brands in the UK, BT branded DECT are a “must have” and retailers will be unwilling to jeopardise their relationship with BT.

• The strength of the UK retailers has exacerbated BT’s predatory conduct, and the resulting low (or more likely non-existent) margins that can be achieved by suppliers to the UK market as well as the harsh terms and conditions imposed, has lead directly to market exit and will heavily dissuade the prospect of new entry in the future.

• The strength of the retail power in the UK market should be considered in Ofcom’s assessment of barriers to entry, as the increase in barriers to entry and expansion is the most significant consequence of the power held by the UK retailers.

BT’s view

346. BT argues that a very small number of buyers account for the bulk of BT’s wholesale consumer telephone equipment sales, giving those buyers significant leverage in negotiations with BT.140 In particular, BT identifies \[\text{[\times]}\], \[\text{[\times]}\] and \[\text{[\times]}\] as having “considerable leverage” with their suppliers, including with BT.141

347. BT has provided Ofcom with the following examples which, it claims, support the conclusion that the power of major retailers constrains its pricing behaviour:

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139 The complainants made further submissions in their 7 June 2006 letter, set out further below in paragraphs 363 to 365.
140 BT submission 6 September 2005.
141 BT estimates that \([\text{retailer}]\) accounts for \([\times]\)% of all fixed line telephone sales, BT confidential submission 6 September 2005.
• In response to retail competition, BT was forced to accept wholesale price reductions in negotiations with buyers between December 2004 and January 2005, while buyers maintained their pre-existing gross margin levels;

• In July 2004, [retailer] negotiated down BT’s wholesale prices on the basis of [植入];
• Retailer has recently reduced the number of BT’s listings and the proportion [植入] allocated to BT [植入] leading to a reduction in the value and volume of BT’s sales to that retailer; and

• In July 2004, BT reduced wholesale prices for the Lyric 1100 model after [retailer] refused to take additional stock at the time unless prices were discounted ([Retailer] was the [植入] selling the phone model at that time).

**Ofcom’s analysis**

348. Between October 2004 and December 2004, just over 62% (by volume) of consumer phones purchased by consumers were bought from mass merchandisers (large electrical retailers such as Argos, John Lewis and Homebase). In addition, a further 26% were sold by electrical goods multiples (such as Dixons and Currys and Comet. Ofcom has considered whether these retailers (or end-consumers through retailers) are able to significantly constrain BT’s pricing in the wholesale telephone equipment market.

These factors are considered in further detail below.

*Ofcom detailed analysis of constraints on BT’s pricing*

349. Ofcom first considers the importance of different retail sales channels to their relative proportion of sales volumes and values.

350. Figure 14 and Figure 15 below illustrate the breakdown of sales channels between major retailer categories.
According to the GfK data set, mass merchandisers are the most important group of retailers though which phones are sold. Mass merchandisers sell up to 62% of all telephones by volume and up to 59% by value as at October-December 2004. Electrical multiples are the second most important group of retailers identified by the GfK data (26% by volume and 28% by value). Examples of retailers within each of these groups are provided below.
- Office equipment retailers (2%) e.g. Office World, Supplies Team
- Mass Merchandisers (62%) e.g. Argos, John Lewis and Homebase
- Mail Order (2%) e.g. www.homephonesonline.co.uk
- Electrical Independents (2%) Independent (small) retailers
- Electrical Multiples (26%) e.g. Comet, Currys, Dixons
- TCS independent Independent (small) retailers
- TCS multiples (7%) e.g. Virgin Megastores, Orange, V shop, Vodafone

352. The concentration of buying power amongst specific buyers is discussed in paragraphs 353 to 401.

**Evidence of countervailing buyer power from the major retail multiples**

353. BT has presented Ofcom with evidence which appears to show that the major retail multiples have considerable ability to exert downward pressure on BT’s prices and terms in the reference market.

354. In July 2004, for example, BT came under strong, and ultimately successful, pressure from [retailer] to retrospectively reduce wholesale supply prices of consumer phones which BT had supplied to [retailer], in recognition of cost savings that [retailer] considered BT to have made. [retailer] supported its request for such a price reduction by way of its own calculation of the savings that [retailer] estimated BT had made, as well as an estimate of unit cost savings it considered had arisen through [retailer]. BT agreed a retrospective improvement to these terms (at a cost to BT of £) and also agreed to improve terms going forward.

355. At around the same time, BT was having to deal with the fact that the Lyric 1100 phone had a stock exposure of approximately £ (representing wholesale price). [retailer], listing the product at that time, refused to take on additional stock at the prevailing wholesale prices (£49.99 for the single handset version and £79.99 for the twin handset version). [retailer] would only purchase on the basis that they would retail these models at £39.99 and £59.99, at their usual margin and BT felt that it had little alternative but to agree to [retailer]’s proposed reduction in prices.

356. A further example to which BT pointed was the situation that occurred in December 2004/January 2005, when BT was forced to accept lower prices (and reduced profit margins) in response to retailers’ demands for lower wholesale prices. The retailers pushed for reductions needed to sustain their own profitability whilst reducing retail prices in order to drive sales volumes. The following analysis sets out the background to the price cuts and considers possible interpretations of the evidence.

357. One of those retailers was [retailer], which promoted both temporary and permanent retail price reductions on a number of BT phone models (including selected phone models). For these phone models, [retailer] achieved retail price reductions through price reductions by BT. [retailer]’s gross margin (i.e. the difference between the wholesale price and the retail price) was maintained. Ofcom asked BT for evidence that large high-street retailers have significant countervailing buyer power and are able to demand price reductions that enable

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142 BT Submission, 6 September 2005.
143 These represent wholesale prices.
them to maintain their margin even if they choose to reduce the retail price to the
demanding customer. BT provided four examples of where it agreed to price reductions
which enabled its retail buyers to maintain their margins.144

358. Specifically, in December 2004, and in response to competitive conditions in the
retail sector, [retailer] discounted prices (between 8% and 36%) for 22 phone
models, 7 of which145 were achieved through BT accepting lower wholesale
prices.146 In January 2005, [retailer] discounted prices (between 7% and 36%) for
22 phone models. All 22 discounts were achieved through BT accepting a lower
wholesale price.147 [retailer] maintained gross margins of approximately [>>]% for
discounted phone models over the period of promotion, whereas BT accepted
reductions in wholesale prices of between [>>]% and [<<]%.

359. Similar phone models were also discounted by other competing retailers, who
were no doubt keen not only to raise their own sales volumes, but also to respond
to the fact that [retailer] was running price promotions on BT product lines.

360. For instance, in December 2004, [retailer] and [retailer] promoted price reductions
(of between 9% and 36%) for 22-27 phone models, 7 of which were achieved
through BT accepting a reduction in its wholesale price. In January 2005,
[retailer] and [retailer] promoted price reductions (of between 6% and 36%) for 22
phone models, all of which were achieved through BT accepting a lower
wholesale price. [retailer] and [retailer] maintained gross margins of [>>] and
[<<]% respectively on over 29 phone models discounted over this period.148

361. Ofcom has evidence of a written record of discussions that took place between
BT and [retailer], and BT and [retailer] indicating that the buyers required BT to
reduce the RRPs in order for BT to maintain its listings. Buyers claimed, in
particular, that price reductions from BT’s competitors were adversely affecting
the BT phones portfolio; hence the need for price reductions.149

362. These events, which relate to some of the BT phone models at the heart of the
complainants’ concerns, appears to Ofcom to provide support for the view that
BT’s pricing in the wholesale consumer phones market is subject to significant
constraint by the demands of its major retailer customers in relation to price.

363. The complainants argue in their 7 June 2006 letter that “BT’s direct sales
channels also provide BT with a significant counter-balance to retailers and their
potential to engage in margin squeeze. BT has the infrastructure, reputation, and
direct marketing capability to take the full margin between commissioned
manufacturer and the consumer in response to retailer demands and retailers are
unlikely to want to provoke BT into aggressive direct competition. BT is the one
manufacturer who can, and where it suits, will withstand large retailers.”

364. The complainants further argue150 that Ofcom has ignored evidence from
Panasonic regarding how price reductions have occurred in the market.
Specifically:

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144 BT submission 21 September 2005.
145 The 7 discounted phone models where BT accepted a wholesale price cut include [>>].
146 The remaining phone models on promotion included [<<].
147 The 22 discounted phone models where BT accepted a wholesale price cut include [>>].
148 BT submission 21 September 2005
149 See paragraphs 630 Error! Reference source not found. onward - for more details
150 Complainants’ 7 June 2006 letter, page 6, paragraph 25.
“During 2004, the de facto price leader was BT (by virtue of both its market share – approx 50% - and the perception amongst customers of it as a prestige supplier in the telecommunications market), and any permanent move by them would require other manufacturers to follow.”

“in our estimation, price pressure in 2004 was created because of the necessity to provide pricing that was competitive with other manufacturers (in particular BT) rather than retailers seeking to increase margin.”

365. The complainants also argue that “…BT was an active participant in the price reductions and knew or at the very least ought to have known that its competitors would have been unable to sustain the price reductions agreed with retailer(s). The effect of BT’s decision to engage in these price reductions was to “squeeze” competitors impacting on their relationship with retailers and hence their profitability at the wholesale level, as their profile at the retail level,”151

366. Ofcom’s detailed analysis of BT’s pricing is set out below which concludes that BT’s pricing was not predatory. Further, the evidence in relation to BT’s pricing decisions indicates, as set out in detail below, that price reductions were generally in response to a competitive market.

367. Ofcom considers there are two reasonable interpretations of this pricing evidence: either countervailing buyer power or competition in the retail sector where end users in that sector constrain BT’s pricing in the wholesale market.

368. Ofcom has also considered evidence on the influence retailers exert on suppliers through retailers’ control over marketing and promotional activities, and the effect that those activities can have in terms of increasing or reducing any particular supplier or brand’s share of the total volume of consumer phones sold by the retailer in question, or even of the total volume of consumer phones sold in the retail (and therefore also wholesale) markets overall.

369. BT has argued that retailers’ choices of supplier for product listings in their promotional material (e.g. the Argos catalogue) can have a significant impact on wholesale suppliers’ market shares. In particular, BT has submitted that Argos has a direct and material influence on BT sales in the retail sector through the Argos Catalogue. For instance, BT have provided evidence that BT’s listing for fixed-line consumer phones fell from 33% to 30% between the Autumn/Winter 2004 catalogue and the 2004/05 Spring/Summer catalogue,152 and that this appears to have correlated with a fall in BT’s market share. For illustrative purposes, Ofcom has therefore considered market shares between July to December 2004 and January to June 2005, below:

Table 4 BT Share of listings in Argos Catalogue 2004/2005153

<table>
<thead>
<tr>
<th></th>
<th>Share of listings</th>
<th>Market share by value</th>
<th>Market share by volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>Autumn/Winter 04</td>
<td>33%</td>
<td>55%</td>
<td>48%</td>
</tr>
</tbody>
</table>

152 That is, of all phone models advertised in the catalogue BT had 30% of those listed products as at the 2004 Spring/Summer catalogue  
153 Table values for Autumn/Winter 2004 are taken from the first week of sales for that catalogue. The values for Autumn/Winter 2005 are taken from the first week of sales in that catalogue. Accordingly, Ofcom does not consider these results to be robust (see paragraph 338).
370. While Ofcom considers that this information could potentially be illustrative of a relationship between Argos catalogue listings and overall market share, the limited amount of data provided is insufficient to draw any robust conclusions about a causal relationship between the two. Common sense would seem to suggest, however, that there is likely to be at least some relationship between listings and sales, and the fact that Argos is able to reduce BT’s listings suggests that, even if BT were a ‘must have’ brand for Argos, Argos can still exert some constraint on BT’s pricing (i.e. by reducing BT’s listings in the Argos catalogue unless and until BT reduced its wholesale prices).

371. Ofcom has also considered evidence of the impact of BT’s proportion of what are termed 'hero slots' within the Argos catalogue both on BT’s share of consumer phone sales through that retailer and on BT’s share of the consumer phone market overall. Hero slots are typically larger size listings of products which are positioned for higher visibility. They also include what is known as a ‘lifestyle’ shot of the product in an everyday domestic setting (unlike normal listings which simply include a picture of the telephone against blank background).

372. Table 5 below compares demand for three BT phone models against hero slot listings obtained by BT in the Argos catalogue. The three products listed in Table 5 obtained hero slots in the Spring/Summer 2005 catalogue, but not in the Autumn/Winter 2005 catalogue. Note that prices did not change throughout the 12 month period in which the products were available in the catalogue. The table below shows that there was a significant change in demand for the listed products after the Autumn/Winter 2005 catalogue.

<table>
<thead>
<tr>
<th></th>
<th>Spring/Summer 05 Catalogue</th>
<th>Autumn/Winter 2005 Sales without hero slots</th>
<th>% change in demand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freestyle 2200</td>
<td>![X]</td>
<td>![X]</td>
<td>![X]</td>
</tr>
<tr>
<td>XA3000</td>
<td>![X]</td>
<td>![X]</td>
<td>![X]</td>
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<tr>
<td>XA3000Twin</td>
<td>![X]</td>
<td>![X]</td>
<td>![X]</td>
</tr>
<tr>
<td>Total BT DECT</td>
<td>![X]</td>
<td>![X]</td>
<td>![X]</td>
</tr>
</tbody>
</table>

Source: BT

373. Table 6 below likewise suggests that there may be a link between BT’s share of Argos catalogue hero slots across all product groups in which BT is active and BT’s total share of sales of consumer phones through that retailer.\(^\text{155}\)

\(^{154}\) BT submission 6 September 2005

\(^{155}\) BT has also claimed that the favourable placement of Philips phones in the A/W 2005 catalogue may have resulted in a decrease in BT’s relative market share. For instance, BT claim that Philips’ share of hero slots increased from 3% to 25%, while BT’s share dropped from 21% to 13% over the same period.
Table 6 BT share of hero slots and market share

<table>
<thead>
<tr>
<th></th>
<th>BT share of hero slots</th>
<th>BT share of sales through Argos</th>
</tr>
</thead>
<tbody>
<tr>
<td>Autumn/Winter 2004</td>
<td>35%</td>
<td>[X]</td>
</tr>
<tr>
<td>Autumn/Winter 2005</td>
<td>13%</td>
<td>[X]</td>
</tr>
</tbody>
</table>

Source: BT

374. As with the data on listings and market share, Ofcom considers the information in Tables 3 and 4 to be potentially illustrative of a relationship between hero slots and share of consumer phones through that retailer. Again, however, it is insufficient to draw any robust conclusions. In particular, Ofcom notes that the data in Table 3 only relates to two time periods. A longer period would have to be looked at before drawing any conclusions about the likelihood of the existence of a causal relationship.

375. Nevertheless, it would appear to Ofcom to accord with common sense to think that there would be at least some relationship between Argos catalogue hero slots and the number of BT phones sold through that retailer. In that regard, Ofcom notes that it has seen documents that illustrate that BT is very keen to ensure that it secures hero slots in the Argos catalogue and has been willing to reduce prices and/or make additional contributions to Argos’ marketing expenditure to ensure that such slots are obtained.

376. It appears, therefore, that wholesale suppliers of consumer phones (including BT) attach considerable value to listings and hero slots in the Argos catalogue.

377. Given that the placement of products within hero slots is determined through negotiation between Argos and suppliers, and depends in part on suppliers’ willingness to ‘pay’ Argos for that catalogue space (e.g. by way of a financial contribution towards catalogue production costs), Ofcom believes that there is considerable scope for Argos to exert constraints on BT through those levers. Indeed, Ofcom notes that BT appears to be under-represented in the Argos catalogue in terms of listings having regard to its share by volume and value and under-represented in terms of hero slots by its value share of sales of consumer phones to consumers through that retailer. That would, at least on the face of it, seem inconsistent with a theory of dominance that assumed an ability by BT to dissuade key retailers, such as Argos, from listing and/or actively promoting non-BT consumer phones.

378. In addition, Ofcom also notes that there appears to be considerable competition between retailers in relation to the retail prices of cordless phones, since if retailers were not to match the prices reductions of other retailers, they would be likely to lose market share. Accordingly, the fact that Argos is able to negotiate lower prices from BT and therefore offer lower prices to consumers, and the fact that other retailers are frequently able to match Argos’ prices or run similar promotions of their own (for example, see paragraphs 358 - 360) suggests that those other retailers are also able to exert price constraints on BT (perhaps by

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156 BT submission 6 September 2005
157 Table values for Autumn/Winter 2004 are taken from the first week of sales for that catalogue. The values for Autumn/Winter 2005 are taken from the first week of sales in that catalogue. Accordingly, Ofcom does not consider these results to be robust.
demanding marketing support payments in return for listings, promotions or shelf-space).

379. BT submitted an internal document to Ofcom which further demonstrate the influence that promotional decisions by retailers have on BT’s pricing. The document requests short-term price reductions in order to support retailer promotion of BT products. It notes the following:

“Temporary pricing support from the number one brand in the UK is seen as an essential element of our proposed offerings. If we did not support promotion the feedback has been that we will lose activity within promotional material (for flyer etc. they only list pricing reduced products) and ultimately shelf space … An example of the risk of not running price promotions was shown through [retailer] for January sale. Products which we carried on for promotion from Christmas through to January (when the prices were permanently reduced), they chose not to promote as for them the period of promotion stretched too far. Hence, BT had no sale presence with them. Our share with [retailer] had increased in November and December to a record level for BT, but in January we saw a decrease to a level which was even lower than pre-Christmas – competitors grabbed share of activity.”\(^\text{158}\)

380. Ofcom considers that there are several plausible interpretations of the data on promotions, listings and hero slots. One interpretation is that it is reasonable to conclude, based on the evidence set out above, that the decisions of the larger buyers on whether or not to include a particular product in a catalogue or feature in a special promotion, provides those buyers with significant strength in negotiations with suppliers. High visibility within the catalogues and in stores is an important but not sufficient requirement to achieving high volume sales. Attractive prices and design are also needed, but without the catalogue listing or in-store promotion the product will not achieve high sales. Ofcom considers that could be supportive of countervailing buyer power. However, Ofcom also considers that it could equally support the view that retail markets are highly competitive, and that the constraint arises not from buyer power, but the end-consumer. It could therefore be interpreted as a constraint arising from competitive retail sectors.

381. Ofcom has also considered representations from suppliers regarding the buying and negotiating position of retailers in the consumer phone market. Respondents were asked whether retailers or other competitors were in a particularly strong buying or negotiating position compared to other markets. They were also asked to describe companies that were particularly strong and also how this strength (if any) is exercised.

382. As discussed at paragraphs 271 to 295 (in the section on barriers to entry, expansion and exit), a supplier present in the market [supplier] and a supplier that recently exited [supplier] have indicated that retailers exert considerable pressure on manufacturers to compete keenly on price and to accept all returns, even where they are not faulty. As noted above, retailers’ insistence on 'no fault found' returns provisions has been cited to Ofcom by more than one supplier as a key difference explaining why wholesaler profitability is higher in continental Europe than the UK and why certain European wholesalers have exited, or decided not to enter, the UK market.

\(^{158}\) BT’s S26 response to Ofcom (Response to question 7, Annex 7).
383. Evidence from wholesalers also supports the more general proposition that the major retailers enjoy considerable buyer power, and that the extent of that buyer power is a distinguishing feature of the UK market, as compared with the continental wholesale consumer phones markets.

384. For instance, a supplier, [supplier], that recently exited the market told Ofcom that:

“Retailers in the UK have mighty buying power and influence end-user buying decisions. Argos is the most powerful retailer, their entire supplier has to co-operate with their promotion program throughout the year. In Q1 2004, we decided not to place our product in their catalogue features page because Argos require [X] which we believe is too high. Consequently, [supplier] was de-listed totally from their next catalogue”.

and

BT is the leading brand as well as the price indicator of the market. However retailers have very strong positioning other [suppliers] brand’s market price to achieve their market share and sales volumes.159

385. Other suppliers make similar claims. One supplier cited by the complainants indicates that variable costs differ between phones produced for the UK and those in Continental Europe due to the returns policy in place in the UK.

“Returns to be taken in consideration. They are significantly higher than in other European countries.”160

and

The retail market is in the UK is much more concentrated than other situations in Europe. Regarding cordless phones, we can consider that a large amount of the market is retained by 3 to 4 players and a significant part by only one actor: Argos. The buying power of these retailers is therefore very strong and allow them to impose very severe conditions to small players or new entrants such as [supplier].161

386. Similarly, although one supplier [supplier] stated that BT was a leading brand and a price indicator in the market, that same supplier simultaneously argued that retailers have a very strong position in the market, with Argos being the most powerful retailer. [Supplier] claim suppliers must co-operate with retailers’ promotion programs throughout the year or risk being de-listed.

387. The European Commission, OFT and Competition Commission all examine countervailing buyer power in assessing any market power which may arise from a merger. For example, the European Commission states in its Guidelines on Horizontal mergers162 that even “firms with very high market shares may not be in a position post-merger, to significantly impede effective competition, in particular by acting to an appreciable extent independently of their customers, if the latter possess countervailing buyer power. Countervailing buyer power in this context should be understood as the bargaining strength that the buyer has vis-à-vis the

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159 [Supplier] S26 response [date].
160 [Supplier] email [date].
161 [Supplier] email response [date].
162 Commission Notice Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings 2004/C31/03 at section V.
seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to switch to alternative suppliers”\textsuperscript{163}

388. The OFT’s Guidelines note, however, that “Size is not sufficient for buyer power. Buyer power requires the buyer to have choice.”\textsuperscript{164}

389. The OFT Guidelines set out a number of factors in assessing whether there is countervailing buyer power.\textsuperscript{165} Ofcom has considered these in analysing the reference market:

(a) “the buyer is well informed about alternative sources of supply and could readily, and at little cost to itself, switch substantial purchases from one supplier to another while continuing to meet its needs”

390. The electrical retailers are very well informed about alternative sources of supply in the market, with most retailers having multiplecommercial relationships with suppliers at any given point in time.\textsuperscript{166} The larger retailers have dedicated product buyers with access to detailed information from current and prospective suppliers. There are minimal switching costs in stocking competing phones since stocks are typically maintained by suppliers (so costs of maintaining stocks reside with suppliers), and retailers can easily choose to take on new models with other buyers. In addition, [a major retailer] has an \textsuperscript{[\times]} licence to use the \textsuperscript{[\times]} brand in the UK and sources phones directly from manufacturers in the Asia-Pacific region which [retailer] then brands. Therefore [retailer] is aware of the possibility of purchasing directly from manufacturers and could do so relatively easily (directly or via an intermediary). Other large electrical retailers can be expected to be aware of this possibility.\textsuperscript{167}

(b) “the buyer could commence production of the item itself or ‘sponsor’ new entry by another supplier (e.g. through a long term contract) relatively quickly and without incurring substantial sunk costs”

391. Again, as has already been demonstrated by the recent entry by Magic Box to the market, as well as through [retailer] self-sourcing phones under the \textsuperscript{[\times]} licence, electrical retailers can sponsor new entry relatively quickly and without incurring significant sunk costs. For example, in discussions with one supplier, the supplier indicated that it was able to establish the necessary relationships with retailers and manufacturers to enter the market and gain a presence in that market within 3-6 months.\textsuperscript{168} Other large electrical retailers would also appear able to sponsor entry with similar ease to [retailer]. The sponsorship of new entry (e.g. self supply) could be used to remove reliance on an existing large supplier.

\textsuperscript{163} Commission’s Horizontal Mergers Guidelines at paragraph 64.
\textsuperscript{164} OFT Guideline 415 Assessment of market power at paragraph 6.1.
\textsuperscript{165} OFT 415 at paragraph 6.2.
\textsuperscript{166} Informal meetings with retailers, June/July 2005.
\textsuperscript{167} Ofcom has not examined what level of purchases [retailer] could switch over but notes that it has a direct relationship with a manufacturer in the Far East.
\textsuperscript{168} \textsuperscript{[\times]}. 
(c) “the buyer is an important outlet for the seller (i.e. the seller would be willing to cede better terms to the buyer in order to retain the opportunity to sell to that buyer)"

392. BT has provided details of its sales by customer as shown below.

**Figure 16 BT DECT phone sales**

[<<]

Source: BT

393. [retailer] is the largest buyer of BT DECT phones in the wholesale market, purchasing [<<]% of BT’s phones. [retailer] is second largest with [<<]%.

It is clear from discussions with all participants and on reviewing BT’s internal correspondence relating to its overall strategy that the major retailers such as Argos are able to maintain a high level of pressure on their suppliers to provide them with stock at prices which both enable them to offer keenly priced products to their customers and also enable them to generate target margins over the wholesale cost.

394. BT has provided a number of examples where buyers have successfully demanded that BT lower its wholesale prices in response to competitive conditions in the retail sector. In some of those cases, BT was required to lower its wholesale prices by as much as [<<]% (the simple average price reduction was [<<]%). These examples are discussed in detail from paragraph 355 to 369.

(d) “the buyer can intensify competition among suppliers through establishing a procurement auction or purchasing through a competitive tender"

395. Whilst the large electrical retailers do not tend to conduct procurement auctions for all items listed or stocked, some retailers do invite tenders (e.g. Phones4U). In addition, there is fierce competition to gain the limited amount of shelf or catalogue space available for DECT phones for which suppliers compete strongly on price, a key selling point. Twice a year, as Argos is planning to publish its catalogue, it approaches suppliers to get their best offers on handsets based on price and features. Argos has told Ofcom that suppliers compete as much as possible on price.

**Conclusion on buyer power**

396. In conclusion, Ofcom has considered whether the behaviour of end-consumers, customers and competitors in the market have constrained the pricing activity of BT in the wholesale consumer phone equipment market. While it is often difficult to distinguish the source of constraint (e.g. whether constraints arise through retailers acting as information flows from end consumers, or through the countervailing buyer power of retailers), the constraints themselves can be readily observed through evidence obtained on pricing decisions taken by BT and responses to those decisions. In particular, Ofcom considers that the evidence on the source of constraints presented above could be interpreted as arising through

169 Note that East Central Distribution was and Rocom is a business to business distributor who sells both to retail and non-consumer outlets. In the case of East Central Distribution, a significant percentage of these sales actually ended up with a high street retailer, in particular, Homebase.

170 Eg see paragraphs 638 onward
retailers acting as information flows from end consumers, or through the countervailing buyer power of retailers (or both). Constraints originating from either source support a non-dominance finding.

397. In conclusion, based on the evidence set out in paragraphs 353 to 395 it is Ofcom’s view that there are constraints on BT’s pricing, including the following:

- buyers are well informed about potential sources of supply and can choose their supplier with ease; indeed, buyers have shown they are willing and able to self supply (e.g. [retailer] with [X] licence);
- sellers (including BT) are willing to cede better terms in order to retain the opportunity to sell through any one of the major retailers;
- there is fierce competition to gain shelf and catalogue space with the major retailer which provides those retailers with additional capacity to pitch the suppliers against each other so as to drive prices down even further or press for better terms; and
- Ofcom does not consider that the power of BT’s brand substantially negates the ability of buyers to exploit the circumstances set out in the previous three bullet points (this issue is discussed further below).

398. However, Ofcom considers that while the constraints on BT’s pricing are readily observable, Ofcom does not have sufficient information available to assess whether in fact the constraints on BT’s pricing arise from countervailing buyer power or competitive retail sector constraints, or a combination of both.

Conclusion on the existence of demand side constraints

399. Taking into account all the evidence, Ofcom concludes that BT is subject to demand side constraints (in particular from the large multiples, namely, Argos, Dixons, and Comet – who together account for over [X] of all BT’s sales of consumer phones) on its prices and terms and is not, therefore, able to price to any significant degree independently of customers, competitors or consumers. Ofcom rejects the complainants’ claims, made following its previous draft decision, that Ofcom was relying on too few suppliers in coming to that view. On the contrary, Ofcom has expressly not relied solely on the ‘buyer power’ of Argos, but has carefully considered a wide range of evidence (including BT’s internal documentation) before coming to the conclusion that BT is subject to effective demand side competitive constraints.

400. Indeed, as discussed in the section below where Ofcom considers whether BT was following a predatory strategy, the internal documents suggest that BT’s overall strategy included a desire to maintain value in the market. However, BT has sometimes found itself having to cut its prices in response to competitive pressures which have been channelled into demands by retailers for BT to cut its wholesale prices and/or offer additional marketing support. BT has therefore been compelled by market conditions to follow the general downward price trend in relation both to analogue and DECT phones from which consumers have been benefiting since 2002. Although Argos is likely to be in the strongest position to demand price cuts, the keenness of competition between retailers is such that any BT-funded promotions that are run by one retailer are likely to result in BT coming under pressure from other retailers to offer them benefits that enable them to compete with those promotions. BT’s internal documentation supports that analysis.
401. While Ofcom considers, for the reasons given above, that the constraints on BT’s pricing behaviour are readily observable, Ofcom recognises that these constraints could be the result of any one of, or a combination of, a number of different (potentially interrelated) factors, such as the behaviour of end-consumers in the competitive retail sector (since demand in the retail sector will inevitably translate into demand in the wholesale market), the general degree of competition between wholesalers, the threat of entry/expansion by competitors or potential competitors, and/or the countervailing buyer power of retailers. Whatever the root source of the competitive constraints to which BT is subject, however, Ofcom believes that the existence of those constraints, taking an overall view of the market and BT’s position within it, supports a non-dominance finding.

The impact of the BT brand on BT’s market position

Complainants’ arguments

402. As already noted, the complainants have suggested that BT’s brand confers on it “obligatory trading status”. This is said to result from its brand recognition arising from its SMP in fixed line telephony. The complainants also argue that while other brands may also have an "A" rating such as Panasonic, they do not enjoy the same recognition and reputation that BT enjoys in respect of telephone products.

403. In response to Ofcom’s previous draft decision, the complainants stated that they had the following concerns in relation to Ofcom’s analysis of the balance between BT’s brand recognition and countervailing buyer power:

“Ofcom has placed insufficient weight on the value of the BT brand and has failed to address the points raised in (the complainants’) the submission. The value of the BT brand is relevant not only in an assessment as to whether the BT brand impacts on countervailing buyer power but also as to whether the reputation and consumer loyalty attached to the BT brand and the level of investment which has gone into the BT brand has created a barrier to entry and/or expansion in the market.

As set out previously in their submission to Ofcom of 16 September, European case law has clearly recognised the importance of brand reputation, recognition and quality (Michelin).

The strength of the BT brand in relation to fixed line telephone equipment in the UK is incomparable to any other provider including Panasonic, Philips and Motorola. BT is virtually synonymous with fixed line telephones in the UK and no other brand comes close in terms of consumer recognition and reputation in this sector. Ofcom appears to have completely ignored the reality of the strength of the BT brand in UK telecommunications. A brief review of information from publicly available sources has revealed the following:

a. The recent trusted brands survey by Readers Digest lists BT as the 2nd most trusted Internet company and the 4th most trusted utility.

b. In the World Communication Awards 2005, BT Global Services was one of the finalists in the "Best Brand" award.

c. The Superbrands Organisation had granted BT “Superbrand” status.

d. The Brand Republic, in its Superbrands case study on BT, notes the following achievements of the BT brand “BT is one of the best known and most powerful brands in the UK. In research, the BT brand scores highly in terms of awareness, and
has been one of the most consistently strong performers in marketing magazines Adwatch survey. But it isn't just BT's advertising which forms public perceptions of the company everything it does touches peoples lives."

404. The complainants argue that Ofcom has not placed sufficient weight on the following statements made by participants in support of the complainants' view of BT's dominance (and in particular, comments in relation to the strength of the BT brand)\(^{171}\):

"Argos considers that BT is the only must carry brand of DECT phone. This is because of the strength of the BT brand and the fact that they have currently have share of more than 50% of the UK DECT market by value (see GFK reports referred to in question 2 above). From a technology point of view, BT products are no more advanced than other brands and their reliability is also on a par with other suppliers. However, the BT brand had considerable strength post de-regulation of the telecom sector."

"Brands such as Panasonic and Philips are important to product range as they help to demonstrate a good, better and best strategy, within the product range hierarchy and they encourage customers to trade up to more inspirational products. However, these brands are relatively interchangeable (i.e. Argos could quite easily deselect Panasonic products and select extra products from Philips or vice versa) due to their brand perception and overall share of the UK DECT market." (Argos Response of 16 September 05, page 4).

"BT's position is unique in Europe[]. PTT (BT) has the highest market share in Europe (excluding Luxembourg and Italy). BT has successfully also increased the share for cordless and kept it for cored phones. We have heard that BT is combining purchase of various products into bonus-schemes that are advantageous. BT is also investing heavily in brand building that is also benefiting the telephony business. You have better control of BT's position as operator of fixed line, GSM and broadband. They have a very strong position. It’s most probable that they use that position for having the extremely strong position with market shares around 50%."  

"BT has also been successful at keeping Siemens (Europe's dominant player in DECT phones) outside the UK market. How they organised that could be of large interest to your study. The phones are bought in Asia by various suppliers. BT is one of the biggest purchasers in Asia as they combine their purchasing power to ensure they receive the lowest price."

"Importance of retailer brand: even if you have access to good products you will have large difficulties to sell without a brand. That will end up with low price and no margins."

(Anonymous supplier, undated).

405. In particular, the complainants consider that the statement made by Argos that BT "is the only must carry brand",\(^{172}\) indicates a different relationship between BT and retailers in contrast to all other suppliers.

BT’s arguments

\(^{171}\) Complainants’ 7 June 2006 letter, page 4, paragraph 17. The references are to Argos (their response of 16 September 2005, page 4) and an anonymous supplier, (undated).

\(^{172}\) Argos’ 16 September 2005 S26 response.
406. BT accepted that it benefits from a well-known and trusted brand, but submits that this is equally true for other suppliers such as Panasonic, Philips and Motorola (the most recent brand entrant to the UK market). BT submits that all of these suppliers have substantial brand recognition arising from their presence in other consumer sectors.

407. BT alleges that phones are likely to be regarded as largely commoditised since many well recognised brands in the market supply similar equipment. BT claims that the commoditisation of cordless phones has been increased through the DECT standard which reduces the degree of differentiation between different brands of cordless phones. BT alleges that while differences between brands still exist with respect to factors such as design, the harmonisation provided by the DECT standard ensures that consumers will base their purchasing decisions primarily on a phone’s perceived value for money.

Ofcom’s analysis

408. Ofcom has considered evidence on product branding by examining product classifications developed by retailers. Ofcom understands that this classification places phone products into one of the following categories

- Entry Price Point;
- Step-Up;
- Mid Price; and
- Top End Premium phones.

409. Entry price phones tend to have a basic specification with a small phone book (i.e. up to 20 number memory) and last number redial. Brands in this segment include Binatone, BT, Opticom, Betacom, Audioline and Geemarc. Step-Up phones have a greater number memory, speakerphone and possibly backlit LCD display. Brands in this segment include BT, Onetel, Cable & Wireless and Southwestern Bell. Mid-priced phones typically have a larger phonebook, speakerphone capability a backlit LCD display and a backlit key pad. Some phones in this range may also feature polyphonic ringtones and SMS text messaging facility. Brands in this segment include BT, ntl, Philips, iDECT, and Magic Box. Top end/Premium phones usually feature 100+ number memory, speakerphone, backlit LCD display, backlit keypad, polyphonic ringtones, SMS text messaging and possibly a SIM card reader. Brands in this segment include BT, Philips, Panasonic, Motorola and Siemens.

410. BT (along with Panasonic and Philips) is a ‘top end’ brand, and therefore few, if any, retailers who offer their customers a substantial range of consumer phones would consider removing BT (or Panasonic and Philips) from their listings completely if, for example, those suppliers were to raise their prices independently of underlying costs or competitive conditions. However, retailers could, for example, reduce listings on those phones that were least competitively priced, or that did not offer the retailer a sufficiently attractive margin. In the case of phones in the latter category, the retailer could also decide not to actively promote those phones and instead to give greater prominence to other brands which offered the retailer better margins.

173 DECT is a standard developed by the European Telecommunications Standards Institute (ETSI), and any phone carrying the DECT label must meet the specifications of this body.
411. Ofcom has considered the complainants’ comment that as BT is a ‘must carry’ brand, retailers are unable to constrain BT’s market power. Ofcom has considered this point at paragraph 370, and considers that although BT may be a ‘must carry’ brand, at least for some retailers, it does not enable BT to necessarily act independently of its buyers. While a retailer may, for example, be unable to de-list BT if BT were to worsen the terms of sale, it could reduce the range of BT’s models stocked. Our analysis of countervailing buyer power from the major retailer multiples is set out at paragraphs 353 to 356 above.

412. Ofcom also believes that BT’s relatively low market share in relation to the wholesale supply of fax machines is relevant to a consideration of the degree to which the high profile of BT’s brand deriving from its SMP in fixed line telephony is liable to translate into a significant competitive advantage in the supply of branded equipment to be used on fixed lines.

413. An analysis of market share data suggests that BT has a relatively small share of the domestic facsimile market (6% in 2004, and 4% in the first half of 2005). Key players in this market include Brother, HP, Samsung and Philips (market shares in first half of 2005 of 24%, 20%, 10% and 11%, respectively). Ofcom considers that this evidence provides at least some support for the conclusion that BT’s brand association with fixed line telephony is not as significant an advantage in the markets for the supply of fixed line equipment as the complainants appear to be suggesting.

414. In summary, Ofcom has considered the evidence and views put to it by both BT and the complainants. On the basis of having done so, Ofcom accepts that BT is likely to be a ‘must have’ brand for a significant number of retailers. Nevertheless, Ofcom considers that the evidence shows that there remain sufficient opportunities for those retailers, through mechanisms other than complete de-listing, combined with other retailers who do not regard BT as a ‘must have’ brand, to ensure, in the context of the conditions in the relevant market, that BT is subject to effective competitive constraints.

**Volume discount structure**

415. Ofcom has considered the pricing structure of BT’s contracts for the sale of consumer phones and in particular the volume discounts available to BT’s largest customers as specified in sales contracts between BT and these customers.\(^{174}\)

- BT’s wholesale pricing structure provides financial incentives to retailers to meet sales targets. [BT’s supply contract with major retailers provide discounts based on a particular volume being reached] and contributions towards marketing costs.

416. There was no discount paid to [retailer] in 2005. A discount of \([\times]\) was paid to [retailer] in 2004 which covered all products sold by BT to [retailer]. This discount represents approximately \([\times\%]\) of BT’s total DECT sales to [retailer].

417. BT includes the cost of any volume discounts in its management accounts for cordless phones (allocated in proportion to revenues of products) and also in its regulatory accounts. Ofcom’s analysis of costs therefore includes the cost of volume discounts where relevant.

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\(^{174}\) Ofcom reviewed sales contracts between BT and [\times] for 2004 to 2005.
418. Ofcom has also received details of the volume discounts that [supplier] offers retailers. For example [supplier] pays [retailer] an additional [%] % discount for every £[ ] achieved over and above a base revenue figure, with this additional retrospective rebate to be capped at [%]%.

419. These volume discounts will provide incentives to retailers to restrict the number of suppliers they stock and potentially affect the share of the retailer’s total purchases from a particular supplier. In considering which particular suppliers to stock retailers will take into account not only the expected revenues from a particular model but also the profitability of that model and also the overall profitability of all products from that particular supplier, taking into account any volume related discounts.

420. Ofcom notes that these discount structures have not prevented market entry or expansion with market entry by Magic Box and expansion (in terms of market share) by Panasonic and Philips.¹⁷⁵

421. For the reasons set out in this section, Ofcom has not found BT to be dominant and therefore has not conducted a detailed analysis of BT’s volume discounts structure. Ofcom has however considered discounting in the context of potential barriers to entry, and on the basis that discount structures are not unique to BT and that there is evidence of both market entry and expansion, Ofcom concludes that BT’s discount structures do not represent a barrier to entry.

**Conclusion on BT’s Position in the Relevant Market**

422. Ofcom has considered market shares, pricing data, barriers to entry and exit, and constraints on BT’s pricing arising from demand side constraints individually and in the aggregate in order to assess BT’s position in the relevant market.

423. The complainants have argued that Ofcom has only considered each factor individually in determining whether that factor rendered BT dominant (and has not done so looking at the aggregate effect of the factors in the round).¹⁷⁶

424. Ofcom rejects this representation for the reasons set out in this section.

425. The complainants alleged that BT’s market share demonstrates its dominant position.¹⁷⁷

426. Although BT’s share is high in this market, Ofcom considers that there are other important factors, in particular low barriers to entry and expansion, and constraints imposed on BT’s pricing from demand side constraints that limit any ability for BT to act independently of competitors and consumers.

427. In that regard, Ofcom has considered evidence that showed that buyers in the market were able to exert downward pressure on BT’s pricing and that BT was willing to cede terms for the opportunity to retain its listings with major retailers.

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¹⁷⁵ In 2004/5 Panasonic increased its share from 11.4% to 16.2%, Philips from 8.5% to 10.1%. In addition the brand Onetel (which is supplied by MagicBox) increased its share from 0% to 4.6%.

¹⁷⁶ The complainants’ 7 June 2006 letter, page 2, footnote 4 and page 9, paragraph 38.

¹⁷⁷ The complainants’ 16 September 2005 and 7 June 2006 letters.
428. With respect to barriers to entry, having analysed the available evidence, (including the evidence of recent successful entry or expansion by, among others, MagicBox) Ofcom considers that there are relatively low barriers to entry and expansion. Indeed, the fact that Argos has been able to source consumer phones directly from manufacturers in the Asia-Pacific region may suggest that the reference market is in fact a global market, or at least that the possibility of some retailers sourcing phones directly from manufacturers in the Asia-Pacific region exerts a constraint on BT’s ability to price independently of competitive pressures.

429. Taking all of the circumstances described above together, Ofcom finds that BT is not dominant in the relevant wholesale market. In reaching that conclusion, Ofcom has taken into account its examination of BT’s pricing behaviour (discussed below), having had regard to the complainants’ allegations that BT’s pricing strategy, and the reputational effects generated by that strategy, had raised barriers to entry and were therefore relevant to whether or not BT should be found to have been dominant during the time period to which the complaints related.
Analysis of alleged predation

Was BT engaging in pricing below cost?

430. In the course of the investigation, Ofcom also considered evidence from BT in relation to its pricing and costs to assess whether, in the event that Ofcom had found BT to be dominant in any relevant market, its conduct could have been considered to be predatory pricing prohibited by Chapter II and Article 82. However, having regard to the relatively high level of BT’s market share, Ofcom has also considered it appropriate to examine whether BT was pricing below cost and whether the complainants’ allegations of predation could be supported in the event that Ofcom’s conclusion on dominance was incorrect. Ofcom undertook this analysis partly because of the allegations that the complainants had made that BT’s pricing strategy had raised barriers to entry and was therefore also relevant to Ofcom’s dominance assessment.

Examination of predatory pricing by EC and UK

431. Predatory pricing is a strategy where a dominant firm deliberately incurs short term losses in order to eliminate a competitor and be able to charge excessive prices in the future.178

432. Both the European and the UK courts have considered predatory pricing in a number of judgments. The ECJ established the legal test for predation in the AKZO179 case as follows:

“(70) It follows that Article (82) prohibits a dominant undertaking from eliminating a competitor and thereby strengthening its position by using methods other than those which come within the scope of competition on the basis of quality. From that point of view, however, not all competition by means of price can be regarded as legitimate.

(71) Prices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive. A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss, namely the total amount of the fixed costs (that is to say, those which remain constant regardless of the quantities produced) and, at least, part of the variable costs relating to the unit produced.

(72) Moreover, prices below average total costs, that is to say, fixed costs plus variable costs, but above average variable costs, must be regarded as abusive if they are determined as part of a plan for eliminating a competitor. Such prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them.”


433. In *ECS/AKZO*\(^{180}\), the Commission had imposed a fine of EUR 10 million on *AKZO* for predatory pricing. *ECS*, a small firm, supplied benzoyl peroxide, which is used in two different applications: as a flour additive and in the manufacture of thermoplastics. *ECS* had traditionally supplied customers in relation to the former use, but attempted to compete for sales for the latter use. *AKZO*, which was dominant in the supply of benzoyl peroxide, was found by the Commission to have abused its dominance by responding to *ECS*'s attempts to move into sales of thermoplastics by reducing prices for benzoyl peroxide as a flour additive to uneconomic levels. The ECJ upheld the Commission's decision.

434. The test laid down by the ECJ in *AKZO* has been applied in later cases.\(^{181}\) In *Tetra Pak II*\(^{182}\), *Tetra Pak* was found by the Commission to have engaged in predatory pricing in relation to its non-aseptic cartons (leveraging its dominance in the market for aseptic cartons). The Commission found that certain of *Tetra Pak*'s prices over a seven year period were below average variable costs, and (save in one year) below average direct variable cost. The Court of First Instance (‘CFI’), applying the criteria in *AKZO*, upheld the Commission's decision.\(^{183}\) The CFI found that *Tetra Pak* had no economic rationale other than eliminating *Tetra Pak*'s main competitor. The ECJ restated the test as laid down in *AKZO*.\(^{184}\)

435. The European Courts have not considered that it is necessary, in order to establish that predation is taking place, to prove that a dominant firm would in the future be able to recoup losses made through pricing below costs now. In relation to the need to prove whether *Tetra Pak* would be able to recoup its losses, for example, the ECJ stated in *Tetra Pak II* that “*It would not be appropriate in the circumstances of the case, to require, in addition, proof that *Tetra Pak* had a realistic chance of recouping its losses*”.\(^{185}\)

436. In the UK, the Competition Appeal Tribunal (‘CAT’) has applied the *AKZO* test in a number of judgments (summarised in the following paragraphs). In its decision in *Napp Pharmaceutical Holdings Ltd*\(^{186}\), the OFT found *Napp* to be dominant in the supply of sustained release morphine tablets and capsules in the United Kingdom and to have engaged in charging predatory prices for sales of sustained release morphine to the hospital sector in that it had sold such products to hospitals at a price that was less than direct cost; the OFT considered that direct costs could serve as a proxy for average variable costs. It found, applying *AKZO*, that *Napp* had sought to eliminate competition in the hospital sector by such pricing and by selectively targeting competitors.

437. On appeal, the CAT said that it was able to conclude that *Napp* had abused its dominant position by offering prices below average variable costs without it first being necessary for it to find that *Napp* had a specific intention to eliminate competition.\(^{187}\) As a precaution, however, the CAT still went on to consider whether *Napp* had a plan or intention to eliminate a competitor. It found that there was nothing in *Napp*'s arguments to rebut the presumption that sales below average variable costs were abusive.

\(^{181}\) See in particular *Tetra Pak II*, Case C-333/94P *Tetra Pak v Commission* [1996] ECR I-5951
\(^{183}\) Paragraphs 142-152
\(^{185}\) *Tetra Pak International SA v Commission* [1996]ECR I – 5952 at paragraph 41
\(^{186}\) OFT decision, 30 March 2001.
438. In Aberdeen Journals\(^{188}\), the OFT imposed a fine on Aberdeen Journals of £1,328,040 for predatory pricing by failing to cover its average variable costs. This decision was set aside by the CAT on appeal on the basis of market definition.\(^{189}\) In its subsequent decision the OFT found Aberdeen Journals to be dominant in the supply of advertising space in both paid-for and free local newspapers in Aberdeen or the circulation area of the Herald & Post, and to have engaged in predatory pricing in the pricing of that newspaper. On the appeal against that decision, the CAT said:

"the cost-based rules set out in AKZO and Tetra Pak II, while providing guidance, are not an end in themselves and should not be applied mechanistically"\(^{190}\).

439. Most recently, in its judgment of 2 September 2005 in Claymore\(^{191}\) reviewing the OFT’s finding of non-infringement of the Chapter II allegations made against Robert Wiseman & Sons Limited, the CAT made a number of findings on how the regulators should diligently approach an assessment of evidence in relation to costs and intent when considering possible predation.

440. In particular, the CAT emphasised that when it came to allocating the costs involved, the investigation must be grounded on a firm and reliable assessment of what the total costs are, and cross-checked as far as possible against the dominant undertaking’s statutory and management accounts.\(^{192}\) The CAT noted the importance of understanding the underlying business reality, understanding what the appropriate costs were, how these costs arose, and how they should be allocated. The CAT considered that the internal management accounts would normally be an invaluable source of information in relation to deciding how the costs should be allocated.\(^{193}\)

441. Further, the CAT noted that a proper determination of total costs was important for two reasons in predatory pricing cases: first, unless there was a clear and reliable determination of total costs it would be difficult to determine which costs out of the total were fixed and which were variable; and secondly, pricing below average total cost (though not below variable cost) may still be abusive in certain circumstances.\(^{194}\) The OFT had not included the cost of capital in its analysis. The CAT noted that it would be appropriate to include an amount representing the cost of capital in determining total costs.\(^{195}\)

442. In relation to intent in predatory pricing cases, the CAT noted that intention may be inferred from the circumstances:

"The phrase ‘intention to eliminate a competitor’ is not entirely straightforward to interpret, since in one sense any competitor, competing in the market, is striving to eliminate – i.e. to drive out – a less efficient rival competitor. What is meant in our view is conduct on the part of a dominant firm which (i) has the reasonably foreseeable result of driving a rival from the market; (ii) goes beyond a normal competitive response

\(^{188}\) OFT decision, 16 July 2001.
\(^{189}\) Case No 1005/1/0/1 Aberdeen Journals Ltd v DGFT [2002] CAT 4, [2002] CompAR 167.
\(^{190}\) [2003] CAT 11 (paragraph 38).
\(^{192}\) Paragraph 216, Ibid.
\(^{193}\) Paragraphs 208 to 211, Ibid.,
\(^{194}\) Paragraph 225, Ibid.,
\(^{195}\) Paragraph 239.
and is disproportionate to the threat; and (iii) has the object or effect of preserving or strengthening a dominant position.

As to the evidence necessary to establish the necessary intention, … it is unnecessary to produce a document showing an intention to eliminate: intention can be inferred from all the circumstances. Among the relevant elements may be the circumstances in which the alleged price cutting takes place. On the other hand, price cutting, in itself, is not predation: circumstances may arise in which prices are above competitive levels, and new entry simply brings prices down to competitive levels to the benefit of consumers. Similarly, inefficient competitors are not protected by the Chapter II prohibition. Nor do we accept Claymore’s suggestion that merely ‘hindering’ the activities or a rival is sufficient. However, a willingness by a dominant firm to accept prices below ATC for a significant period without any other explanation (e.g. a short-term recession) may indicate an intention to eliminate a rival from the market.\(^{196}\)

443. Indeed, the case law even suggests that prices above average total costs may be deemed abusive in exceptional cases; for example, if those prices for part of the strategy of a super-dominant undertaking to drive a new entrant out of the market\(^ {197}\) Ofcom does not believe that BT, even if it were dominant, could reasonably be argued to have a super-dominant position such that it could be found to have abused its position of dominance by charging prices in excess of average total costs. Further, the evidence does not suggest that BT has selectively targeted the complainants’ customers with price cuts in order to drive the complainants out of the market.

444. Ofcom notes that there are a variety of ways in which price-cost data can be measured for the purposes of an investigation into whether or not predation is taking place. The appropriate costs measures may vary according to the market that is being examined (in investigating telecommunications markets characterised by very high sunk costs in terms of network investment, for\(^{198}\)
example, Ofcom generally considers long run incremental cost (‘LRIC’) to be the appropriate measure\(^{198}\).

445. Accordingly, Ofcom has considered carefully the approach that it should take in relation to measuring costs for the purposes of the present. In particular, Ofcom has:

- considered carefully the time period over which costs should be classified as variable or fixed;
- considered whether a ‘combinatorial’ approach in respect of common costs should be adopted in the circumstances of the case;
- ensured that all relevant costs are considered through a series of reconciliations between the different accounts available, including audited regulatory accounts and assessed the reasons for any discrepancies;
- made specific provision for the cost of capital; and
- reviewed BT’s allocation of common costs.

446. Finally, Ofcom has considered whether BT’s internal documents provide any evidence of “intent”, as defined by the CAT in *Claymore*\(^{199}\).

**Identifying costs to be used to test for possible predatory pricing**

*Losses be assessed on the basis of the dominant firm’s costs*

447. In analysing costs in the context of a predatory pricing case, the case law has focussed on the costs of the allegedly dominant firm, here BT, rather than those of competitors (actual or theoretical). In line with the case law, Ofcom considers that in this case the appropriate costs to consider are BT’s own costs. The detrimental effect of predatory pricing can be described in terms of the exclusion of competitors who are able to supply phones as efficiently as (or more efficiently than) BT.

**Relevance of brand value**

448. The complainants have argued that Ofcom should include in its calculation of costs an additional amount to reflect the benefit that BT’s consumer phone business derives from use of the BT brand. In particular, other distributors of phones sold under a brand name (e.g. MagicBox) typically pay a royalty fee to the manufacturer.

449. Ofcom does not accept that argument. One of the most important functions of the price-costs tests involved in an investigation into an allegation of predatory pricing is to reveal evidence that may justify a presumption – or perhaps in some cases even a conclusion – that prices are being set at commercially irrational levels (leaving aside any market foreclosing effects). It is therefore appropriate to take account of all of BT’s actual costs in connection with its activity of selling consumer phones, including by taking account of an appropriate contribution by that division of BT’s business to the marketing necessary to maintain and promote the BT brand from which all parts of BT’s business benefit. Ofcom considers that the costs of BT in developing and maintaining its brand are included in the common costs that are allocated to all

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\(^{199}\) See para 404 above.
products, including DECT phones, in BT’s fully allocated costs (discussed further below).

450. It is not appropriate in Ofcom’s view, however, to add, on top of that contribution to marketing and other brand maintenance costs, an uplift in connection with the fact that some consumers have a degree of loyalty to the BT brand and may be prepared to pay a small premium for a BT branded product (perhaps because, for example, those consumers perceive the BT brand to be an assurance of quality). That is because it is perfectly rational for BT to price its products at profitable levels, even if BT were unable to achieve levels of profitability that exceeded (rather than tapped into and profited from) its brand reputation.

451. Furthermore, Ofcom believes that it is not only BT whose consumer phones business benefits from an ability to successfully promote its phones under its own (as opposed to licensed) brand name. Panasonic and Siemens also sell phones which Argos has categorised as Top End/Premium. Ofcom notes that BT’s brand derives largely from its established position as a supplier of fixed line telecoms services. However, other suppliers and brands in the reference market also derive their strength from being well established in other markets, whether that market is telecommunications (in the cases of NTL and Onetel, which brands are licensed to Harvard and MagicBox respectively) or consumer electronics (in the case of Panasonic, for example). Ofcom considers that consumer electronics has a close association with consumer phones (which, particularly in more advanced forms such as DECT, are just another form of consumer electronics devices that consumers have in their homes).

452. Ofcom accepts that there are certain relatively new players in the market (such as MagicBox) which do not have an established brand name. However, as MagicBox has demonstrated, it is possible for market entrants without an existing brand name to access the marketing advantages of having such a brand by selling phones under such a brand under licence. It is true that the new entrant would have to pay to use that brand. Nevertheless, it is also true that in any market some players will have certain advantages that are capable of having a monetary value attributed to them and that some other players do not have. In Ofcom’s view, the fact that some of BT’s competitors in the relevant market do not have access to as valuable a brand as BT’s without having to pay royalty fees does not mean that BT’s costs have somehow thereby been raised or that BT should be required to charge higher prices in recognition of the advantage that its well known brand provides. Accordingly, Ofcom have not added an uplift to BT’s costs in recognition of the value of BT’s brand in addition to the allocation the common costs set out in paragraph 449 above.

The relevant cost standard

453. In assessing potential predatory pricing, case law suggests that two tests are relevant. Firstly, do revenues cover the variable costs to supply the good or service? Secondly, do revenues cover the total costs of supplying that good or service? The purpose of these tests is to identify any pricing decisions which were potentially not commercially rational in a competitive market and which could therefore be regarded as evidence of predatory pricing with potential anticompetitive effects.

454. This section discusses what is meant by variable and total cost in general, how these concepts have been applied to this case, and the specific tests that Ofcom
has used to determine whether or not there is any evidence that BT’s pricing of its cordless phones was anti-competitive.

**Fixed and variable costs**

455. Variable costs are defined as those that vary with the volume of goods supplied over the relevant time period (and average variable costs are total variable costs divided by the relevant volume). In assessing variable costs, two questions need to be considered:

- What is the relevant time period over which to assess costs?
- What is the relevant measure of volume to consider?

456. Fixed costs are those costs that do not vary with the volume of goods supplied over the relevant time period.

457. In Ofcom’s view a key factor in considering whether to use an incremental or variable approach to cost analysis is the cost structure of the business. For example, an incremental analysis is particularly suited to network based industries such as telecommunications. BT’s handset sales business can be described as one of wholesale procurement and distribution where the largest costs are those of buying in manufactured handsets for resale and there is minimal investment in fixed assets (such as plant and equipment). In these circumstances a variable costs terminology is arguably more appropriate than an incremental one.

**The relevant time period and volume increment**

458. Two factors are relevant in determining an appropriate period over which to assess costs:

- the period over which the ‘low’ prices prevailed; and
- any other period relevant to pricing decisions in the business.

459. Generally speaking, the longer the period over which costs are considered variable, the larger the proportion of costs that are variable and the smaller the proportion of costs that are fixed.

460. The period over which the alleged low prices prevailed is significant because it provides a minimum time horizon. For example, if a price was a special offer for a single week or month, it may be relevant to consider costs that were variable during that week or month when low prices prevailed. However, if low prices had been sustained (without rising) for a much longer period (say one year), it is reasonable to expect that prices should cover the costs that were variable with output over that one year period. Otherwise, there is a risk that Ofcom could conclude that it would be reasonable for the dominant firm to fail to recover costs that could have been avoided (i.e. were variable) in the longer period.

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200 Aberdeen Journals: CAT judgment at paragraph 354 “What the Director should do, in the first instance, is to identify provisionally the period over which pricing below cost is suspected. He should then take that period and examine whether costs are variable over that period. We do not exclude the possibility of the Director taking other periods, for example a year or a period of months, or even less, as a cross check, if to do so would be reasonable from a business perspective. Whether the period taken is a reasonable period will be a matter of fact and degree”
461. The allegations of below cost pricing in this case apply to promotional prices being applied to individual models for periods of between 2 weeks and one month between December 2004 and March 2005. In addition, the complaint states that “[the complainants] very strongly suspect that a whole range of BT DECT models are being sold below cost”.

**The relevant volume measure**

462. In addition to the relevant time period, it is necessary to consider the relevant volume measure for which Ofcom should assess the variable or fixed nature of costs.

463. A number of different increments of volume can be considered – for example one particular unit (i.e. a single phone) or a particular model of phone, or the product line in general (i.e. all DECT phones). The variable cost recovery test compares revenues arising from the sale of that particular increment of volume to the costs of supplying that volume. The relevant volume measure will depend on a number of factors including the relevant period, the extent of the alleged pricing abuse and the timescale of relevant business decisions.

464. In the circumstances of this complaint, as explained below, Ofcom considers two volume/time increments relevant in considering the recovery of variable costs – an analysis of the profitability of individual batches of phones and the profitability of individual models over their lifetime.

**Monthly analysis per batch of phones**

465. Firstly, an analysis of individual pricing and stock purchasing decisions can provide an insight into how BT was reacting to market conditions and whether individual prices recovered the relevant variable cost. In this case the relevant period over which costs can be considered variable would be the period over which the pricing or purchasing decisions would apply – typically between three and six months. An analysis of monthly profitability will therefore include sufficiently short a period to assess the profitability of individual pricing decisions - a longer minimum period (of, say, one year) could fail to identify shorter periods of abusive pricing.

466. In its analysis of a sample of individual phone models by month, Ofcom considers the appropriate volume measure to assess the fixed or variable nature of phone costs to be a minimum single order of phones which have already been designed and for which the factory is tooled up for. This is typically 1,000 telephones. This quantity is similar to the minimum quantity of handsets that the larger retailers typically order. Deliveries to retailers are normally scheduled on a monthly basis with volumes ranging from 1,000 to 25,000. A smaller increment, say a few hundred units or less, would not be representative of the volume on which typical pricing decisions are made, and would normally only apply to end of line volumes or one-off arrangements (where additional cost factors may be relevant – see paragraph 576).

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201 Para 1.8 of the complaint
202 Para 1.6 of complaint
203 BT’s response to Q10 of Ofcom’s draft 1st s26 notice dated 27 May 2005
467. In order to undertake this analysis, Ofcom has therefore reviewed the profitability each month of a sample of BT’s DECT phones during the period under investigation – the financial year 2004/5. This analysis will average out the profitability of sales of different batches in a particular month and also each model across different customers in a particular month. However, it is Ofcom’s view that whilst there may be variations in pricing between customers in a particular month, such variations can be expected in a competitive market and will reflect relative bargaining positions, pricing structures such as volume discounts and variations in underlying terms and conditions (for example reflecting the treatment of returns).

_Lifetime profit of model_

468. Where an individual model has not recovered its variable costs during individual months, a further analysis of the profitability of the phone over its lifetime may provide a useful insight into the decision to sell that particular model below its variable costs. In particular it may be the case that old or obsolete phones in stock at the end of their lifecycle are being sold off at a price below apparent variable cost but at a profit maximising level reflecting the need to compete with new and more attractive models.

469. In analysing the profitability of an individual model over its lifetime the appropriate increment of volume is the total volume produced over the lifetime of the product. In this case, the additional costs of designing the phone and its packaging become relevant and are therefore included in the variable cost test.

_Average Total Cost Test_

470. In AKZO the court found that where pricing was above average variable cost (‘AVC’), but below average total cost (‘ATC’), then further evidence of intent was required in order to establish predatory pricing had occurred or was occurring.

471. The calculation of ATC (total cost divided by the number of units produced) for an individual product (or model) in a multi-product firm is problematic, in particular because of the need to consider how to allocate common costs – those which are attributable to more than one product.

472. In this case, most fixed costs incurred by BT are also common to other products. For example, many of the costs of BT’s High Street and Consumer Distribution business are relevant to more than one product.

473. For a multi-product firm, it can be useful to examine whether

(a) each product recovers the incremental cost associated with its production (which will in most circumstances be the same as average variable cost); and

(b) revenues exceed total incremental costs for all products plus all relevant common costs (i.e. the combinatorial incremental cost of all products)

474. However, where there is evidence of intent, such an approach to common cost recovery may not be sufficient to identify anti-competitive pricing behaviour. For example, it is not excluded in all circumstances that a situation where a supplier that charged only the incremental costs of production to one group of customers or individual products and recovered all common costs from another group of
customers or products could be consistent with an anti-competitive pricing strategy. Accordingly, it may be relevant to consider the extent to which particular products or customers contribute towards the recovery of common costs.

475. Ofcom’s analysis has directly addressed the profitability of individual phone models in its analysis – see paragraph 554 onwards. Ofcom has also considered whether there is any evidence that BT may have targeted below-cost prices to individual customers in order to make it difficult for its competitors to supply to strategically important retailers.

476. Firstly, Ofcom has reviewed the annual framework contracts which BT has with its retailers which set out the basic retail-wholesale margin at which BT will supply phones. Each of these provides a basic margin together with details of additional payments BT will make for marketing and promotion which typically vary with the amount of goods sold. The contract also indicates how returns made under warranty will be treated and accounted for. In Ofcom’s view the differences in these contracts reflect those which could be expected in a competitive market.

477. Secondly Ofcom has reviewed all relevant emails, internal pricing papers and other documents relating to the pricing of the 10 DECT phone models listed in paragraph 554 and found the evidence does not suggest that BT was strategically targeting particular prices at particular retailers with a view to limit its competitors ability to supply to that retailer.

478. Thirdly Ofcom has considered the relative margins earned by retailers on phones from different suppliers. Ofcom obtained data from major retailers on the margins they earned from major suppliers. In particular Ofcom requested data on:

- average net margins for entry level, mid-range and top-of-range cordless phones during the period January 2004 – March 2005 for BT, Binatone and the two next largest suppliers (by value).

- details of any instances where net margins for individual products were significantly (more than 5%) lower than average for significant (ie more than 10,000) volumes including an explanation of why the retailer accepted a lower margin on these particular models.

479. Individual retailers’ calculations of net margins differ and so comparison between retailers needs to be treated with some caution. However the data indicates that the margins earned by retailers on BT’s products are typically in the middle of the range of margins earned by the retailers on cordless phones during 2005 from different suppliers as illustrated in Figure 17 below which shows minimum, maximum and average margins for a range of suppliers and retailers compared to those for BT. Figure 17 shows that BT’s margins typically fall between the minimum and maximum margin earned by major retailers from a range of suppliers for different categories of phones.

**Figure 17 Retailers’ Margins**

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204 average of individual margins earned by supplier
480. In Ofcom’s view the range of margins earned by retailers on different types of phones from different suppliers is consistent with a competitive market. The evidence does not suggest that BT was offering lower cost phones to particular retailers.

481. Fourthly Ofcom has considered BT’s pricing of individual models to particular retailers in its review of the Freestyle 2100 model, which was of particular concern to the complainants. In Ofcom’s view (as set out in paragraph 586) BT’s pricing of this model is consistent with that which could be expected in a competitive market.

482. Ofcom has therefore concluded that the evidence does not indicate that BT was incurring losses on phones sold to a particular retailer with a view to increasing its market share with strategic retailers and driving its competitors from the market.

483. One approach to the calculation of average total cost in a multi-product firm is the fully allocated cost ("FAC") methodology which allocates all common costs to individual products by using a cost allocation methodology such as an allocation in proportion to product revenues or volumes. The FAC approach will also include any variable or fixed costs specific to a particular product.

484. In practice, if a product or model covers its FAC (assuming underlying allocation methodologies are appropriate) it is reasonable to assume that there is unlikely to be anti-competitive pricing of the products concerned, on the basis that it would imply that the supplier should be recovering a higher than “reasonable” amount of common costs from a particular product.

485. If a product or model fails the FAC test then it may be necessary to consider whether this is part of an anti-competitive strategy. In considering the firm’s strategy in pricing individual products or models below FAC, it would be relevant to consider whether common costs were being recovered over a range of models or products (so called “combinatorial tests”) or, in practice whether the FAC test is passed at a more aggregated level.

486. In the case of cordless phones, BT used revenue as the basis for allocating sales and general administration costs (SG&A) costs of BT’s Home Communications & High Street Distribution ("HC&HSD") business to individual models (the regulatory
accounts are based at product, not model level). In Ofcom’s view this is a reasonable approach\textsuperscript{205} and is also an appropriate cost methodology for allocating other common costs to individual models.

487. Ofcom has applied two FAC tests in this investigation – firstly for the sample of individual models and secondly for all DECT phones. The results of these tests are set out in paragraphs 589 onwards.

488. Ofcom’s analysis of intent is set out at paragraph 630 onwards.

Sources of information

489. Ofcom has obtained financial information on BT’s DECT phone business from two principal sources: BT’s regulatory accounts and BT’s management accounts.\textsuperscript{206} In addition Ofcom has obtained details of the complainants’ costs which it has been able to compare with those of BT in order to identify and understand any differences in types and levels of costs incurred in supplying cordless phones.

BT’s regulatory accounts

490. BT’s regulatory accounts are prepared in accordance with regulations stemming from BT’s status of having SMP in certain defined markets and serve a number of different purposes including a means for ensuring that BT’s prices are set in accordance with any regulatory requirements, such as cost orientation. BT has not been found to have SMP for the supply of DECT phones or for the supply of fixed-line telecommunications equipment. However, BT’s regulatory accounts include cordless phones which are accounted for as a separate product – “P393 Cordless Telephones”. BT’s Detailed Attribution Methods (or “DAM”)\textsuperscript{207} sets out how costs and revenues are treated in BT’s regulatory accounts and includes the following entry for the cordless phones product:

\textsuperscript{205} For example, an allocation based on revenues is proposed in the recent EC DG Competition discussion paper on Article 82: “In case of multi-product companies it may be difficult to calculate ATC because of certain common costs, which are fixed costs that are necessary for the production of more than one product and where it is difficult to allocate these costs to the different products. Where necessary to apply a cost benchmark based on ATC, the Commission will allocate common costs in proportion to the turnover achieved by the different products unless other cost allocation methods are for good reasons standard” http://europa.eu.int/comm/competition/antitrust/others/article_82_review.html

\textsuperscript{206} As highlighted by the CAT in Claymore, a company’s statutory and management accounts are a key source of data in assessing predation.

\textsuperscript{207} see http://www.btplc.com/Thegroup/Regulatoryinformation/index.htm
491. In determining the appropriate costs to include in a predatory pricing analysis, the regulatory financial statements are a useful source of data as they:

- are subject to independent audit;
- are based on established costing methodologies (including an allocation of common costs) which are set out in BTs Detailed Attribution Methods (“DAM”);\(^{208}\)
- are derived from BT’s audited financial statements and group-wide financial accounting system;
- are reconciled to BT’s group accounts; and
- where appropriate, include an allocation of common costs or overheads from other BT business units.

492. In particular, the regulatory accounts can be regarded as providing a useful source of data to calculate the “total” costs for a product or service. Summary profits for BT’s cordless phones products as accounted for in BT’s regulatory accounts shown in Table 7 below:

Table 7 BT’s regulatory accounts Product P393 Cordless Telephones

<table>
<thead>
<tr>
<th>£ ’000</th>
<th>2003/4</th>
<th>2004/05</th>
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<tbody>
<tr>
<td>Revenue Internal/External</td>
<td>[X]</td>
<td>[X]</td>
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<td>less:</td>
<td></td>
<td></td>
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<tr>
<td>Connect Chrgs/OSP</td>
<td>[X]</td>
<td>[X]</td>
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<tr>
<td>Rentals</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Enhanced Maintenance</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Other turnover</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td><strong>Revenue Total</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Network Charge</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail Costs</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>CCA adjustments</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td><strong>Profit (net margin)</strong></td>
<td>[X]</td>
<td>[X]</td>
</tr>
</tbody>
</table>

\(^{208}\) BT: Detailed Attribution Methods
Source: BT209

493. BT’s regulatory accounts therefore indicate that in both 2003/4 and 2004/5, BT’s revenues from its cordless phone business covered fully allocated costs (as defined in the regulatory accounts).

494. Ofcom notes that one of the phones cited by the complainants (the Synergy 700 Twin) is a combined DECT and answer phone. These products are accounted for in BT’s regulatory accounts under product group: P395 Answering Machines. This product group includes answering machines, and combined telephones/answering machines. The regulatory accounts for these products are summarised in Table 8 below.

**Table 8 BT’s regulatory accounts Product P395 Answering Machines**

<table>
<thead>
<tr>
<th>£ ’000</th>
<th>2003/4</th>
<th>2004/05</th>
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</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>[X]</td>
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<td>less:</td>
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<tr>
<td>Operating Costs</td>
<td>[X]</td>
<td>[X]</td>
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<tr>
<td>Return</td>
<td>[X]</td>
<td>[X]</td>
</tr>
</tbody>
</table>

Source: Ofcom derived from BT data210

495. Table 8 above indicates that BT’s revenues from selling answering machines (including combined phones/answering machines) exceed fully allocated costs as defined in the regulatory accounts.

496. Table 9 below summarises BT’s regulatory accounts for cordless phones and answering machines.

**Table 9 BT’s regulatory accounts for Cordless Phones and all Answering Machines products**

<table>
<thead>
<tr>
<th>£m</th>
<th>2003/4</th>
<th>2004/05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Operating Costs</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>CCA adjustments</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Profit</td>
<td>[X]</td>
<td>[X]</td>
</tr>
</tbody>
</table>

Source: Ofcom summary of data provided by BT

497. Table 9 above shows that based on BT’s regulatory accounts, revenues from BT’s cordless phones and answering machines businesses exceeded fully allocated costs. Figure 18 below shows a monthly comparison of gross margins on combined DECT phone & answering machines compared to DECT phones.

---

209 BT Supplemental financial statements p295 and regulatory recon_electronic.xls provided by BT on 1 July 2005 (email from CW)

210 Ofcom prepared a summary of the regulatory P&L based on a detailed listing of all regulatory account total a provided by BT in DT’s email to Hugh Kelly dated 16 September 2005
498. The figure above shows that in 11 out of 12 months, the margin on DECT Answering Machines products exceeded that for DECT Phones products.

499. In Ofcom’s view it is reasonable to assume that, as DECT phones are less profitable than combined phones and answering machines, any evidence of predatory pricing behaviour is more likely to be identified in a detailed review of DECT phones. Ofcom has therefore focused its analysis on DECT models (together with a detailed review of the profitability of the Synergy 700 Twin model cited by the complainants). In addition Ofcom notes that the complainants have in particular alleged\(^{212}\) that BT’s pricing was targeted at the “high volume/low value segment of the market”. Ofcom’s detailed analysis of BT’s DECT phone business has therefore focused on the low value models identified by the complainants.

**BT’s management accounts for DECT Phones**

500. BT’s DECT phones are sold through the BT Home Communications and High Street Distribution (HC&HSD”) division of BT Retail. DECT phones are accounted for in the “Traditional Products” business of this division. Summary results from BT’s management accounts for the DECT phones product line in the Traditional Products business are shown in Table 10 below.

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\(^{211}\) Ofcom calculation of percentage gross margins as DECT phones and DECT answering machines as set out in BT’s response to Q13 of Ofcom’s s26 Notice of 8 June 2005

\(^{212}\) Para 4.18 of complaint
Table 10 BT’s Management Accounts – DECT Phones

<table>
<thead>
<tr>
<th></th>
<th>2003/4 £’000</th>
<th>2004/5 £’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product Cost</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other cost of sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales &amp; General Administration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BT213

501. The “Internal” sales shown in BT’s management accounts relate to sales to internal sales channels other than BT’s HC&HSD business (such as BT Northern Ireland and BT’s on-line shop).214

502. Ofcom noted significant differences between BT’s management accounts and regulatory accounts as summarised in Table 11 below:

Table 11 Differences between Management Accounts and Regulatory Accounts

<table>
<thead>
<tr>
<th>£’000</th>
<th>Management accounts</th>
<th>Regulatory accounts</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003/4 Revenues</td>
<td>[X]</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Costs</td>
<td>[X]</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Profit</td>
<td>[X]</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>2004/5 Revenues</td>
<td>[X]</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Costs</td>
<td>[X]</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Profit</td>
<td>[X]</td>
<td>[X]</td>
<td>[X]</td>
</tr>
</tbody>
</table>

Source: BT215

503. Differences are due to a number of factors including:

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213 Provided in BT’s response to Ofcom’s s26 notice of 8 June 2005 contained in email from [X] (BT) to Hugh Kelly (Ofcom) on 17 July 2005
214 http://www.shop.bt.com/page/home
215 BT’s response to Q11 of Ofcom’s 4th section 26 Notice of 12 August 2005
- costs included in management accounts but not in regulatory accounts
- timing differences
- end of year auditing adjustments

504. BT were asked to provide a reconciliation between the two sets of accounts, but stated “These costs are allocated using a ‘total BT’ allocation of costs, therefore attempting a reconciliation will not find a viable solution”. BT did provide an indication of cost categories included in the regulatory accounts but wholly excluded from the management accounts as set out in Table 12 below:

Table 12 Differences between Management Accounts and Regulatory Accounts

<table>
<thead>
<tr>
<th></th>
<th>2003/4</th>
<th>2004/5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit as per management accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unexplained difference in revenues:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costs identified by BT as not in management accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SLRC Variance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant Support</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IntProdChargefromCor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accomm Plant Net</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Misc</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apparatus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motor Transport</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Computers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AccommPlant(LndLrd)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Office Machines</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emp Profit Sharing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCA adjustments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other costs in regulatory a/cs but not in management a/cs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit as per regulatory accounts</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BT

505. The “Other” category relates to costs in regulatory cost categories where some of the costs are included in management accounts but others are not. These are discussed further in paragraph 522 onwards.

Analysis of monthly management accounts

506. In order to assess the monthly profitability of BT’s cordless phones business and also the profitability of individual phone models, Ofcom requested a monthly breakdown of BT’s management accounts for DECT phones and a sample of monthly profit and loss accounts for individual phones.

507. The revenues and costs in BT’s detailed monthly management accounts analysis (and used for analysis of individual phone profitability) differed from the management accounts figures presented in BT’s reconciliation of its regulatory accounts to management accounts. Differences are due to:

- inclusion in management accounts of cordless analogue phone revenues and costs; and
- inclusion in management accounts of sales to other BT units.

---

216 BT’s response to s26 notice contained in email from [BT] to Hugh Kelly (Ofcom) 1 July 2005 (spreadsheet “regulatory recon_electronic.xls”)
217 as above
508. Table 13 below sets out Ofcom’s reconciliation of BT’s revenues and cost of sales for BT’s detailed monthly management accounts analysis and the management accounts totals provided from its regulatory accounts reconciliation:

**Table 13 Reconciling BT’s monthly DECT phone management accounts to management accounts for all cordless phones 2004/5**

<table>
<thead>
<tr>
<th>Reconciling BT’s Management Accounts 2004/5</th>
<th>Revenues</th>
<th>Cost of sales</th>
<th>Gross Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management accounts totals as per regulatory accounts reconciliation</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
</tr>
<tr>
<td>Less cordless analogue external sales</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
</tr>
<tr>
<td>Less cordless internal sales</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
</tr>
<tr>
<td>Total</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
</tr>
<tr>
<td>Total net revenue /COS as per Monthly management accounts</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
</tr>
<tr>
<td>Sales credits and warranty returns</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
</tr>
<tr>
<td>Total as per monthly management accounts</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
<td>[ &lt; ]</td>
</tr>
</tbody>
</table>

Source: Ofcom analysis

509. Ofcom's management accounts for DECT phones are summarised in the table below.

**Table 14 BT’s detailed management accounts for DECT phones**
<table>
<thead>
<tr>
<th>£ '000</th>
<th>2003/4</th>
<th>2004/05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Revenue (post discount)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Sales Credits</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Warranty Returns</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Net Revenue</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Product Cost (SPP)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Cost Credits</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Freight</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>ADP - User Guide &amp; Packaging</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Alloy - Product Design</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Marketing A&amp;P</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Supply Chain (MHC)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Exchange loss/profit (PPV)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Other</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Total Cost Of Sales</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Gross Margin (Gross Revenue)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Gross Margin (Net Revenue)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Sales General &amp; Administration costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pay</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Marcomms</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Business Expenses</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Accomodation</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Other</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>Total SG&amp;A</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>EBITDA (Gross Revenue)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
<tr>
<td>EBITDA (Net Revenue)</td>
<td>[X]</td>
<td>[X]</td>
</tr>
</tbody>
</table>

Source: BT\textsuperscript{218}

510. BT’s management accounts for its DECT products reflect an allocation of costs incurred within the HC&HSD business unit, but not those incurred at a “higher” level and which are common to other BT businesses.

511. Ofcom’s reconciliations between regulatory accounts, cordless management accounts and DECT management accounts ensure that, for the purposes of this case, all relevant costs and revenues have been considered in calculating relevant costs and revenues.

**Application of Tests**

512. As discussed in paragraphs 465 et seq above, Ofcom has considered BT’s pricing decisions from a number of different perspectives:

**Average Variable Cost Tests**

- On a monthly basis, did individual phone models recover average variable costs?

\textsuperscript{218} BT’s response to Q22 of Ofcom’s s26 notice of 12 August 2005
• Where phones did not recover average variable costs on a monthly basis, did they recover variable costs over the lifetime of the model?

*Fully Allocated Cost Test*

• Over their lifetime, did individual phone models recover Fully Allocated Costs?

*Combinatorial Test*

• Did BT’s DECT phones in total recover variable and Fully Allocated Costs?

**Calculating variable costs**

513. As discussed in paragraph 465 Ofcom considers that a reasonable period over which to assess the variable or fixed nature of costs to be between 3 and 6 months. Ofcom has therefore reviewed the cost categories in BT’s monthly management accounts and regulatory accounts in order to determine which costs are fixed or variable in relation to increases in volumes of individual phones sold over this period.

514. A number of different adjustments were considered:

• Exclusion of costs from BT’s management accounts but which are not considered variable;

• Addition of any costs considered variable but not included in BTs management accounts (but for example which are included in BT’s regulatory accounts);

• Addition of any cost of capital that is variable over the relevant time period (and not included in either the management or regulatory accounts); and

• Timing adjustments to better match costs and revenues to the correct period.

*Management account cost categories*

515. Table 15 below sets out Ofcom’s fixed/variable classification of the different cost headings in BT’s management accounts relative to an increase in volume of a typical order batch (1,000-25,000 units) over a period of 3-6 months.

---

**Table 15 Classification of management account cost categories**
<table>
<thead>
<tr>
<th>Cost category</th>
<th>Fixed (F) or Variable (V)</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost of sales:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product Cost (SPP)</td>
<td>V</td>
<td>This represents the cost of the phones ex factory and is variable with volume of sales (the situation where end of line/obsolete/remainder stock is being sold is discussed in paragraph 576.</td>
</tr>
<tr>
<td>Cost Credits</td>
<td>V</td>
<td>These costs represent reductions to revenues arising from agreed price reductions and therefore vary with the volume sold.</td>
</tr>
<tr>
<td>Freight</td>
<td>V</td>
<td>Freight costs relate to costs of importing phones from suppliers. Cost is dependent on volume imported and therefore treated as variable.</td>
</tr>
<tr>
<td>ADP - User Guide &amp; Packaging</td>
<td>F</td>
<td>This represents an allocation of costs from BT’s designer of user guides and packaging material. This does not vary with volume of units sold.</td>
</tr>
<tr>
<td>Alloy - Product Design</td>
<td>F</td>
<td>This represents an allocation of costs from BT’s designer of phones. This does not vary with volume of units sold.</td>
</tr>
<tr>
<td>Marketing A&amp;P</td>
<td>V</td>
<td>BT stated 219 “Marketing, advertising and promotion costs [in the management accounts] are contractually agreed with major customers for the supply of advertising and promotional activity” and set out in annual contracts with major customers. These are typically set as a percentage of sales. [11]. Ofcom have treated this cost as variable on the basis that every additional product sold generates an additional cost.</td>
</tr>
<tr>
<td>Supply Chain (MHC)</td>
<td>F</td>
<td>This represents warehousing costs charged from BT’s in house supplier. Capacity and costs are agreed on an annual basis and can therefore be regarded as fixed for the purpose of this analysis.</td>
</tr>
<tr>
<td>Exchange loss/profit</td>
<td>V</td>
<td>Depends on volume of purchases.</td>
</tr>
<tr>
<td><strong>Sales General &amp; Administration expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pay</td>
<td>F</td>
<td>Pay costs do not vary with volume.</td>
</tr>
<tr>
<td>Marcomms</td>
<td>F</td>
<td>General marketing costs assumed to be fixed.</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>F</td>
<td>Research and development costs, do not vary with volume sold.</td>
</tr>
<tr>
<td>Business Expenses</td>
<td>F</td>
<td>BT has stated 220 that costs in this category include travelling and subsistence and hospitality which can reasonably be treated as fixed relative to volumes.</td>
</tr>
<tr>
<td>Accommodation</td>
<td>F</td>
<td>BT has stated 221 that costs in this category comprise charges from BT’s group property business and relate to the costs of office accommodation which can reasonably be treated as fixed relative to volumes.</td>
</tr>
</tbody>
</table>

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219 Response to Q8 of Ofcom’s 4th s 26 Notice of 12 August
220 Telephone discussion between Hugh Kelly (Ofcom) and BR (BT) et al 9 September 2005
221 Telephone discussion between Hugh Kelly (Ofcom) and BR (BT) et al (BT) 9 September 2005
Table 15 (continued)

<table>
<thead>
<tr>
<th>Cost category</th>
<th>Fixed (F) or Variable (V)</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other</td>
<td>F</td>
<td>BT have stated that costs in this category include bad debt provisions, external development, training, mobile phone costs. Other BT recharges, stationery, catering and other. With the exception of bad debt costs, these can all be regarded as fixed relative to volumes. The treatment of bad debt provisions is less clear. To the extent that they relate to debts from insolvent customers there is an argument that the cost is not directly related to volumes of individual models sold. On the other hand to the extent that they are incurred in proportion to total revenues and across all customers, there is an argument for including them in variable costs. Ofcom has not included bad debt provision costs as variable on the basis that they are not material and that allocating these costs to individual models is problematic.</td>
</tr>
</tbody>
</table>

Source: Ofcom analysis of BT’s management accounts

Additional costs from regulatory accounts

516. As noted in paragraph 507, BT’s management accounts do not include all common costs or overheads allocated from other BT business units.

517. Ofcom has reviewed the cost categories in the regulatory accounts which BT has stated are not included in the management accounts in order to identify whether or not there any variable costs incurred in supplying cordless phones which are included in the regulatory accounts but not in the management accounts.

518. The regulatory cost categories identified by BT as not being included in the management accounts and shown in Table 15 above relate to various allocations of costs and overheads from other BT business units.

519. Ofcom has reviewed the individual account codes included in these categories (including where relevant the details of the costs and costing allocation methodology as set out in the Detailed Attribution Methods) in order to identify whether or not any of the costs could be considered variable in the time period being considered.

520. The most significant cost categories are

- Maintenance – primarily pay and stores issues related to maintenance activities
- Plant support - BT’s Detail Attribution Methods states that this cost category “contains the costs of activities undertaken to support the running of BT’s Network”.
- Motor transport – depreciation on vehicles
- Computers - depreciation

521. In Ofcom’s view these specific regulatory cost categories identified by BT as not being included in the management accounts are not variable with the volume of DECT phone sales over a 3-6 month time period and can therefore be excluded from a variable cost analysis.

522. The £[<] for 2004/5 of other costs included in the regulatory accounts but not included in the management accounts are more difficult to identify. Ofcom has

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222 Telephone discussion between Hugh Kelly (Ofcom) and BR (BT) et al (BT) 9 September 2005
223 Sector BK Plant Support description p80 of the DAM
obtained a detailed breakdown of BTs regulatory accounts in order to assess the nature of these additional costs and their relevance to the cost analysis in this investigation.

523. Two cost categories in particular contribute to this difference: sector BF: “General Management & Other” and sector B8: “Marketing & Sales”.

524. BT’s regulatory accounts include under sector BF: “General Management & Other” a total of £[>], not all of which is included in the management accounts, with the difference contributing to the difference of [>]. These costs are described in BT’s Detail Attribution Methods224 as follows:

This sector shows costs of general management activities and other general expenses.

A significant proportion of the costs in the sector are pay costs for managers and support staff employed on activities of a general management nature. This includes the cost of Business Unit board members and other senior managers. In addition, there are a variety of other expense types and corporate level provisions recorded in the general management sector.

Sector breakdown

The key items recorded in this sector are shown below:

Newstart leaver payments
This relates to pay costs recorded under the “Newstart” scheme for leavers

General management pay costs
This relates to non-engineering time recording pay costs, for people designated with management responsibility. This includes board members for business units, senior managers and support staff working on general management activities

General management and other incidentals
This includes costs such as conference facilities (non training related) at non-BT premises; the cost of awards to employees under the ‘Recognition in BT’ scheme and associated administrative expenses; costs of payments to customers under the ‘Customer Service Guarantee Scheme’ for failure of BT service such as missed appointments or repeated loss of service or payments for damage caused by BT to property of a third party; non trade subscriptions; other incidental costs (low value items)

General legal charges
This relates to general legal charges incurred by BT Group insurance charges
This is the allocation of group insurance premium costs to business units (from group risk and insurance)

Corporate provisions
This relates to the profit and loss account costs of a variety of corporate level provisions made by BT

Non core Other operating costs; wages and salaries; other core costs; intra-group costs

This relates to operating costs incurred by non-core businesses (i.e. subsidiaries, self-accounting units, etc.), in categories such as wages and salaries, other operating costs, costs incurred performing work for the core business and intra-group costs.

525. Some of the costs within this category are included in the management accounts (for example BT’s management accounts include the direct cost of employing managers - total pay costs in the management accounts for 2004/5 were £[<<]; other administration costs are included in the headings for “Business Expenses” and “Other”, which total £[<<]).

526. Other costs included in this sector are allocations of overhead costs incurred across BT’s business and include:

- Other management pay costs allocated to the business (£[<<])
- Group redundancy costs

527. A number of costs in the category are allocated using the “EXCEPT” methodology to Organisational Unit Code225 (“OUC”) M which are described by BT as follows:

This base is used to attribute the costs booked by Organisational Unit Code (OUC) M (BT Retail Markets) which are not otherwise attributed using other bases. The base is used to attribute costs of a general nature for which there is no direct causal relationship with any product or service. It covers supervision and general management overheads, relating to the full range of BT retail’s activities, including customer services, which is represented by the organisational unit code, S.

Methodology

The costs are apportioned pro rata to all the pay costs incurred, on both capital and current account expenditure, and previously attributed from the Organisational Unit Codes (OUCs) within M and S. Effectively, these costs are added as an overhead to other pay costs.

528. Costs for which “there is no direct causal relationship with any product or service”226 will not vary with output of a particular product in the relevant time period in this case and can therefore be regarded as fixed.

529. In Ofcom’s view, the evidence in this case does not suggest that there are any material costs included in the category “BF: General Management & Other” that are variable with the volume of phones sold over the short to medium term.

530. The regulatory cost category “B8: Marketing & Sales” totals £[<<], and includes account 207172 - “Other publicity MYG” (£[<<]) to which costs are allocated primarily on the basis of revenues. The Detailed Attribution Methods states that “Typical costs in this area are publicity, advertising and exhibition expenditure.”227 For the cordless phones business advertising and promotional expenditure largely comprises of payments to retailers for inclusion in catalogues/promotional material and in-store promotions.

531. The total advertising costs included in BT’s management accounts for 2004/5 is £[<<] compared to £[<<] in the sector B8 Marketing & Sales in the regulatory

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225 Page 232 of the DAM
226 ibid
227 DAM p201
accounts. There are a number of reasons for the difference between these two costs:

- the cost of activities included in the regulatory activities but excluded from the management accounts
- timing differences in allocation of costs between the two, for example a number of costs are allocated using the cost base “DTNIAH” which:

“is used to apportion HC & HSD (Product Management & Innovations) publicity expenditure across BT HC & HSD Products such as corded and cordless telephones, answering machines, telephone ancillaries and fax machines. Typical costs in this area are publicity, advertising and exhibition expenditure.

Methodology

The base is derived by obtaining the Consumer Publicity expenditure by campaign for the full year. Each campaign is assigned a driver on the CAMERA database run by Retail Marketing based on the agreed business case within BT Retail. The campaigns associated with Communications Products are identified and those publicity costs are split between the CP products based on Period 9 product revenue.

Data Source/s

CAMERA System

Rationale

As publicity drives sales, it is appropriate to apportion publicity costs on a revenue basis.”

532. Thus the regulatory accounts will include an allocation of marketing costs based on the actual split of sales across different products in the nine months to December (ie ignoring any relative differences in sales between products for the last 3 months in a year).

533. In Ofcom’s view, whilst marketing costs which are directly related to revenues, such as the “marketing support” payments to retailers which are set as a percentage of revenues, are clearly variable with respect to volume, the variable or fixed nature of other marketing costs is less clear.

534. For example, a wide-ranging promotion of BT goods and services will be allocated across a wide range of products. However, it is not clear whether this cost is variable in respect of volumes sold or whether it should be regarded as fixed. In part the classification should depend on the time period over which costs are being considered – the longer the timescale the greater the proportion of costs which should be considered variable.

535. In the context of this investigation, and in particular the relevant time period for variable costs of 3-6 months Ofcom believes that for DECT phones only the “marketing support” paid to retailers and included in the management accounts need be considered as variable for individual models, and the remaining marketing costs can reasonably be treated as a fixed common cost to which DECT phones make a contribution.
536. In Ofcom's view therefore there are no significant variable costs for DECT (or cordless) phones included in BT's regulatory accounts that are not included in its management accounts (with the exception of working capital discussed below) and so it is reasonable to use the more detailed monthly management accounts (as adjusted by Ofcom) to assess whether BT was recovering its variable costs during the period.

Minimum return on capital employed & working capital – the “Cost of Capital”

537. In the context of competition analysis, profit measures typically need to include a return on investment – the “required” or “normal” profit. For example, the business should earn sufficient profit to finance the interest payments on its debt and make dividend payments to its shareholders.

538. A number of different measures of profit can be used to determine what the “required” level of profitability should be, including Return on Capital Employed (“ROCE”) and Return on Turnover (“RoT”)\textsuperscript{228}.

539. BT's management accounts do not include either the costs of working capital or a minimum required return on capital employed (or cost of capital). Working capital represents the funds required to finance the day to day activities of the business such as holding stocks and funding outstanding payments due from customers. The minimum required return on capital employed is a wider measure of the funds needed to finance the business and includes the costs associated with longer term assets and liabilities such as fixed assets and long term bank loans.

540. In Ofcom's view, working capital costs are variable with output; for example, increasing turnover will increase the amount of funds due to the business from customers. Whether the cost of funding long term assets and liabilities should be considered variable in a particular case will depend on the period of time relevant to the investigation. The minimum required return on capital employed would often be considered a variable cost. In the circumstances of this particular investigation and in particular the relatively short period of time considered to assess variable costs for the products considered in this complaint, however, it would be possible to argue that it would be reasonable to consider this cost not to be variable. Nevertheless, Ofcom notes that in other cases where fixed assets are material, and for example, where economic depreciation can be related to volume, there may be an argument for considering the total cost of capital to be variable in the short term. Given that the cost of funding long term assets and liabilities is not material to this investigation Ofcom has not found it necessary to conclusively decide this issue.

541. The total value of long term assets and liabilities allocated to BT's entire cordless phone business in the regulatory accounts, not all of which would be allocated to its DECT business, is £\textsuperscript{229}. The associated return on capital employed for this amount would be in the region of £\textsuperscript{229} which Ofcom does not consider to be material in the context of total revenues for the cordless business of £\textsuperscript{229}.

542. Ofcom has considered three different approaches to estimating the working capital requirements of BT’s DECT phones:

\textsuperscript{228} For a discussion on this topic see paragraphs 1.24 to 1.27 of the OFT economic discussion paper Assessing profitability in competition policy analysis, published July 2003
\textsuperscript{229} Total revenues for product group P343 Cordless Phones 2004/5
• regulatory accounts
• management accounts
• average payment terms

543. In addition, for comparative purposes, Ofcom has considered the costs of working capital provided by the complainants. These were stated to be between $\text{[>X]}\%$ and $\text{[<X]}\%$ of turnover\textsuperscript{230}.

544. The working capital balances relating to the Cordless Phones product group and management accounts for cordless phones are shown in Table 16 below:

Table 16 cordless phones working capital requirements

<table>
<thead>
<tr>
<th>Total working capital</th>
<th>Cost of capital %</th>
<th>Minimum return on capital employed</th>
<th>Implied return on turnover %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management accounts</td>
<td>$\text{[&gt;X]}$</td>
<td>11.40%</td>
<td>$\text{[&gt;X]}$</td>
</tr>
<tr>
<td>Regulatory accounts - working capital only</td>
<td>$\text{[&gt;X]}$</td>
<td>11.40%</td>
<td>$\text{[&gt;X]}$</td>
</tr>
<tr>
<td>Average Payment terms</td>
<td>$\text{[&lt;X]}$</td>
<td>11.40%</td>
<td>$\text{[&lt;X]}$</td>
</tr>
</tbody>
</table>

Source: BT\textsuperscript{231}

545. In order to calculate the minimum return on capital employed, Ofcom has applied an estimate of the weighted average cost of capital (“WACC”) to the total estimated working capital of the business. The WACC used by Ofcom was 11.4% as calculated in Ofcom’s recent statement: “Ofcom’s approach to risk in the assessment of the cost of capital”\textsuperscript{232} as applicable to BT’s businesses (excluding BT’s copper access business)\textsuperscript{233}.

546. Differences between the working capital balances as per the regulatory accounts and management accounts can be attributed to:

• Timing: Management accounts are as at 31 March 2005, regulatory accounts are average of opening (1 April 2004) and closing (31 March 2005) balances. Neither sets of accounts balances are prepared in the required format on a monthly basis
• Analogue phones included in regulatory accounts but not in management accounts
• Revenues are treated differently in the two sets of accounts gross of discounts in the management accounts and net in regulatory accounts

\textsuperscript{230} As set out in Annexes 1 and 2 of the Complaint
\textsuperscript{231} Email from [\text{>X}] (BT) to Hugh Kelly (Ofcom) 15 September 2005
\textsuperscript{232} http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/#content paragraph 8.19
\textsuperscript{233} There are arguments why an appropriate WACC for BT’s DECT phone business would be both higher and lower than the average for BT’s non-copper access business. For example, the DECT phone business requires very low level of fixed asset investment and the capital employed is therefore largely variable with the scale of the business. In this case the risk of underutilised assets is low suggesting a lower WACC. On the other hand the risk of poor purchasing decisions leading to losses or low profitability on individual models is relatively high suggesting that a higher WACC may be appropriate. It is by no means certain which of these two effects might be expected to dominate; even if one effect were stronger than the other it would be difficult to quantify any such difference in risk. Ofcom therefore believes that it is reasonable to use its estimate of the cost of capital for BT’s non-copper access activities as a whole in considering BT’s DECT phone business.
• End of year accounting adjustments (including provisions) are included in regulatory accounts but not in management accounts

• The regulatory accounts prepared on a fully allocated cost basis include allocations of balance sheet items shared with business units other than BT’s cordless phones business such as creditor balances relating to common costs

547. In Ofcom’s view, the variable and potentially negative nature of the working capital requirements for BT’s cordless phones business indicate that a minimum return on capital employed approach is problematic. In previous cases where a minimum return on capital employed approach has proved problematic, regulators have used a minimum Return on Turnover approach. For example, in BSkyB:

“... the Director considers that return on turnover is the best measure of DisCo’s profitability in the current case and that, for the purposes of this investigation, it should be required to achieve a return of at least 1.5%. Given the level of commercial risk faced by DisCo, this rate is a conservative assumption of the minimum that DisCo might be expected to earn.”

548. A similar view on profitability measure was taken by the then Monopolies and Mergers Commission (MMC) in its report on BT235, where instead of using ROCE, the MMC calculated RoT for BT’s call business. The MMC considered that the reason this approach could be applied to BT’s call business was the “very high proportion of turnover accounted for by bought-in services” (as is the case in this investigation). The MMC concluded that a RoT 1.5% would be appropriate for BT’s calls-to-mobiles activity.

549. In Ofcom’s view a reasonable assumption for the minimum level of profit required in this case is a minimum RoT of 1.5%, consistent with BT’s management accounts, the costs of working capital of its own competitors and also with previous competition cases where a minimum RoT approach has been adopted.

Timing differences

550. One of the difficulties in interpreting BT’s monthly management accounts is that certain key costs are not fully matched to revenues with the result that profit figures for individual months may be misleading. Two particular costs give rise to timing differences – sales credits and warranty returns.

551. When BT lowers the price of a phone to some major customers, this does not typically result in the lowering of the price at which the phone is invoiced to the customer and at which the sale is included in revenues. Instead, the phone is invoiced at the originally agreed price and a subsequent adjusting “sales credit” note is raised after say three months, reducing the net revenues earned in that later month (ie revenues are started as gross revenues less sales credits and warranty returns in the month). Thus the net revenue shown for the relevant

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234 BSkyB, paragraph 413.
235 British Telecommunications Plc: A report on a reference under section 13 of the Telecommunications Act 1984 on the charges made by British Telecommunications Plc for calls from its subscribers to phones connected to the networks Cellnet and Vodafone, 21 January 1999. The MMC concluded (paragraph 2.113) that calculating a return on net assets employed was an unreliable basis for setting a reasonable return as the mean net assets employed in call activities are not only relatively small but they consisted for the most part of working capital items which could fluctuate considerably from year to year.
236 Ibid, paragraph 2.116. In the case of BT, “over 80% of the retail price to consumers represents the cost of bought-in services” (paragraph 2.112).
phones in the month they are sold is overstated and revenues for the phones sold in the month the sales credit is posted to the accounts are understated. For a permanent price change the issue is the period the retailer takes to claim compensation to equivalent new buy price against stock they hold at the time of the price change.

552. BT’s revenues and costs for phones in a particular month relate to stock physically sold in that particular month. When goods are returned under warranty, revenues are reduced by the price of those phones returned, but the cost of the phone remains in the period the phone was originally sold\(^{237}\). Thus there is a timing mismatch as revenues and costs in the period the stock was originally shipped are overstated and revenues in the period the stock is returned are overstated.

553. Ofcom has adjusted for these timing differences by reallocating monthly sales credits and warranty returns for individual models to prior periods in an attempt to better match revenues and costs.

Is there any evidence of BT selling individual DECT phone models below average variable cost?

554. Ofcom requested monthly sales and cost of sales data for a sample of phones from BT. The phones selected were the five models cited by the complainants in their complaint and the top five (by revenue) models in the 2004/5 financial year:

- Phones cited by complainants:
  - Freestyle 2100
  - XC 100
  - Lyric 1100
  - Synergy 700/2 am
  - Studio 1100
- Next top 5 DECT phones
  - Studio 100
  - Freestyle 2200
  - Freestyle 2200/T
  - Studio 100/2
  - Freestyle 2100/2T

555. In addition to considering the profitability of BT’s DECT phone business overall, Ofcom has considered the profitability of individual phones, both over the period of the investigation and also on a monthly basis.

556. Overall, BT’s DECT phone business recovered variable costs and made a contribution towards fixed and common costs of £\[><\]m or \[><\]% of revenues as shown in Figure 19 below:

**Figure 19 Total contribution to fixed costs after Ofcom adjustments 2003/4 - 2004/5**

\[><\]
Source: Ofcom calculation

---

\(^{237}\) Where goods are returned new and unused, the cost of the original sale and revenues are adjusted. Where returned goods or damaged stock is repaired, repackaged and resold, the associated costs and revenues are charged to the profit and loss account in the period the goods are sold. (Source: BT’s response to Q12 of Ofcom’s 4th Notice of 12 August 2005.)
557. Figure 20 and Figure 21 below shows the total and unit monthly contribution to fixed costs of the sample models after Ofcom's adjustments set out in paragraph 553.

**Figure 20 Total contribution to fixed costs after Ofcom adjustments by model 2004/5**

![Graph showing total contribution to fixed costs after Ofcom adjustments by model 2004/5.](image)

Source: Ofcom calculation

**Figure 21 Unit contribution to fixed costs after Ofcom adjustments by model 2004/5**

![Graph showing unit contribution to fixed costs after Ofcom adjustments by model 2004/5.](image)

Source: Ofcom calculation

558. Figure 20 and Figure 21 above show that for the majority of models assessed revenues exceeded variable costs and made positive contributions to the recovery of fixed costs.
559. One model, the Lyric 1100 does not recover its variable costs during the period. BT’s pricing decisions for the Lyric 1100 model are discussed further in paragraph 570.

560. In addition to the total contribution during 2004/5, Ofcom has considered the monthly profitability of each model, which is shown in Figure 22 below.

**Figure 22 Monthly contribution to fixed costs after Ofcom adjustments by model**

![Graph showing monthly contribution to fixed costs by model]

Source: Ofcom

561. Figure 22 above shows that with the exception of the Lyric 1100, revenues on a monthly basis also tended to exceed variable costs and that the models made a positive contribution to the recovery of common costs.

562. In addition, Ofcom notes that the volatility of the monthly results reflects fluctuations in allocations of variable costs as well as timing differences which have not been adjusted for. Any results for an individual month are therefore likely to be subject to a significant degree of error, particularly when compared to the results over several months or more.

563. In addition to the losses for the Lyric 1100 model, Figure 22 also shows a small number of instances where the monthly contribution of a phone towards fixed costs was negative but not significantly or with any persistence. Ofcom has reviewed the data underlying these negative results and is satisfied that they have arisen due to the fluctuations of the underlying accounting data, and if the accounting data were to be further refined and underlying timing differences and allocation issues resolved would show a positive contribution.

564. Fluctuations in unit costs are in part due to an allocation of fixed and common costs based on unadjusted revenues – a more accurate approach would be to allocate costs based on adjusted revenues (ie after taking into account the timing differences of sales credits and warranty returns). This reallocation would primarily result in a reallocation of costs for a particular product between months. Ofcom has not undertaken such a detailed reallocation of costs on the basis that
to do so would be very time consuming and would not materially affect the overall conclusions of the analysis.\footnote{238}{Any reallocation would primarily be reallocating costs between months for the same product rather than between products on the basis that total adjusted costs and revenues for each product across the 2 financial years 2003/4 and 2004/5 remain the same.}

565. The losses on the Lyric 1100 phone arose in June 2004 to December 2004 and applied to a total volume of [×] phones (out of a total of [×] million phones sold during the period – less than [0-.5]%). Ofcom has investigated the pricing decisions of this phone in detail in order to gain an understanding of BT’s business and pricing strategy.

\textit{Lifecycle profitability}

566. Given the below variable cost pricing of the Lyric 1100 model, Ofcom has reviewed the profitability of this product over its lifetime in order to assess whether or not it recovered relevant variable costs.

567. Figure 23 below shows the monthly contribution to fixed costs of the Lyric 1100 model

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure23.png}
\caption{Figure 23 Monthly contribution to fixed costs after Ofcom adjustments Lyric 1100}
\end{figure}

568. Figure 23 shows that whilst the Lyric 1100 was initially sold with a positive contribution towards fixed and common costs, from June 2004 onwards it failed to recover variable costs and over its life cycle failed to recover £[×] or [0-5]% of its variable costs.

569. In view of the failure of this individual model to recover its variable costs both during the period under review, but also over its lifecycle, Ofcom has reviewed in detail BT’s pricing decisions for the Lyric 1100 model.

\textbf{Detailed review of BT’s pricing decisions in relation to the Lyric 1100}

570. As shown in Figure 23 above, Ofcom’s analysis has identified that the Lyric 1100 model, failed to recover the relevant variable costs considered over the period covered by this investigation and incurred losses for a period of 6 months between June 2004 and December 2004. Ofcom has undertaken a detailed review of the purchasing and pricing decisions for that phone to identify whether there was any evidence that BT’s pricing decisions for this particular model could have been motivated by an intention to exclude or discipline competitors or harm competition.

571. The Lyric 1100 phone was introduced in January 2004 and withdrawn in December 2004.\footnote{239}{BT’s response to Q2 of Ofcom’s 1st s26 Notice of 28 June 2005} Volumes of phones ordered, sold and in stock are shown below:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
Month & Ordered & Sold & In Stock \\
\hline
Jan 2004 & 1000 & 700 & 300 \\
Feb 2004 & 900 & 500 & 400 \\
Mar 2004 & 800 & 400 & 500 \\
Apr 2004 & 700 & 300 & 600 \\
May 2004 & 600 & 200 & 700 \\
Jun 2004 & 500 & 100 & 800 \\
Jul 2004 & 400 & 0 & 900 \\
Aug 2004 & 300 & - & 1000 \\
Sep 2004 & 200 & - & 1100 \\
Oct 2004 & 100 & - & 1200 \\
Nov 2004 & 0 & - & 1300 \\
Dec 2004 & - & - & - \\
\hline
\end{tabular}
\caption{Volumes of phones ordered, sold and in stock for Lyric 1100}
\end{table}
Source: BT\textsuperscript{240}

572. The cost (ex factory), wholesale price and RRP over the same period are shown in Figure 25 below

**Figure 25 Lyric 1100 – price and cost analysis**

573. Figure 25 indicates that the Lyric 1100 model was not selling well in the retail market at the initial RRP of £79.99 and that it was not until the RRP was reduced to £39.99 (£34.03 excl VAT) that the product was able to be sold in volume. BT provided its retailers with an average margin of [\(\times\)]\% over the RRP with a

\[\textsuperscript{240}\text{BT’s response to Q13 of Ofcom’s } 1^{\text{st}} \text{ s26 Notice of 28 June 2005}\]
resulting average wholesale price of £\[\times\]. The average monthly ex-factory price of the phone was £\[\times\] (October-December 2005).

574. Ofcom does not consider that BT’s failure to recover the relevant variable costs over the period covered by this investigation in relation to this one particular phone model is, when viewed against the background of all the relevant circumstances, sufficient to enable Ofcom to conclusively infer predatory intent. Accordingly, as set out below, Ofcom has obtained information and documents from BT to assess BT’s intent in setting prices for the Lyric 1100. In particular, Ofcom has reviewed the email discussion leading up to the decision to reduce the price of the Lyric 1100 in July 2004. The following internal and external email exchanges set out the reasons behind BT’s decision to reduce the price:

- email from [\times] (Account Manager, BT) to [\times] (Line of Business Leader, BT) and [\times] (Commercial Analyst, BT) 19 July 2004:

  Lyric 1100
  [retailer] are currently are only major account listing this product, but regrettably failed to sell at current price points and they are looking for our support to help clear through their stock holding. At the right price they are prepare to stick with the product to help clear through our stock holding and the paper sets it proposals to establish a new permanent price for the single at £39.99.

  regrettably both leave us with negative GM but represent the best value we can now realistically expect to get for the stock

- email from [\times] (Line of Business Leader, BT) to [\times] (Account Manager, BT) and [\times] (Commercial Analyst, BT) 26 July 2004:

  “Lyric 1100 – I’m reluctant to let this go through at negative margin, but if you are really sure that there are definitely no other opportunities to clear the stock through then we’ll have to bite the bullet on this one and push through to clear”

- email from [\times](Head of Sales, BT) to [\times](Line of Business Leader, BT), [\times](Account Manager, BT) and [\times](Commercial Analyst, BT) 26 July 2004:

  “I share your concerns about margins but I can support the view at present that we have no other interest at current prices and even a further £\times\ reduction seems not to be enough considering the very low level of sales [retailer] are experiencing at the moment”

- email from [\times](Commercial Analyst, BT) to [\times](Commercial Manager Home Consumer and High Street Distribution Finance) 26 July 2004:

  “Lyric 1100 and Lyric 1100 twin

  The proposal is to permanently reduce the prices of these products
  We have £\990k worth of stock to clear and the total margin giveaway is £\times.
  I asked [\times] to double check the stock comp numbers in his spreadsheet and they look ok.
  [\times] has signed this off too
  [\times] assures me this is the best price we can get for this stock and our best chance of clearing it, so I am happy to sign this off”

- email from [\times](Commercial Manager Home Consumer and High Street Distribution Finance) to [\times](Account Manager, BT) 26 July 2004:
“I conclude [concur] with your assessment

However my only points are that we need to ensure that:

- the customer has a no returns policy to avoid a truck load being returned in a few months time – I believe the lower price we have offered should account for this
- identify the true value of the stock in our balance sheet and what is the actual monies we are going to receive from the customer (ensure we mention price in the contract)
- have we ensure[d] all options have been considered for selling these products – seconds etc ?”

email from [>>](Account Manager, BT) to [>>](Commercial Analyst, BT) 27 July 2004:

“I can confirm that the [>>] deal doesn’t allow for them to return the stock”

575. In Ofcom's view, from the documents it has reviewed, BT’s pricing decisions regarding the Lyric 1100 model do not provide evidence of any intent to price at a level below costs in order to exclude competitors (or otherwise harm competition). Rather, the evidence appears to be entirely consistent with legitimate commercial behaviour and appears to be objectively justified in the light of the circumstances of this case. In that regard, Ofcom notes that:

- BT’s objective was to clear existing stocks which were not selling at initial prices; and
- the price was reduced in steps until stock could be sold.

In addition, Ofcom has not seen any evidence of BT ordering additional stock in a climate when it was obvious prices would need to be reduced. Rather BT’s internal decision making prices considered the options and noted the loss making nature of the reduced prices.

576. In addition, in Ofcom’s view, it could be argued that, in the particular circumstances for this model at that point in time (i.e. a situation where a model has reached the end of its life and is being withdrawn, and where there are no plans to buy any more stock from manufacturers), the relevant cost to consider is not the average cost of buying one more unit, but rather the opportunity cost of that unit. In these circumstances, the relevant opportunity cost could be considered to be the most profitable alternative option for disposing of the stock. In this case, provided the firm takes reasonable steps to maximise its revenues, and the additional costs of transporting the stock exceed revenues, the firm will be acting in a profit maximising way consistent with a competitive market and the behaviour, in the absence of any other evidence of intent, should not necessarily be regarded as anti-competitive.

Conclusion on pricing below variable cost

577. Overall, BT’s cordless phones made a contribution to common costs of £[>>]m or [>>]% of (net) revenues after recovery of variable costs during the year 2004/5. Ofcom has not found any evidence of persistent pricing by BT below average variable costs.

578. However, as noted above at paragraph 570 Ofcom identified one example of pricing below average variable cost in relation to relatively small volumes of stock
(the Lyric 1100 model) of a product which was being withdrawn. Ofcom does not consider that this example indicates predatory pricing by BT. It appears on the evidence available to Ofcom that BT’s behaviour is entirely consistent with profit maximising behaviour in the actual circumstances of the case, in particular where existing stocks were not selling at initial prices and the price was reduced in steps until stock could be sold in a rapidly evolving market characterised by short model lifecycles, technical innovation and falling prices and where a firm offers a large number of models.

579. In conclusion, Ofcom does not consider that BT’s pricing behaviour in relation to the Lyric 1100 model can be regarded as predatory given the particular circumstances of the case. This is consistent with the case law, in particular with the CAT’s judgment in the Napp case where the CAT considered whether pricing below average variable costs by a dominant firm could be due to objectively justifiable commercial behaviour rather than as part of a strategy to eliminate competitors. This is also consistent with the OFT’s draft guidelines on Assessment of Conduct which anticipate that there may be a number of legitimate commercial reasons for pricing below average variable costs, including loss leading, short run promotions, network effects, economies of scale and new products, unanticipated shocks, and option value.241

**Total cost recovery**

580. In addition to the recovery of variable costs, Ofcom has assessed the recovery of average total costs by BT’s DECT phones. As discussed in paragraph 473 onwards, a useful approach in assessing total cost recovery in a multi-product firm is to determine whether or not products are recovering a fully allocated cost.

581. This section sets out the adjustments made by Ofcom in applying BT’s FAC regulatory accounts for Cordless Phones to a consideration of the recovery of total costs for DECT phones.

**Analogue Phones**

582. BT’s regulatory accounts include analogue phone sales which are not relevant to this investigation. According to BT’s management accounts, total revenues for analogue phones in 2004/5 were £[×] out of total cordless phone revenues of £[×] ([(×)%]). BT have stated that “It is not possible within P393 [the regulatory product group for cordless phones] to split out revenues and costs between DECT & Analogue”.242 Whilst revenues for analogue phones can readily be identified (using the management accounts split), BT’s regulatory cost structure does not differentiate between analogue and DECT phone costs and so any allocation would be at least to some extent arbitrary.

583. BT’s management accounts split between analogue and DECT indicates that analogue sales are [×] as shown in the table below

<table>
<thead>
<tr>
<th>Table 17 Profitability of analogue, DECT and internal sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>[×] Source: BT243</td>
</tr>
</tbody>
</table>

584. This suggests that the profits of BT’s DECT phone business would be greater than one which included both DECT and analogue phones.

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241 OFT 414a Assessment of conduct, April 2004 at paragraph 4.12.
242 BT response to Q11 of Ofcom’s 4th s26 Notice of 12 August 2005
243 BT response to Q11 of Ofcom’s 4th s26 Notice of 12 August 2005
585. Ofcom has therefore excluded from its profitability analysis the revenues and costs associated with analogue phones derived from BT’s management accounts. In addition Ofcom has excluded from its profitability analysis a proportionate amount of costs attributable to analogue phones included in the regulatory accounts but not in the management accounts (see paragraph 516 onwards).

Rental Business

586. BT’s regulatory accounts for Cordless Phones include the revenues and costs associated with the rental of cordless phones. Rental income from cordless phones in 2004/5 amounted to £\[\times\]244, less than [0-5]% of total cordless revenues. It is not possible to separately identify the costs associated with this rental income from BT’s management or regulatory accounts. In Ofcom’s view it is not necessary to adjust BT’s accounts for P393 Cordless to exclude rental revenues on the basis that they are de minimis.

Cost of capital

587. The need to include a cost of capital in a predatory pricing case is discussed in paragraphs 537 onwards.

588. As set out in paragraph 541, the capital employed in BT’s DECT business largely comprises working capital. In Ofcom’s view this, and the variability and uncertainty regarding the working capital balances in the year, suggest that the most appropriate approach to including a minimum level of profit in the predatory cost analysis is to adopt a minimum return on turnover. In Ofcom’s view a minimum return on turnover of 1.5% is reasonable as being consistent with management accounts data, competitors costs and previous approaches taken by regulators relevant.

Do DECT phones as a product group recover fully allocated costs?

589. After the exclusion of the analogue phones and addition of the cost of working capital, the profit of BT’s DECT phone business is £\[\times\]m as shown in Table 18 indicating that overall BT’s product group recovered fully allocated costs and can therefore be regarded as recovering average total costs.

Table 18 Ofcom’s adjustments to BT’s regulatory accounts profit for Cordless Phones

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244 Total revenues in F8 code 092210 “Apparatus Rentals Cordless & ISDN Tel Bu”
Do individual phone models recover fully allocated costs?

590. Having established that DECT phone in total recover fully allocated cost, Ofcom has gone on to examine whether the individual phones cited by the complainants recovered a fully allocated cost.

591. Figure 26 below shows the contribution to fixed and common costs together with the net profit of each model (after deducting fully allocated costs)

Figure 26 Contribution to fixed/common costs and net profit by model

![Bar chart showing contribution to fixed/common costs and net profit by model](chart.png)

Source: Ofcom calculation

592. Figure 26 shows that in addition to the Lyric 1100 model discussed in paragraph 570 above, the XC100 model whilst making a positive (though small) contribution towards fixed and common costs, failed to recover its fully allocated cost.

Lyric 1100

593. Ofcom’s analysis of BT’s pricing decisions for the Lyric 1100 model are set out in paragraph 570 onwards.

XC100
During the financial year 2004/5 BT's revenues from the XC100 model were £[£] which made a contribution towards fixed and common costs of £[£] (0-5% of revenues) compared to fully allocated costs of £[£]. This is illustrated below.

Figure 27 XC100 model - Profitability analysis 2004/5

[<<]
Source: Ofcom analysis

Ofcom has considered whether there is any evidence to suggest that BT’s pricing of the XC100 model could be regarded as anti-competitive.

The Freelance XC100 model was introduced in September 2002 as part of a range of exclusive models, sold only to certain major retailers (Argos, Dixons and Comet). The XC100 model was exclusive to Comet. The model initially sold at a purchased from the factory at a cost of £[£] to be wholesaled to retailers at £[£] and retailed to consumers at £[£]. The model continued to be ordered by Comet until March 2005, albeit at reducing margins. The exclusive models were manufactured to order, with the customer taking the risk of warranty returns. There were therefore no stocks held other than in transit to the customer.

In May 2004 BT reduced the wholesale price to £[£] in the expectation that it would still be earning a positive “Trade” margin of £[£] (or [%] of purchase price) on each phone. The paper proposing this price reduction noted that BT needed to reduce prices on these exclusive models “in order to re-establish previous [volume] levels and avoid a [customer’s] move to non BT competitive products.” The paper also noted the need to “re-position exclusive pricing at entry levels” indicating a need to match competitors process on entry level phones.

The [%] “Trade” margin calculated by BT in approving the price was the lowest of all the exclusive prices which ranged from [!]% to [!]% (for various bundles of the same phone to different retailers).

In Ofcom’s view the pricing of the XC100 needs to be considered as part of BT’s overall pricing strategy with the major retailers. On the one hand, not all models could be priced at this low margin level, at which neither fixed nor common costs would be fully recovered.

In Ofcom’s view, pricing of individual models at a level which covers variable costs and makes a contribution towards fixed and common costs but does not recover a fully allocated cost is not necessarily anti-competitive. This is particular likely to be so where, as in the present case:

- the product group (ie DECT phones) as a whole recovers fully allocated costs;
- the model concerned is one of a series (ie the range of exclusive models) in which other models make significantly greater contributions; and

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245 Business Case for the Freelance range dated 18 June 2002 as provided in BT’s response to Q7 of Ofcom’s s26 Notice of 8 June 2005
246 HC&HSD Financial Authority Committee pricing paper 04021PC – exclusives Pricing Fastrack paper dated 26 May 2004 provided in BT’s response to Q7 of Ofcom’s s26 Notice of 8 June 2005
247 Ibid
• pricing is consistent with commercial practices to be expected in a highly competitive market.

601. On the other hand, it is not unreasonable or necessarily anti-competitive for a supplier to offer different products at various levels of profitability so as to maximise overall profits provided each product recovers its variable costs and in total, all fixed and common costs are recovered.

Freestyle 2100

602. The complainants have cited the BT Freestyle 2100 model as one which they believe BT was selling below cost and against which they could not compete.248 The complainants stated that this model was being selectively discounted at Argos during the periods 22 September 2004 to 19 October 2004, 15 December 2004 to 24 December 2004, and 16 February 2005 and 15 March 2005. The retail price during these periods was £19.75. The complaint stated that these were not “one-off promotions” and that “[the complainants] expect that BT is continuing to purchase and stock this model”.249

603. Ofcom has investigated in detail BT’s pricing of this particular product during the periods cited by the complainants to be targeted discounts.

604. The Freestyle 2100 model was introduced in August 2003 at a recommended retail price of £33 (excluding VAT), an average wholesale price of £[£] and an ex-factory cost of £[£]. The business case for introducing the phone250 stated that the model was an “entry level DECT”251 and that BT expected to sell [>] in the first 12 months.

605. The product sold in significant volumes: [>] in the first 12 months as shown in Figure 28 below which also shows outstanding volumes of stock ordered by BT from the supplier, sales and BT’s stock -in-hand.

Figure 28

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248 Paragraph 1.8 of complaint dated 29 March 2005
249 Ibid
250 Final Business Case for Freestyle 2100 and Freestyle 2500 29 April 2003 provided in BT’s response of 1 June 2005 to Q7 of Ofcom’s first s26 notice
251 Ibid para 1.5
606. Figure 28 shows that after June 2004, no further volumes were ordered by BT from the supplier and that sales to retailers ceased in November 2004.

607. The prices and variable costs incurred in respect of these sales are shown in Figure 29 below

**Figure 29 BT Freestyle 2100 model – costs and prices**

Source: BT data, Complainants, Argos

608. The periods cited by the complainants as being below cost (ie 22 September 2004 to and 15 March 2005) are those relating to retail sales, for which the relevant wholesale sales would have been in the period July 2004 – November
2004. A key period in this analysis is the summer 2004 sale (June/July 2004) when BT planned a significant sale of the Freestyle 2100 model prior to its discontinuation and replacement by the Freestyle 2200 model. Pricing and purchasing decisions for the summer sale were made in March and April 2004. For example, BT’s pricing paper for the price reduction to a RRP of £24.99 (from £34.99) in April 2004 (for promotion in July of 2004) commented that:

"By promoting the Freestyle 2100 at £24.99 as the headline price and encouraging accounts to limit stock for this entry level, we can shift focus for promotion around the bundle propositions."

"the Freestyle 2100 is being sold through at this price, hence volumes reflect a last buy in, not sales out. This will withdraw the product"

[retailer], [retailer], and [retailer], have agreed to guarantee taking [%] of their forecasts [so] which greatly reduces our risk of stock exposure"

609. The pricing paper indicated that at a retail price of £29.78 (£24.99 excl VAT), the wholesale price to retailers would be £\[\times\] providing the retailers with a [%] margin. The paper estimated total direct costs at £\[\times\] providing a margin on direct costs of £\[\times\] or [\times]% (previously [\times]%).

610. Internal correspondence indicates that BT were intending to restrict the volume of Freestyle 2100 phones sold at these low volumes, but that additional stock was ordered prior to the July sales:

Email from PP to DD & others 25 March 2004

“Final buy on the Freestyle 2100 at a permanent price reduction, Gary estimates he will have around 20k of stock left and the end of May and has put an order in for a further 50k to be delivered beginning of June (this figure can be reduced if necessary). We therefore need to limit the amount of final buy to a reasonable level so we don’t flood the market. This way we don’t have to claim back the next quarter and have a clear run for the launch of the Freestyle 2200.

Tying in with this is a commitment to whatever mixture of bundle proposition if most appropriate. I know there has been some debate about getting tye in, but the principle objective here is to lead with the £24.99 headline and then gain value though upgrading in our bundle offers.”

611. The additional purchase referred to in this email is shown in Figure 30 which shows that as at May 2004 some 70,000 units of Freestyle 2100 were in stock. Figure 30 also shows the volumes of Freestyle 2100 phones BT expected when it was planning in the July 2004 promotion (85,000) together with the actual volumes (25,000).
612. Figure 30 shows that in April 2004 BT planned to purchase a significant number of Freestyle 2100 phones (50,000) which, together with existing stock (30,000), it would sell in the July sale at a low (but positive) margin. Actual sales were significantly lower than planned – 12,477 in July. As a result of this failure to sell in the July sales, BT found themselves with some 86,000 units of Freestyle 2100 which they needed to sell in order to make way for the replacement Freestyle 2200’s.

613. A review of BT’s emails indicates that this was recognised as a serious commercial mistake:

*Email from MM to DD 13 July 2004*

“Spoke to [retailer] – don’t think they can take advantage – told them we had [𝕏] not the [𝕏] we really have!!!!!!... Where are we going to sell [𝕏] I had no idea there was this much”

*Email from MM to EE et al 13 July 2004*

“It looks as though we will have [𝕏] units of the Freestyle 2100 left at the end of the current promotion this is potentially a major stock issue... At current sale rate of [𝕏] a week (as [retailer] will be delisting at the end of July for new catalogue) we will have 57 weeks stock and [the model] will have been replaced in our core range by the [𝕏].

I have the following proposition which I have talked through with DD and he is supportive:

- The key to clearing this will be to regain a listing at [retailer]
• The current [retailer] buy price is £[< ] and they have requested that we support to £[< ]. I suggest we go back with an offer price of £[< ]. going [< ]% of the way to the target price
• … bringing the total commitment to [< ] units

I am confident that at [< ] I can sell the remaining [< ] to [retailer] and [retailer] with delivery from the 25th August as yet not discussed with these accounts

Email from AA to MM et al 14 July 2004

“I believe we’re getting some of the basics wrong again here. Whilst we can probably dig our way out (yet again) we have to ask at what cost. This behaviour is massively contributing to the ‘driving value out of the market effect’.”

Email from EE to AA et al 14 July 2004

“Looks like the promotional deal is just about min margin bench @ [< ]% so I have advised that we proceed.”

Email from PP to AA et al 14 July 2004

“My view on this is that, yes, there will be substitution around the Freestyle 2200’s however I feel that [retailer] ’s plan is to hit the lower end branded products with this and make an impact against other retailers, hence most of the substitution will probably be against [supplier], who by the way are also looking to clear out low entry stock. It is therefore a case of if we don’t take the opportunity, [supplier] will. We would then be left with a bigger stock implication.”

614. Argos has stated that it bought [< ] units of Freestyle 2100 from July 2004 which it sold at a reduced margin.\textsuperscript{252} Argos explained this as follows:

“This product was on sale to customers as a core line until its discontinuation in July 2004. As a result of BT’s stock management a large volume became available beyond this time. Argos acquired [< ] units of this discontinued line with a view to offering its customers a high functionality item at what amounted to an entry level telephone price. Although the margins were not as lucrative as Argos would have liked, Argos felt that, commercially, it was consistent with its value message to offer this discontinued product line for sale to its customers. This product line was also likely to be offered to other high-street retailers and Argos did not wish to be seen as uncompetitive by not stocking this particular product line – which was promoted by Argos in its October 2004 flyer. The un-promoted margin up until July 2004 was [< ], scoop purchase margin beyond this was [significantly less].”

615. A retail price of 19.75\textsuperscript{253} (or £16.81 excluding VAT) and margin of [< ] implies that the wholesale price at which Argos purchased the “scoop” was £[< ]. BT bought the phones at an average cost of £[< ]\textsuperscript{254} and an average variable cost of £[< ]. BT was therefore recovering the relevant variable cost on the sale of these phones and making a positive contribution to common costs.

\textsuperscript{252} Argos response to s26 notice [date]
\textsuperscript{253} Complaint dated 29 March 2005
\textsuperscript{254} Average cost of phones between March 2004 and November 2004
616. In Ofcom's view, BT’s strategy of selling discontinued lines at low margins (% when the phones were being retailed at £24.99) in order to maintain revenues and increase sales of more profitable “bundles” (packs of multiple units) was not inconsistent with behaviour that was to be expected in a competitive market, given that the phones were expected to, and did, both make a positive contribution to common costs and contribute to the sales of more profitable bundles.

617. In relation to the further price reduction to enable a retail price of £19.75 to be reached this would clearly have been commercially rational if the stock being sold represented stock-in-hand which had not proved possible to clear at original prices and could not have been returned to the manufacturer (which would normally be the case for DECT phones which are not faulty), assuming that the purpose of the price reduction was to maximise overall revenues. However, in this case BT deliberately chose to buy in additional stocks of a model it was otherwise about to discontinue and sold that stock at a price above variable cost, but below a fully allocated cost. In those circumstances, two questions are relevant to the analysis of whether BT’s behaviour constituted predatory pricing:

- Is there any evidence of intent to foreclose the market (whether in the form of express intent or intent that can be inferred from the circumstances)?
- Was BT’s pricing consistent with a competitive outcome?

618. Ofcom therefore considered BT’s pricing decisions of the Freestyle 2100 model. The complainants alleged that this model was repeatedly sold below cost, was not a redundant model and they expected that BT is continuing to purchase and stock this model. This was not the case. Ofcom has found that, whilst this model was sold for six months to March 2005 at the low retail prices cited in the complaint (but above average variable costs), the model had not been purchased by BT since June 2004 as it was being replaced by the Freestyle 2200 model. The evidence suggests that BT’s strategy in purchasing the additional volumes was to offer an attractively low priced model (Freestyle 2100) but only in combination with a higher margin bundle (pack of 2-4 cordless phones). The evidence does not suggest that BT intended to “flood the market” or to drive value out of the market or to drive competitors from the market. However, it appears that this strategy failed dramatically and that retailers were not persuaded to buy the Freestyle 2100 on the terms offered. The large volumes which BT needed to sell after July 2004 can, therefore, in part, be attributed to a commercial mistake by BT which over-ordered and then struggled to sell surplus stocks in advance of the new model being introduced. Ofcom notes that in order to sell such large quantities the retailers were also persuaded to accept lower margins than usual (on the basis that the retailers preferred to sell the low priced phones at a low margin than see them being sold exclusively by their competitors).

619. BT recovered its average variable cost for the Freestyle 2100 in all periods and recovered fully allocated costs for the phone over the total period of the investigation but not fully allocated costs in the period after July 2004. Ofcom recognises that BT did decide to purchase further stocks between March 2004 and May 2004 with a view to selling below fully allocated costs (but always above average variable costs), however, this was planned for a limited volume for a particular model over a very short period of time before launching a new model. In circumstances such as this where a product is priced above variable cost but

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255 Paragraph 1.8 of complaint dated 29 March 2005.
below total cost, case law suggests that the pricing is only likely to be abusive if there is evidence of intent to predate. In considering intent the question of whether the firm is recovering its total costs in aggregate across all products is relevant. In this case BT was recovering its total costs (as assessed using a fully allocated cost approach). In addition, the evidence in BT’s documents in relation to this model does not suggest predatory intent and therefore Ofcom has concluded that the pricing of this product was not anti-competitive.

Summary

620. In relation to the recovery of total costs, Ofcom has found that, overall, BT’s DECT phones recovered their fully allocated costs during the period under review.

621. A review of individual models has found two models that did not recover their fully allocated cost during the period of the investigation (2004/5) – the Lyric 1100 and the XC100.

622. The losses on the Lyric 1100 model can be attributed to the need to sell off obsolete stock once it became apparent that the product was not selling at the planned profitable price levels. Ofcom has reviewed BT’s pricing decisions and found BT to have acted in a commercial and profit maximising manner.

623. The XC100 model was a low cost, low margin product sold exclusively to a major retailer on a dedicated basis. The risks involved in ordering the product were minimal – goods were purchased from the factory to match retail orders and the risk of returns was borne by the retailer under a “buy-out guarantee”. Under such an arrangement, it is reasonable to expect lower margins than where the distributor holds speculative stock and bears the risk that customers will return stock that need to be inspected and repackaged. The low margins were clearly set to be competitive with other “entry level” products, and in a manner that gave BT very low profit levels. Further, Ofcom examined BT’s documents in relation to this product and did not find any evidence of predatory intent.

624. One model, the Freestyle 2100 covered fully allocated costs during the overall period of the investigation (2004-2005) but not during the period after July 2004. The model recovered average variable costs throughout. Ofcom considered BT’s pricing decisions for this model in detail and found that the evidence does not suggest predatory intent. Rather, BT made a commercial mistake overestimating demand leaving it with stock which it was forced to sell at a low price, just above variable cost, for a short period. It did not order these phones again after June 2004 as the model was replaced by the Freestyle 2200.

Conclusion on predatory pricing tests

625. Ofcom has undertaken a wide range of tests to determine whether or not BT is pricing or has priced DECT phones below cost, none of which indicate that BT has been engaging in predatory pricing.

(a) Firstly, Ofcom has assessed whether BT’s pricing of DECT phones recovered relevant variable costs for the period April 2004 – March 2005 on a total basis over the period and on a monthly basis. On this measure BT was recovering all relevant variable costs.

(b) Ofcom then assessed the pricing of a sample of individual models over the period of the investigation and on a monthly basis. Over the period of the investigation, each model with one exception (the Lyric 1100) recovered average variable costs. Ofcom has reviewed in detail the pricing decisions relating to this model. The losses were small and in Ofcom’s view the
relevant pricing decisions were consistent with competitive behaviour and do not provide evidence of predatory pricing.

(c) Ofcom then considered whether BT’s cordless phones business were recovering total costs using a Fully Allocated Cost approach over the period of the investigation. Ofcom notes that this test is potentially stricter than that needed to establish below cost pricing, but it does provide a useful measure of overall cost recovery. BT’s pricing of its cordless phones business as a whole recovered costs on a fully allocated cost basis for the period under review.

(d) Ofcom then considered whether individual phone models were recovering average total costs during the period of the investigation, again using a Fully Allocated Cost approach. In addition to the Lyric 1100 model, Ofcom found one other model the XC100 model which, whilst recovered relevant variable costs, did not recover its fully allocated costs. Ofcom again notes that testing each model against its fully allocated cost represents a stricter test than is needed to establish below cost pricing. Ofcom examined BT’s pricing decisions for this model and is satisfied that BT’s decisions were consistent with competitive behaviour and do not provide evidence of predatory pricing.

(e) Finally Ofcom considered BT’s pricing of the Freestyle 2100 model, which covered fully allocated costs during the overall period of the investigation (2004/5), but not during the period after July 2004 when it was discounted in order to sell off surplus stock (at a price just above variable cost). Ofcom has found that BT made a commercial mistake in respect of its purchases of these phones and over estimated demand for this redundant model which it was then forced to sell at a low price and for which retailers accepted lower than usual margins. Ofcom found that the evidence does not suggest predatory intent in BT’s pricing decisions in respect of this model.

Ofcom’s consideration of the complainants’ submissions on whether BT’s costs/prices are indicative of predation

626. Ofcom has considered the submissions on costs and financial performance submitted by the complainants to determine whether this provides any evidence of anticompetitive pricing by BT.

627. Binatone provided Ofcom with draft annual accounts for the year ended 31 March 2005 and also an analysis breaking their total UK business into DECT phones and other products. These are summarised in the table below:

Table 19  NB Confidential to BINATONE

| [<>] |

628. In Ofcom's view the submissions from the complainants regarding their own costs and product profitability indicate that they are themselves able to sell DECT phones at a level that recovers variable costs and makes a positive contribution to fixed costs.

629. As already noted at paragraph 447 the relevant test for predation as set out in the case-law relates to an assessment of the dominant firm’s price against its own costs. However, even on the comparison suggested by the complainants, BT’s
prices are typically the same or higher for equivalent phones supplied by the complainants – prices which would cover the complainants own variable costs and make a positive contribution to their fixed costs. On this basis, it is Ofcom’s view that on the evidence available, it would appear that even at BT’s pricing levels, the complainants would be able to recover at least their variable costs and make a contribution to the recovery of fixed costs.

Is there any documentary evidence that BT was pursuing a predatory strategy?

630. Ofcom, in the course of its investigation, requested BT’s internal documentation relating to the sample of DECT products listed below and authored by, received by, and/or sent by the 23 named individuals or individuals whose positions in the DECT business are named from 1 April 2005 to May 2005 as set out in Table 20

Table 20 Source of documents reviewed by Ofcom

<table>
<thead>
<tr>
<th>Position</th>
<th>Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>COO</td>
<td>AA</td>
</tr>
<tr>
<td>Financial Controller</td>
<td>BB</td>
</tr>
<tr>
<td>Head of Marketing</td>
<td>CC</td>
</tr>
<tr>
<td>Head of Sales</td>
<td>DD, EE</td>
</tr>
<tr>
<td>Head of Operations</td>
<td>FF</td>
</tr>
<tr>
<td>LOB leaders</td>
<td>GG, HH, II</td>
</tr>
<tr>
<td>Commercial Analysts</td>
<td>JJ, LL, MM;</td>
</tr>
<tr>
<td>Account Manager</td>
<td>NN</td>
</tr>
<tr>
<td>Others</td>
<td>AA, OO, PP, QQ, RR, SS, TT</td>
</tr>
</tbody>
</table>

631. Of the 23 individuals named by Ofcom in its request, BT were unable to retrieve any data from the following 7 people who have since either moved role within BT or left BT altogether without any of their data being retained: VV (who left in October 2003), KK and UU (who both left in December 2003), WW (who left in June 2004), XX (who left in January 2005), VV (who left in February 2004) and AB (who left in April 2005).

632. For those individuals whose data could not be retrieved, the destruction of this data was made in accordance with BT’s Information Retention Policy\(^\text{256}\) (10th edition, 26 March 2004 – the first edition of BT’s policy was issued on 18 April 1996). The practice of the teams involved was to require a leaver’s laptop to be re-built so that another member of the team could use it. The laptop would have been re-built within a short time of the employee leaving the team. These individuals are VV (who left in October 2003), KK and UU (who both left in

\(^{256}\) BT’s 19 August 2005 letter to Ofcom.
December 2003), VV (who left in February 2004), WW (who left in June 2004), XX (who left in January 2005) and AB (who left in April 2005). QQ (who left in March 2005) had left documents with his manager and these documents were retrieved.

633. In addition, of all the individuals BT interrogated and from whom data was retrieved, 3 have only partial data due to file loss or corruption. These were: RR, CC and LL.

634. However, the other employees listed or whose positions are listed in Table 20 are likely recipients or senders of relevant documentation which would have been held by these individuals and would therefore have been captured in this way.

635. BT have also retrieved or interrogated data from 4 individuals not listed in Table 20 but who have replaced persons listed who have left their respective role. These are: RR, SS, TT and EE (Head of Sales since May 2004).

636. In particular, Ofcom examined the documents relating to BT’s strategy (including research in preparing and developing that strategy), BT’s pricing and purchasing decisions including:

- notes of internal and external meetings at which DECT telephones were discussed;
- copies of any internal and/or external letters, faxes, e-mail correspondence and memos discussing the pricing and purchasing of DECT telephones;
- copies of any and all prepared business cases setting out the rationale for the pricing and purchasing of DECT telephones;
- copies of any and all underlying data analysis used to calculate the price of DECT Telephones, together with workings and/or explanations of how the data analysis was used to calculate the prices for DECT telephones;
- copies of any and all documents carrying out an analysis of BT’s position vis-à-vis its competitors in the provision DECT telephones, including analysis of competitors’ pricing and BT sales strategies;
- copies of any and all documents carrying out any other analysis of BT’s competitors in the provision DECT telephones, including analysis of competitors’ pricing;
- copies of any compliance review/assessment made by BT in respect of the pricing and purchasing of DECT telephones;
- copies of internal e-mails and project team meeting minutes and notes relating to DECT Telephones.

637. The sample comprised the following products:

Freestyle 2100
BT XC 100
BT Lyric 1100
BT Synergy 700 Twin with answering machine
BT Studio 1100
Freestyle 2200
Freestyle 2200 Twin
638. In reviewing those documents Ofcom has kept in mind the CAT’s recent comments in *Claymore* in relation to assessing intention where the CAT noted that intention is "conduct on the part of the dominant firm which (i) has the reasonably foreseeable result of driving a rival from the market; (ii) goes beyond a normal competitive response and is disproportionate to the threat; and (iii) has the object or effect of preserving or strengthening a dominant position."\(^{257}\)

639. Ofcom has set out below a sample of its key findings from the document review. Ofcom considers that these internal documents are likely to be a good indicator of the true intentions behind BT’s pricing behaviour. In addition, Ofcom believes that those documents do not suggest that BT pursued an overall predatory strategy. Rather, the documents seen by Ofcom suggest lively competition in the market with price reductions being driven primarily by retailers, and BT seeking to retain value in the market and positive margins in a market characterised by lively price competition.

640. Whilst there is some use of aggressive language about competitors, this does not by itself provide evidence of an intention to predate. On the contrary, a keen desire on the part of competitors to overtake one another is the lifeblood of competition. In Ofcom's view the market conditions at the time can be characterised as competitive with:

- excess manufacturing capacity in the Asia-Pacific region\(^{258}\)
- commoditisation of DECT phone production leading to falling production costs resulting in lower prices through the value chain, and
- retail competition/retailers constraining wholesale prices to competitive levels

641. In particular Ofcom has considered whether or not there was any evidence in the documents it reviewed which indicate a deliberate strategy on the part of BT to foreclose the market to the complainants. There was no such evidence. Rather, the evidence is consistent with a competitive market.

642. In such market conditions, an aggressive approach to pricing decisions is consistent with a competitive market outcome. Ofcom’s review of BT’s decisions indicates that BT’s behaviour is consistent with a competitive market and has found the evidence does not suggest anti-competitive intent or behaviour.

643. In Ofcom's view the evidence from its review of material from BT clearly indicates that reductions in price were largely in response to demands from retailers and

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\(^{257}\) See para 442 above.

\(^{258}\) For example: a 2005 survey (Cordless Phones China Sourcing Report 2005 (Global Sources)) found that more than 40% of DECT phone manufacturers in Hong Kong were operating at less than 50% capacity.
were only granted after some resistance of BT e.g. Email from PP (BT, Commercial Analyst) to YY and others (BT) 18 August 2004

“we have been told that the competition is lowering their pricing (and this is an A Brand, not a B Brand) and we will be uncompetitive in the high street if we don’t act. We are aiming to keep up some prices so we can promote and have done so where we can. Our focus in the high street is to grow value through colour screen and bundles”

644. BT Email from HH (BT, Line of Business Leader) to PP (BT, Commercial Analyst)

“Binatone already have the DECT E3300 on offer in Safeways for £14.98 with the title banner “One third off”, so will more than likely be there again between now and x-mas. Whilst I don’t advocate attacking the market at such a low price point I do believe we should support the Studio 100 RRP reduction from £34.99 to £24.99 […]”

645. There is also clear evidence that the larger retailers applied pressure on BT to provide them with lower prices to enable them to compete in the retail market: E.g. Email from [XX] (Argos, Trading Division) to MM (BT, Commercial Analyst) 3 August 2004

“As per our conversation, please find the following lines that we require funding on to go up against [retailer]. We will need the funding for the full two weeks of the promotion, As you will appreciate, we cannot be compromised on pricing and need to react…..

If [retailer] are being funded, we need at least the same support too. This issue needs addressing, and we don’t see that as as we are BT’s [XX] customer we should be exposed to this threat without your support”

646. On occasion BT refused approaches from retailers to lower prices and chose not to sell phones at unacceptably low margins. E.g. Email from HH (BT, Line of Business Leader) to AA (BT, COO) 18 February 2004

“RESPONSE TO [retailer] On this occasion I suggest that we decline to revise our quoted prices, and advise that we were unable to find suitable products prices to meet the requirements”

647. Similarly in another example, an email from AC to DD, 27 June 2005, in relation to pricing of Studio 1100:

“let’s keep the price up … more margin for us and we seem to be doing tooo [sic] many promotions and losing tooo [sic] much margin”.

648. There appears to be evidence to demonstrate that BT sought to discontinue the promotion of products that produce poor margins. E.g., email: from HH to DD, 11 July 2005

“I would like to make some counter proposals for the Shareholder mailing as follows: Delete all the BT Freestyle 2200 and 2500 products – we really do not need to promote these products any more than necessary, especially as this range provides poor margins. …”

259 Ref PP946 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
260 Ref 2AE1 BT response to Ofcom 3rd s26 Notice of 4 August, 2005
261 Ref 2AE6 BT response to Ofcom 3rd s26 Notice of 4 August 2005
262 Ref PP1045 BT response to Ofcom 3rd s26 Notice of 4 August 2005
263 Ref PP228 BT response to Ofcom 3rd s26 Notice of 4 August 2005
When faced with slow moving stock, BT took considerable efforts to maximise revenues from the sale of that stock. For example see the correspondence relating to the Lyric 1100 model set out in paragraph 574 onwards.

BT has in place a process which requires price reductions to be financially assessed and justified on commercial grounds. All changes to pricing require the submission of a business case for approval. The level of approval required ranges from that of the Line of Business Leader and a commercial analyst (for expenditure of less than £\(x\)) to the Commercial and Financial Controllers of BT Retail for expenditure of more than £\(y\). 

Email from PP(BT, Commercial Analyst) to AA(BT, COO) and others 7 June 2004

“When I went to FAC with the summer sale case, there was a few products in their with margin around \(z\)%, but it was agreed that as long as the whole case showed margin above what we aim at, then this would go through. However there is a much stronger emphasis on EBIT now”

The Commercial Business Case for Christmas Sale 2004 showed that Christmas sale prices were expected to generate net revenue of £\(w\) and GM of £\(v\)\(\%\) margin return at a cost against margin of £\(u\)M. The commercial justification was that, if BT did not support the promotions, it would suffer reduced exposure in promotional material/shelf space. Yet despite keen price competition from competitors, BT’s concern was to price products competitively while still maintaining a price premium over ‘B’ brands. In a background paper to the Christmas 2004 sale, BT stated:

“Retailers are taking lower entry level pricing. [supplier] are driving down prices. Rumour is that [supplier] will also have a £49.99 Colour screen at Christmas. BT will aim to maintain a £5 - £15 premium above the lowest entry level pricing, this equates to a 20% price difference.”

There also appears to be evidence that demonstrates that phone models can easily be produced or marketed in different countries. E.g. PP186: Email from DD dated 11 July 2005:

“On the Studio 100 and twin I’d really like to offer to \(\times\) for the Africa/Middle East opportunity rather than put in the High Street, these are currently category C so not in the full excess list yet but should be, I think they would just cause too much of a bulk in the retail environment at one time.”

There is also evidence that BT considered maximising the benefit of selling surplus stock through requiring retailers purchasing the lower priced products to purchase other higher priced stock (see for example email from PP(BT, Commercial Analyst) to MM(BT, Commercial Analyst) and others 22 March 2004:

“We offer the Freestyle 2100 at £24.99, but limit stock to a tie in with a bundled offering ie if they want \(\times\) of the Freestyle 2100’s then they have to take an additional \(\times\) of a bundled, or a mix of bundle offerings”

Ref PP846 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3 
Ref BT response to Ofcom 1st s26 Notice, Vol 3
“Competitive Landscape – Forecast” document attached to email from PP(BT) to AA et al dated 7 June 2004. In Vol 10 3211 of BT’s response to Ofcom’s S26 Notice of 14 July 2005
Ref PP186 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
Ref PP808 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
654. Thus BT considered restricting the supply of aggressively priced (and therefore attractive to the retailers) Freestyle 2100 stock to those retailers also purchasing more profitable bundled packs (e.g. 3 or 4 phones in one pack for consumers to place around the home). For example, email from AD to JB ([retailer]) on 22 September 2004\textsuperscript{269}, Regarding sale to [retailer] of a total of \textdollar\textsuperscript{[sic]} \textdollar \textx\ Freestyle 2100 units:

\textit{"I am prepared to offer [retailer] \textdollar\textsuperscript{[sic]} \textdollar \textx\ per unit on the additional \textx\ pieces which take this deal well below our cost price. In recognition of this and that we are supporting the clearance of the \textx\ twin and trio and the \textx\ single and Twin we would want [retailer] to take in the \textx\ single and twin and the \textx\ single and twin for peak volume requirement to be discussed."}

655. Whilst some of the wording in relation to the pricing of Freestyle 2100 indicates an aggressive approach by BT (there are references to “we should be pushing the market from an aggressive bundle perspective” and “we must be aggressive on our bundle pack to really hit the competition where it hurts as that is where they are growing the market”\textsuperscript{270}), BT’s prime stated aim was to drive higher value sales and its approach evaluated the overall effect of the summer sales offer on BT’s margins. Further, this series of emails indicated that BT’s competitors were also focussing on the pricing of bundled retail sets: “The major growth is around bundles and our entry level competitors have been focusing on this area, not around the entry level price point. This is obvious in the Argos catalogue with Binatone not going below £24.99”\textsuperscript{271}: “All activity is around bundles at the moment with half price offers round twin’s, trio’s and quads. I would say that we would be better driving a half price message around this section. For example NTL have a £69.99 quad in comet”\textsuperscript{272} Thus BT appears to have strategically considered that its profits could be maximised by increasing sales of high margin bundles in a very competitive market by tying them to the limited supply of an attractively priced discounted models which was about to be withdrawn and replaced (the Freestyle 2100 was withdrawn in November 2004).

656. This is also evidenced in the Pricing Business Case for Summer Sale 2004 (Version 1, April 2004)\textsuperscript{273}:

\textit{"This sale period will focus around strong, aggressive bundle price reductions to create maximum impact in a period which is flooded with offers from competitors. BT is committed to being the No.1 telephone brand in the UK market and in order to continue to prove ourselves as a market leader we must be aggressive and focused in our sale activity and support with our value propositions. ... By promoting the Freestyle 2100 at £24.99 as the headline price and encouraging accounts to limit stock for this entry level, we can shift focus for promotion around the bundle propositions. Which means we are in a position where we can lead with a headline price and then execute the bundle lever to up sell consumers to the higher value propositions. Retailers have been asking for value offered propositions to push up ARPU and this proposal has been enthusiastically supported by them as a means to delivering [sic] this aim."}

\textsuperscript{269} Ref PR822-823 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
\textsuperscript{270} Ref PP760 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
\textsuperscript{271} Ref PY773 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
\textsuperscript{272} Ref PY773 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
\textsuperscript{273} Ref CG1297-1301 BT response to Ofcom 3rd s26 Notice of 14 July 2005 Vol 3
657. From an overall reading of the documents against the background of its detailed examination of the pricing levels adopted by BT, Ofcom does not consider that there is evidence of a predatory strategy or of an intention to exclude Binatone or any other competitor through targeting low-end models. In particular, Ofcom notes that during the period in which BT was attempting to aggressively sell the Freestyle 2100 it did so at a time when it had a large quantity in stock (nearly 83,000 in July 2004) and when the product was about to be replaced by a newer version - the Freestyle 2200 was introduced in the summer of 2004. Thus BT had a reasonable commercial rationale of rapidly disposing of its stock of the older model, and it attempted to do so in a manner which maximised overall margins. Further, during the relevant period, BT’s pricing of Freestyle 2100 phones covered the relevant variable costs, although had it not done so, Ofcom recognises that there are arguments (as discussed in paragraph 576) that on the basis the stock was already purchased and the model was being withdrawn a different (and lower) cost base could be more appropriate.

658. Further, from the documents reviewed, the evidence does not suggest that BT deliberately purchased high volumes of stock which it could not have expected to sell other than at a loss making price. As of December 2004, BT held a stock holding of 3.9 months of sales\textsuperscript{274} which in Ofcom’s view is not excessive.

659. BT actively considered stopping supplying retailers where excessive demands for reductions were made e.g. Email from LL(BT, Commercial Analyst) to ZZ(BT)\textsuperscript{275} 21 April 2005:

“… The \[retailer\] account had a dramatic decline in 04/05 (down from £\[\times\]m in 03/04 to \[\times\]m) I would cancel the account and spend time on a more profitable area…..Overall would appreciate your view as to why we shouldn’t de-list them”

660. There is evidence that BT was not willing to price reductions that did not generate positive contribution to fixed costs: e.g. email from LL(BT, Commercial Analyst) to MM(BT, Commercial Analyst) 4 December 2003:

“\[\times\]”

661. There is also consistent evidence that other suppliers were acting aggressively in the market to drive purchase prices down and forcing BT to react: e.g., as previously noted, Argos presented BT with a detailed analysis of the profitability of their sales to Argos and negotiated a £\[\times\] retrospective payment towards marketing costs\textsuperscript{276} based on a detailed review by Argos of BT’s operating costs and profitability. A number of further examples are also detailed in the section on Retailer customer and end-consumer constraints on BT’s pricing behaviour above.

\textsuperscript{274} Stock turnover report ref DC810 BT response to Ofcom 3\textsuperscript{rd} s26 Notice of 14 July 2005 Vol 24
\textsuperscript{275} Ref DC972 BT response to Ofcom 3\textsuperscript{rd} s26 Notice of 14 July 2005 Vol 24
\textsuperscript{276} Ref DT1 BT response to Ofcom 3\textsuperscript{rd} s26 Notice of 14 July 2005 Vol 24
\textsuperscript{277} June 2004 Argos presentation to BT (provided in email from BR(BT) to Hugh Kelly (Ofcom) dated 6 September 2005) and email from DD to BB dated 6 June 2005 ref DC937 BT response to Ofcom 3\textsuperscript{rd} s26 Notice of 14 July 2005 Vol 24
662. In summary, Ofcom has reviewed the internal BT material and has not found any significant evidence which would support a finding of an overall intent to predate by BT. Rather the documentary evidence supports Ofcom’s conclusion that BT does not have market power and that its reductions in price were in response to pressure from strong retailers in a competitive market. Further, any decisions by BT to cut prices and launch offers faced considerable internal review within BT seeking to maintain profitability as far as possible and ensuring that prices covered average variable costs in all cases and FAC overall. This is also consistent with all the evidence in this case as set out above.
Section 4

Conclusion

Following the analysis set out above, Ofcom has concluded that BT has not infringed the Chapter II prohibition or Article 82 in relation to its pricing of cordless telephones from the period from April 2004 to March 2005. Ofcom has concluded that BT is not dominant in the relevant market for fixed lined telephones in the UK due to a number of factors, in particular low barriers to entry and demand side constraints. Furthermore, from a detailed examination of BT’s prices and costs Ofcom has concluded that, even if BT had been found to be dominant, its pricing behaviour would not have constituted predatory pricing. Therefore Ofcom has decided to dismiss the complaint.

Signed

David Stewart
Director of Investigations
1 August 2006
Appendix

Information requested under S26 of the Competition Act 1998

8 June to BT:

1. Monthly management accounts for the relevant business unit that procures and sells cordless phones for the financial year to 31 March 2005. Where available accounts should be provided in excel format. Where available written reports, commentaries, or other analyses should also be provided. If appropriate provide copies of other regular management accounts or other management reports relating to cordless phones for the financial year to 31 March 2005.

2. A schedule showing the full range of BT phones for the following periods: (i) from 1 January 2004 to 31 December 2004; and, (ii) from 1 January 2005 to 31 March 2005. The schedule should show:
   - the wholesale selling price
   - recommended retail price (‘RRP’)
   - ex-factory price
   - total cost of sale
   - gross margin
   - date model was introduced
   - total volumes sold
   - whether model is current, being phased out or obsolete

3. A schedule of your cordless phone equipment suppliers (including if appropriate suppliers of electronic circuitry and the external housing for DECT cordless phone handsets) showing the key products supplied and BT’s total spend with each supplier for the year ending 31 March 2005 months and major phone types sold. Total spend should be reconciled to cost lines in the management accounts provided in 1. above.

4. A schedule listing your cordless phone customers showing the total revenues from each customer (including if appropriate a total for direct sales to the public). Sales to other BT business units should be included and identified as such. Total revenues should be reconciled to revenues in the management accounts provided in 1. above.

5. For the relevant business unit that sells cordless phones, copies of all:
   - strategy documents produced by the business including marketing strategy, procurement strategy since 1 April 2004
   - business plans produced since 1 April 2004
6. Copies of all market research and competitor analyses prepared by or for BT since March 2004 for the relevant business unit that sells cordless phones.

7. Copies of all BT’s internal pricing papers produced since 1 April 2004 relating to cordless phones. To the extent that pricing papers for the models listed in 13. below were prepared prior to March 2004, also provide copies of those papers. Include all relevant documents referred to in the pricing papers, in particular, excel spreadsheets for budgets and business plans.

8. Copies of any BT Retail and BT Group board papers or other decision making bodies within BT referring to the business unit that sells cordless phones since 1 April 2004

9. Copies of the relevant supply contracts for each of the phones listed in 13. below relevant to sales in the year ending 31 March 2005

10. Copies of the current sales contracts with the top 5 customers covering the phones listed in 13. below above relevant to year ending 31 March 2005

11. Contact details of the responsible person at each of your 10 largest customers whom we may contact to discuss the market, terms and conditions of sale and other issues relevant to this investigation

12. For the most recent period available, a reconciliation between BT’s regulatory accounts and its management accounts for the relevant business unit that produces and sells cordless phones as provided in 1. above.

13. A historic product profitability analysis for the cordless telephone models Free Style 2100, BT XC 100, BT Lyric 1100, BT Synergy 700 Twin with answering machine, BT Studio 1100, and for BT’s top 5 best-selling cordless phone products (in addition to the listed models – ie 10 analyses to be provided in total) on a unit basis for year ending 31 March 2005. This should show the following on a per unit and total basis (the analysis shown is illustrative – provide to a similar level of detail using BT’s terminology and cost classification). For the purposes of this question, the top 5 selling models are to be identified on the basis of volume rather than value.

Gross revenues
  o Discounts
  o Returns

Net Revenue
Cost of Sales
  o Ex factory cost
  o Transport, insurance
o Other product costs
  o Product development costs
  o Product testing costs
  o Cost of Return to Manufacturers from retailers of unsold phones as distinct from returns under guarantee.
  o Returns under guarantee: The cost of refurbishment and revenue of sales of second hand phones.
  o Cost of promotional and other types of support to retailers/sellers of BT phones.

Gross Margin
  o Sales and General Admin Costs
  o Advertising and Promotion
  o Salaries
  o Office costs
  o Accommodation
  o Allocated overheads
  o General admin

Profit before finance costs
  o Finance Costs
  o Stock write downs
  o Other
    o Exchange loss/profit

Profit before tax

14. To the extent that any of the cost headings included in the profitability analysis above are not included in the management accounts please provide full details of the actual costs incurred for each of the months covered in the management accounts for the relevant products.

15. For each of the phones for which a profitability analysis in 13. above is prepared:
  o a full history of the sale price of the phone from 1 April 2004 – March 2005
  o a schedule of monthly sales, purchases, returns, goods-in-transit and stock in hand of the phone

Price details and volumes in this analysis should be reconciled to the total sales in the profitability analysis provided in 13. above.

**Queries on s26 response to above questions – 20 June 2005**

1) Provide Annex 1.1 disaggregating it into the product ranges disclosed in your response and indicating which product ranges would be captured within the regulatory product code P393. Provide a copy of the response in an electronic format.

2) Annex 2.2: explain how the gross margin is obtained and what costs are included in under the headings used.
3) Reconcile the schedules supplied in Annex 3 to Cost of Sales figure for the relevant product range on your revised Annex 1.1 (Q1 above).

4) Re-supply Annex 4 in an electronic format together with a reconciliation to the Revenue figure for the relevant product range in revised Annex 1.1 (Q1 above).

5) Regulatory to management accounts reconciliation: provide a reconciliation of (irrespective of audit status) to March 2005. The reconciliation should reconcile to EBITDA and separately list and quantify each type of additional costs included in the regulatory accounts but not in management accounts.

6) Re-supply the schedules provided in connection with your answer to Q13 in electronic format with a summary schedule aggregating the product lines which should be reconciled to the relevant product range in revised Annex 1.1 (Q1 above).

**Additional information required**

7) For the year to March 2005 provide in electronic format a breakdown of product code P393 broken down as far as F8/OUC level of detail. The totals should be agreed to those provided in the revised response to question 12 (regulatory accounts reconciliation).

**On 28 June to BT**

16. A historic product profitability analysis for the cordless telephone models Free Style 2100, BT XC 100, BT Lyric 1100, BT Synergy 700 Twin with answering machine, BT Studio 1100, and for BT’s top 5 best-selling cordless phone products (in addition to the listed models – ie 10 analyses to be provided in total) on a unit basis for the year ending 31 March 2004. This should show the following on a per unit and total basis (the analysis shown is illustrative – provide to a similar level of detail using BT’s terminology and cost classification). For the purposes of this question, the top 5 selling models are to be identified on the basis of volume rather than value. Please provide your answer in an electronic spreadsheet.

Gross revenues
- Discounts
- Returns

Net Revenue

Cost of Sales
- Ex factory costs
- Transport, insurance
- Other product costs
- Product development costs
- Product testing costs
o Cost of Return to Manufacturers from retailers of unsold phones as distinct from returns under guarantee.
o Returns under guarantee: The cost of refurbishment and revenue of sales of second hand phones.
o Cost of promotional and other types of support to retailers/sellers of BT phones.

Gross Margin
o Sales and General Admin Costs
o Advertising and Promotion
o Salaries
o Office costs
o Accommodation
o Allocated overheads
o General admin

Profit before finance costs
o Finance Costs
o Stock write downs
o Other
o Exchange loss/profit

Profit before tax

17. To the extent that any of the cost headings included in the profitability analysis above are not included in the management accounts provide full details of the actual costs incurred for each of the months covered in the management accounts for the relevant products.

18. For each of the phones for which a profitability analysis in 1. above is prepared:

  o a full history of the sale price of the phone from 1 April 2003 – March 2004
  o a schedule of monthly sales, purchases, returns, goods-in-transit and stock in hand of the phone.

  Price details and volumes in this analysis should be reconciled to the total sales in the profitability analysis provided in 1. above.

19. In an electronic excel spreadsheet, a breakdown of the total revenues and costs for product code P393 (cordless phones) for 2003/4 and 2004/5 to F8 code level of detail including F8 code titles and amounts. The totals for 2004/5 should be reconciled to the amounts in the management accounts – regulatory accounts reconciliation which is being provided in response to our s26 notice of 8 June 2005.

On 14 July to BT

1. Provide any and all documents from 1 April 2003 to date relating to BT’s strategy (including research in preparing and developing that strategy), BT’s decision making and BT’s approval of proposals for pricing and purchasing of DECT telephones. BT’s response should include, but not be restricted to:
• notes of internal and external meetings at which pricing and purchasing of DECT telephones were discussed;
• copies of any internal and/or external letters, faxes, e-mail correspondence and memos discussing the pricing and purchasing of DECT telephones;
• copies of any and all prepared business cases setting out the rationale for the pricing and purchasing of DECT telephones;
• copies of any and all underlying data analysis used to calculate the price of DECT Telephones, together with workings and/or explanations of how the data analysis was used to calculate the prices for DECT telephones;
• copies of any and all documents carrying out an analysis of BT’s position vis-à-vis its competitors in the provision DECT telephones, including analysis of competitors’ pricing and BT sales strategies;
• copies of any and all documents carrying out any other analysis of BT’s competitors in the provision DECT telephones, including analysis of competitors’ pricing;
• copies of any compliance review/assessment made by BT in respect of the pricing and purchasing of DECT telephones;
• copies of internal e-mails and project team meeting minutes and notes relating to DECT Telephones

2. Number all documents supplied in response to this Notice and provide an accompanying index listing each document including the title, date, author and brief description of the content. Please also identify the authors of the correspondence and their role at BT.
Annex B to Notice of 14 July under section 26 of the Competition Act 1998

<table>
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<tr>
<th>Position</th>
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<td>COO</td>
<td>AA, KK</td>
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<td>Head of Marketing</td>
<td>CC, VV</td>
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<td>Head of Sales</td>
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<td>Head of Operations</td>
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<td>Head of Voice Products</td>
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<td>Head of Business Services</td>
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<td>DECT Product Manager</td>
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<tr>
<td>Others</td>
<td>AA, AB, XX, LL, OO, PP, QQ, NN, MM</td>
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</table>

On 12 August to BT

1. In respect of the analysis provided in response to question 2 of the first Notice (response in annex 2.2):
   a. Confirm that the Gross Margin calculated in annex 2.2 does not include the following costs which are included in the gross margin calculation set out in BT’s response to question 13 of the first Notice:
      - Sales Credits
      - Warranty Returns
      - Cost Credits
      - ADP - User Guide & Packaging
      - Alloy - Product Design
      - Marketing A&P
      - Exchange loss/profit (PPV)
      - Other

      If any of these costs are included in the analysis set out in annex 2.2 please provide details of which costs are included and reconciliation between the two gross margin calculations.

   b. Provide in electronic excel spreadsheet format a copy of the analysis provided in response to question 2 (response in annex 2.2) for each month in 2002/3, 2003/4 and 2004/5
c. Provide an explanation of why the volumes, revenues and costs in the analysis in annex 2.2 differ from those provided in response to question 13 of the first Notice. For example, in BT’s answer to question 13, the volumes for [X] in December 2004 equal [Y], whereas in BT’s answer to question 2 (in annex 2.2) the volumes for [Z] in December 2004 equal [W]; similarly, from question 13, SPP (inc freight) equals [M] or [N], whereas from question 2 this number equals [O].

2. To what does the “SPECIALS” sheet in your response to question 3 of the first Notice (response in Annex 3) refer?

3. Further to BT’s response to question 5, provide in electronic excel spreadsheet format, copies of annual budgets for 2002/3, 2003/4, 2004/5 and 2005/6 for the Cordless DECT product range and for the Core (Traditional) business as a whole. All supporting spreadsheets should also be provided together with any accompanying descriptions or management summaries.

4. Explain whether there are any sales included in the analysis provided in response to question 2 of the first Notice (response in annex 2.1) which are not included in the GFK data provided in response to question 13 of the first Notice – whilst the two are not directly comparable in terms of time periods, the GFK data appears to contain lower volumes suggesting that not all sales are included.

5. In respect of the analysis provided in response to question 15 of the first Notice provide the same monthly analysis for 2002/3 and 2003/4 in electronic excel spreadsheet format.

6. Provide an explanation of working capital requirements of the DECT business. In particular, the average payment terms:
   a. To manufacturer
   b. From retailers
   c. From other significant customers

   Provide a calculation indicating the working capital requirements of the DECT phone business (using 2004/5 as an example), and to the extent that these are negative (ie net current assets are positive) explain how these are funded and if any corresponding cost of working capital is allocated to the business in either the management accounts or regulatory accounts.

In respect of the analysis provided in response to Q13 of the first Notice

7. Provide an explanation of how foreign currency transactions are accounted for, including:
   a. When and how BT purchases foreign currency
   b. At what exchange rate is the cost of sales of phones sold in a month recorded?
   c. What does the foreign currency cost in the profit and loss account represent

8. What costs are included in marketing A&P? How are these calculated? How are these allocated?

9. How is R&D calculated, allocated and accounted for?
10. Describe the process for purchasing additional phones from manufacturers including how the purchase is authorised

Queries related to BTs response of 1 July to Ofcom’s follow-on questions to BTs 26 June s26 responses

11. The spreadsheet “regulatory recon_electronic.xls”, sheet “0405 Reconciliation” provides a reconciliation between management accounts and regulatory accounts for 2004/5 showing revenues and costs broken down by sector (lines 31 to 87). Provide a similar reconciliation (in electronic excel format) for 2003/4.

12. The spreadsheet “regulatory recon_electronic.xls” contains detailed breakdown of all relevant F8 and OUC codes (sheets “0405 Revenues”, “0405 Costs”, “0304 Revenues”, “0304 Costs”) for 2003/4 and 2004/5 for the product “P393 Cordless Telephones”. Provide a revised spreadsheet which also includes the relevant sector classification for each OUC/F8 combination in similar worksheets for costs and revenues for 2003/4 and 2004/5.

13. In the “04/05” worksheet in spreadsheet “regulatory recon_electronic.xls” there is a listing for:

M [×] [×] [×]

Provide an explanation of what the F8 code / OUC classification represents and what activities/transactions are posted to this account (Ofcom could not find a reference to this F8 code in the 2004/5 DAM).

Other queries

Own retail channels.

14. How does BT account for sales of DECT phones through its own retail channels? Provide the following data (headings as taken from BT’s response to question 13 of first Notice) for each of 2002/3, 2003/4, 2004/5 in respect of total DECT phones sold through BT’s own retail sales channels (for example, BT web sales through http://www.shop.bt.com/icat/phones):

- Gross Revenue (post discount)
  - Sales Credits
  - Warranty Returns
- Net Revenue
- COS
  - Product Cost (SPP)
  - Cost Credits
  - Freight
  - ADP - User Guide & Packaging
  - Alloy - Product Design
  - Marketing A&P
  - Supply Chain (MHC)
  - Exchange loss/profit (PPV)
  - Other
- Total COS
- Gross Margin (Gross Revenue)
15. In respect of the reconciliation between regulatory and management accounts provided in spreadsheet “regulatory recon_electronic.xls” explain:
   a. What sales cell G38 “Cordless: Internal” refers to
   b. Why there are no SG&A costs allocated to “Cordless: Internal” sales
   c. Reconcile the revenues (£[×]m) and costs (£[×]m) included in “Cordless: Internal” to revenues and costs for internal sales in the management accounts shown in your response to question 21 below.

16. The spreadsheet “customer revenues recon_electronic.xls” refers to revenues from “TMX TRADING LTD (BT People)” Explain what this refers to.

17. **Product returns**
   a. Provide an explanation of the accounting treatment for returns – for example, adjustment to revenues, cost of sales, repairs, returns to manufacturers, sales of damaged stock.
   b. Provide for each of 2002/3, 2003/4, 2004/5, the total number of returns, total cost of sales relating to returns broken down by cost category and total revenues arising from sale of any returned goods.

18. **Analogue phones** – Provide details of the total revenue and related volume of cordless analogue phones sold (in 2003/4 and 2004/5) which are included in the regulatory accounts product group P393 “Cordless Telephones” (and provide details of the relevant F8/OUC codes).

19. **Cordless phones – rentals** – Provide the total revenue and relevant volume from the rental of cordless phones included in the regulatory accounts product group P393 “Cordless Telephones” (and provide details of the relevant F8/OUC codes).

20. **Wholesale Price reductions** - BT understands from discussions with Argos, that sales during the period covered by a particular contract are made at the price stated in the contract, and subsequent reductions in retail prices agreed to by BT are then reflected in a reduced wholesale price effected by means of a credit adjustment to the original invoice amount (priced as per the contract). Indicate whether Ofcom’s understanding is correct and provide a description of the relevant accounting entries. In particular indicate in both BT’s management accounts and regulatory accounts the relevant accounting codes used to reflect the transaction. Also provide a calculation showing the total value of any sales credits in 2004/5 to (a) Argos and (b) other retailers for which such an adjustment was made.

**Management accounts breakdown**

21. The spreadsheet “Monthly Traditional 0405_v2_electronic.xls” provides a detailed breakdown of “ledgered” (ie external) sales by product type (lines 53 to 167). Provide a similar breakdown for internal sales (“The Intra P&L represents all internal BT sales”).

22. The spreadsheet “Q13_Product Analysis recon_electronic.xls” provided by BT by email on 1 July in worksheet “Overall Summary” provides a monthly analysis of management accounts for a sample of products. Provide a similar monthly breakdown for the total Cordless DECT product range for 2004/5 and 2003/4.
On 25 August to BT

1. Attached is an Excel spreadsheet ‘S26 request template.xls’ with monthly data on retail volumes and sales revenues for BT consumer phone groups from January 2002 to May 2005 (Source: GfK)

2. Ofcom wishes to confirm whether the data (sourced from GfK) on retail sales represents a fair and accurate estimate of BT’s volumes and sales revenue from which Ofcom can determine BT’s share of the consumer phone market.

3. Please confirm whether the data represents a fair and accurate estimate of all sales by BT in the market within each relevant product group tabled.

4. For the avoidance of doubt, please separately identify (as a separate line entry in the space provided) volumes and sales revenue for each product group directly to retail customers (e.g. through BT Direct).

5. Your response should reconcile or explain any discrepancies between the retail figures (sourced from GfK) and wholesale figures submitted by yourself.

6. This includes stating clearly whether all volumes and sales revenues are inclusive/ exclusive of warranty returns. If possible, please separate these out.

7. Total sales should equal the sum of rows 6 and 7 in table 1a and 2a and rows 20 and 21 in tables 1b and 2b. Where the total sales volume or revenue differs from the sum by more than 1 per cent, please highlight within the spreadsheet and provide reconciliation or explanation for the difference.

8. Ofcom wishes to confirm with BT whether changes in shares over time reflect an underlying change in market share or whether they reflect a change in the product/price mix within a phone group. Could BT identify whether it has maintained or changed the pricing points at which BT sells products. For instance, does BT maintain the same proportion of phone models at entry level prices, mid level and high price segments of the market across the period.

4 January to BT

1. Please provide details of consumer telephone promotional and marketing literature included in quarterly fixed line telephony customer bills for the period from January 2004 to December 2005. On what basis are costs of mailing this material to BT fixed line customers allocated to BT’s consumer telephone business?
Please provide the relevant Sector/OUC/F8 Code account references for the costs of this material

2. Please provide the total revenue and relevant volume from the rental of corded telephones in 2004/2005. (Note we already have this data for cordless phones but for completeness we ask for the data on corded phones).

3. Does BT have any evidence to support the statement that “While differences between brands still exist with respect to factors such as design, the harmonisation provided by the DECT standard ensures that consumers will base their purchasing decisions primarily on a phone’s perceived value for money.” (RBB Economics paper entitled BT’s position in the supply of fixed line telephone equipment).

4. Please provide data on BT’s share of sales for facsimile machines to resellers for the period January 2004-June 2005. Preferably, the data should be monthly, however, where monthly data is not available, annual data would be acceptable.

Information requested informally from BT

Action points following meeting with BT 7 September 2005

1. BT’s views on the relevant geographic market
2. Innovations and how designs and features of phones changed in the past
3. % changes in BT’s RRPs and corresponding % changes in BT’s ‘sale’ wholesale prices
4. Explanation of differences in margins by retailer and information on relative power between retailers
5. Expand Table 3 – ‘hero’ placements in Argos to include more examples/data
6. Figure 8 – evolution of DECT prices excluding BT in total market and a graph showing the evolution of entry level DECT prices only and excluding BT prices in total market

8 September by email from Hugh Kelly to BT

1. BT’s monthly management accounts (eg as provided in response to q22 of BTs response to Ofcom's 4th s26 Notice of 12 august 2005) contain the following cost categories.
   · “Alloy - Product Design”
   · SG&A cost category “Other”
   · Supply Chain (MHC)
   · “Business Expenses”
   · “Accommodation”
Provide an explanation of what costs/activities each of these categories includes and provide a list of the corresponding Sector/F8/OUC accounting codes in the regulatory accounts.

2. The Management accounts include a cost category "[X]". Provide a description of how these costs are incurred, and in particular the extent that costs are fixed or variable in relation to volumes sold.

3. BT’s response to Q21 of Ofcom's s26 Notice of 12 August provides a breakdown of Intra P&L sales.
   a. Provide an explanation of what sales are included in these categories.
   b. The gross margin shown for these sales is [X] than for the [X] sales ("The [X][X]"). Provide an explanation of why this is the case including a list of any costs that are included in the [X] cost of sales but not in the Intra cost of sales.

9 September by email from Hugh Kelly to BT

BT's regulatory accounts for the product group Cordless Phones (P393), indicate a [X] capital employed for 2002/3 and 2003/4 (I don't have 2004/5 capital employed numbers)

Do you have a similar statement for 2005? Also the amounts for stock and debtors look very different to those provided in your response to Q6 of our s26 of 12 August:

| Stock £M    | [X] |
| Debitors £M | [X] |
| Creditors £M | [X] |
| Total £M   | [X] |

15 September by email from Hugh Kelly to BT

1. The detailed sector/F8 breakdown for 2004/5 includes £[X] for F8 code 209124 – see below:

   [X] [X] [X] [X]

   Provide an explanation of what is represented by these costs and in particular whether or not they are also included in the management accounts for DECT phones.

2. Provide a copy of the regulatory accounts and management accounts for product P395 2004/5 Answering Machines in the same format as that provided in BT’s response to Q11 of Ofcom's 4th s26 Notice of 12 August.

3. Provide a copy of BTs annual management accounts for 2003/4 and 2004/5 to gross margin level for answering machines using the same headings as provided in BTs response to Q22 of Ofcom's 4th s26 Notice of 12 August

4. Provide an explanation as to why the amount for stocks/stores of DECT cordless phones provided in BT’s response to Q6 of Ofcom's 4th s26 Notice of 12 August
Competition Act 1998 - Complaint against BT relating to pricing of digital cordless phones

(£[×] as at 31 March 2005), is so different to that shown in BT’s regulatory accounts for Product P393 Cordless telephones (Sector G1 Trading Stocks: £[×]as at 31 March 2005) (as provided in LL’s email to Hugh Kelly of 13 September)
Perhaps you could give me a call to discuss the context and background to these queries and let me know how long you will need to respond

28 September by email from Chris Bowley to BT

I am interested in obtaining information on the sample size and methodology for a Drummond Madell 2004 U&A customer survey that BT provided Ofcom on 8 July 2005, Volume 2, Annex 6 in response to the first Ofcom s.26 (question number 6):

“Copies of all market research and competitor analyses prepared by or for BT since March 2004 for the relevant business unit that sells cordless phones”

5 October by email from BT to Tanya Rofani

ECD

When we spoke today, you asked if we could estimate the proportion of BT phones sold by ECD, since you had found it difficult to get hold of anyone at ECD able to give you this information. Alternatively, you asked for assistance in contacting ECD.

12 January by email from Chris Bowley to BT

Could BT please provide the following market share data in Excel or Excel compatible format:
1. BT market share in DECT
2. BT market share for “all consumer phones”
3. Competitor market shares in DECT
4. Competitor market shares for “all consumer phones”
5. BT Direct sales

Please provide volume and value market share measures in your response to 1-5 above.

Please provide data for each month during the period June 2005 – December 2005 (inclusive). If this is not possible, please contact me so that we can discuss an alternative reporting period.

Please provide details where there are any changes to estimation methodology compared to previous submissions to Ofcom.

25 January by email from Chris Bowley to BT

In BT’s submission of 8 June 2005, Volume 2, BT provided information on the relative shares (both value and volume measures) of the following segments within the consumer phone market:

Answer machine
Single handsets
Cordless analogue
DECT
Corded with AM
Décor
2-piece
1-piece

Question to BT

Ofcom now requests BT provide the same breakdown of shares by segment, for part or all of the 2005 calendar year by Friday, 27 January 2005.

3 February by email from Chris Bowley to BT

I was hoping to obtain some additional information from BT arising out of BT’s Response to Ofcom’s 6th Section 26 Notice dated 4 January 2006 (email to Ofcom from yourself on 5 January).

In that email response to question 2 of Ofcom’s information request, BT identifies the number of installed residential corded rental phones for 2004/05.

Question

Could BT please provide the number of residential corded rental phones that were replaced during that period? If the information is available, could BT identify the breakdown of reasons for replacement of rental phones?

OTHER PARTIES

Information requested under S26 of the Competition Act 1998

On 18 August to Panasonic

2. Attached is an Excel spreadsheet ‘S26 request template - Panasonic.xls’ with monthly data on retail volumes and sales revenues for Panasonic phone groups from January 2002 to May 2005 (Source: GfK)

3. Ofcom wishes to confirm whether the data (sourced from GfK) on retail sales represents a fair and accurate estimate of Panasonic’s volumes and sales revenue from which Ofcom can determine Panasonic’s share of the consumer phone market.

4. Please confirm whether the data represents a fair and accurate estimate of all sales of Panasonic telephones in the market within each relevant product group tabled.

5. For the avoidance of doubt, please separately identify (as a separate line entry in the space provided) volumes and sales revenue for each product group sold directly to retail customers (e.g. through a direct channel such as internet sales).
6. Your response should reconcile or explain any discrepancies between the retail figures (sourced from GFK) and wholesale figures submitted by yourself.

7. This includes stating clearly whether all volumes and sales revenues are inclusive/exclusive of warranty returns. If possible, please separate these out.

8. Total sales should equal the sum of rows 6 and 7 in table 1a and 2a and rows 20 and 21 in tables 1b and 2b. Where the total sales volume or revenue differs from the sum by more than 1 per cent, please highlight within the spreadsheet and provide reconciliation or explanation for the difference.

On 25 August to Binatone

1. Attached is an Excel spreadsheet ‘S26 request template - [supplier].xls’ with monthly data on retail volumes and sales revenues for [supplier] phone groups from January 2002 to May 2005 (Source: GfK)

4. Ofcom wishes to confirm whether the data (sourced from GfK) on retail sales represents a fair and accurate estimate of [supplier]'s volumes and sales revenue from which Ofcom can determine [supplier]'s share of the consumer phone market.

5. Please confirm whether the data represents a fair and accurate estimate of all sales of [supplier] telephones in the market within each relevant product group tabled.

6. For the avoidance of doubt, please separately identify (as a separate line entry in the space provided) volumes and sales revenue for each product group sold directly to retail customers (e.g. through a direct channel such as internet sales).

7. Your response should reconcile or explain any discrepancies between the retail figures (sourced from GFK) and wholesale figures submitted by yourself.

8. This includes stating clearly whether all volumes and sales revenues are inclusive/exclusive of warranty returns. If possible, please separate these out.

9. Total sales should equal the sum of rows 6 and 7 in table 1a and 2a and rows 20 and 21 in tables 1b and 2b. Where the total sales volume or revenue differs from the sum by more than 1 per cent, please highlight within the spreadsheet and provide reconciliation or explanation for the difference.

On 25 August to Argos
1. Ofcom wishes to understand how the market for cordless and DECT phones operates and what influences buying decisions of key buyers such as Argos. To help us in this understanding, please provide the following:

- Copies of the presentations and papers supporting the DECT and cordless phones listings in the most recent catalogue.
- Expected volumes, retail price and gross margins for all DECT phones in the most recent catalogue.
- Our understanding is that BT typically reduces the wholesale price of its phones to Argos when there is an agreement that a reduction in the retail price is needed to improve sales volumes. Ofcom wishes to understand the extent to which Argos’ gross margins are affected under those circumstances.
- Please describe the process of discounting in general and how variations in wholesale prices to those set out in the contract are affected.

2. Does Argos consider there to be market segmentation within the DECT product group? Please explain these segments in terms of differences in price and functionality. For instance, are there features of DECT phones that suggest segmentation into different pricing groups (e.g. low price entry phones, mid price ‘step up’ phones and high price phones)? If so what are the features that are typical of phones in these different price categories.

3. Please rank what is important to your customers when deciding which DECT phone to buy? Brand? Price? Features? Aesthetic appeal? Innovative features? Please provide any consumer surveys undertaken by or for Argos which address these issues.


5. Please list your DECT phone suppliers for last five years. Please describe the criteria used for additions or deletions of phone suppliers from this list.

6. Does Argos consider any of its current suppliers to be providing must carry brands? Why or why not?

**On 15 December to Comet, Dixons, Argos, John Lewis:**

1. Provide average net margins for entry level, mid-range and top-of-range cordless phones during the period January 2004 – March 2005 for BT, [supplier] and your two next largest suppliers (by value).

2. Provide details of any instances where net margins for individual products were significantly (i.e. more than 5%) lower than average for
significant (ie more than 10,000) volumes. Provide an explanation of why you accepted a lower margin on these particular models.

3. How important is retailer brand in the market for consumer telephones? In [retailer]'s view, could new entrants with unknown branded phones be able to enter and expand in the market through sales at a well-known retailer?

On 15 December to Onetel, ntl:

1. In which European countries does [supplier] supply cordless phones?

2. How did [supplier] come to have a brand presence in the UK fixed line telephone market?

3. What was the commercial reason for choosing to have a brand presence in UK fixed line telephone market?

4. What were the key risks perceived when considering establishing a brand presence in this market, if any?

5. State the key terms and conditions that underpin the contractual relationship between suppliers in the market and [supplier], including revenue sharing arrangements and payments for franchise fees. Does [supplier] face any price or volume risk in this market?

6. How does [supplier] brand compare to others in the market (i.e. does the brands occupy or some or all price points). Please explain your answer.

7. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

On 15 December to Ericsson:

1. Has Ericsson considered entering the UK consumer telephone market? If so, when and what were the major competitive threats identified at the time. In particular did you consider the price levels at the retail or wholesale supply a risk? Please explain. What were the key reasons for Ericsson entering/not entering the market, including any barriers to entry? Please rank these and assess their significance to you in making your decision.

2. Please provide copies of any documentation that relates to the business considerations to not enter the consumer telephone equipment market in the UK including, but not limited to:
   - Business plans
   - Board papers
• Management papers
• Analyses commissioned by Ericsson (e.g. such as consultants reports)

3. In your view, is a strong consumer brand a pre-requisite for entry into the UK market? Do you see this as a barrier to entry (a) for Ericsson (b) for other companies with no existing consumer or retail brand?

4. In which European countries does Ericsson supply cordless phones?

5. From Ericsson’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   • Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (e.g. design new packaging, instructions).
   • Are the variable costs for producing a phone for the UK market any different to those for other European countries?

6. If known, explain the key differences between the UK market and other European markets which Ericsson. In particular,
   • Can Ericsson identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
   • How different are wholesale and retail prices for cordless phones across Europe?

On 15 December to Sony:

7. Has Sony UK considered entering the UK consumer telephone market? If so, when and what were the major competitive threats identified at the time. In particular did you consider the price levels at the retail or wholesale supply a risk? Please explain. What were the key reasons for Sony entering/not entering the market, including any barriers to entry? Please rank these and assess their significance to you in making your decision.

8. Please provide copies of any documentation that relates to the business considerations to not enter the consumer telephone equipment market in the UK including, but not limited to:
   • Business plans
   • Board papers
   • Management papers
   • Analyses commissioned by Sony UK (e.g. such as consultants reports)

9. In your view, is a strong consumer brand a pre-requisite for entry into the UK market? Do you see this as a barrier to entry (a) for Sony UK (b) for other companies with no existing consumer or retail brand?
10. In which European countries does Sony UK supply cordless phones?

11. From Sony UK’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (e.g., design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries?

12. If known, explain the key differences between the UK market and other European markets which Sony UK. In particular,
   - Can Sony UK identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
   - How different are wholesale and retail prices for cordless phones across Europe?
   - How do other terms and conditions vary?

On 15 December to Panasonic, Harvard

8. In which European countries does [supplier] supply cordless phones?

9. From [supplier]’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (e.g., design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries? If so, how and why?

10. Does [supplier] consider that companies in the UK market, such as retailers or other competitors, are in a particularly strong buying or negotiating position compared to other markets? Can [supplier] describe which companies are particularly strong and also how this negotiating or buying power (if any) is exercised?

11. Explain the key differences between the UK market and other European markets which [supplier] supplies. In particular,
   - Can [supplier] identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
   - How different are wholesale and retail prices for cordless phones across Europe?
   - How do other terms and conditions vary?
• Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range cordless phone models during 2004 for the UK and other major European markets.

12. Please provide prices for a typical (eg best selling) entry level, mid-range and top-of-range cordless phone model for each of the months during July 2004 – March 2005.

13. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or retailers in the UK market (b) other factors. Please provide details in your answers.

14. In [supplier]’s view, was pressure from any one retailer or group of retailers to reduce wholesale prices materially stronger than from others during the period? If so what is the reason for this pressure to reduce prices (eg lower prices from other suppliers (if so which suppliers), to stimulate demand, to meet volume targets)

15. Provide details of monthly gross margins for average entry level, mid-range and top-of-range cordless phone models during the period January 2004 – March 2005.

16. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

17. Do you consider [supplier] has had opportunities in the consumer telephone market to expand and to grow market share from 2004 onward? Please provide a clear explanation of the factors involved.

On 15 December to DBTel, Logicom

1. Do you intend to remain in the consumer telephone equipment market in the UK? If not, when do you plan to exit that market? If you have already exited the market please indicate when. Explain [supplier]’s commercial reasons to exit the consumer telephone equipment market in the UK. Please rank these factors and assess their significance.

2. Explain the impact of the commercial decisions of your competitors, your suppliers, your distributors and your retail customers (e.g. Argos, Comet, Dixons) on your company’s decision to exit the consumer telephone equipment market in the UK. In relation to your retail customers:

  • In [supplier]’s view how important is it for a supplier to have its products retailed by any one particular retailer or group of retailers?
  • Typically how different are wholesale prices between the major retailers?
• How different are the terms and conditions for different retailers?

3. Provide copies of the key documentation relating to the decision to exit the consumer telephone equipment market in the UK including, but not limited to:

- Business plans
- Board papers
- “For Discussion” documents
- Research, undertaken or commissioned by [supplier] (e.g. such as market reports, consumer surveys, or other market analyses)

4. Which suppliers does [supplier] perceive to be its direct competitors in the UK wholesale consumer telephone equipment market? Is this competition across all model phones or only some? Please specify which.

5. Provide prices for typical (e.g. best selling) entry level, mid-range and top-of-range cordless phone models for each of the months during July-December 2004.

6. In [supplier]’s view, was demand from any one retailer or group of retailers to reduce prices materially stronger than from others during the period January 2004 - March 2005?

7. In which European countries does [supplier] supply cordless phones?

8. Does [supplier] consider that retailers in the UK are in a particularly strong buying position compared to other markets? Can [supplier] describe which retailers are particularly strong and also how their buying power (if any) is exercised?

9. From [supplier]’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   • Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (e.g. design new packaging, instructions).
   • Are the variable costs for producing a phone for the UK market any different to those for other European countries?

10. Please provide prices for a typical (e.g. best selling) entry level, mid-range and top-of-range cordless phone model for each of the months during July 2004 –March 2005 (if available).

11. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or

13. Explain the key differences between the UK market and other European markets which [supplier] supplies. In particular,

- Can [supplier] identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
- How different are wholesale and retail prices for cordless phones across Europe?
- How do other terms and conditions vary?
- Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range cordless phone models during 2004 for the UK (if available) and other major European markets.

14. Would [supplier] consider re-entering the wholesale consumer telephone market in the UK? If so, please identify which factors would be important to this decision.

15. In your view, is a strong consumer brand a pre-requisite for entry into the UK market? Do you see this as a barrier to entry (a) for [supplier] (b) for other companies with no existing consumer or retail brand?

16. In your view, could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

20 December to Amstrad

1. In which European countries does Amstrad supply fixed-line phones?

2. From Amstrad’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (eg design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries? If so, how and why?

3. Does Amstrad consider that companies in the UK market, such as retailers or other competitors, are in a particularly strong buying or negotiating position compared to other markets? Can Amstrad describe...
which companies are particularly strong and also how this negotiating or buying power (if any) is exercised?

4. Explain the key differences between the UK market and other European markets which Amstrad supplies. In particular,

- Can Amstrad identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
- How different are wholesale and retail prices for fixed-line phones across Europe?
- How do other terms and conditions vary?
- Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range fixed-line phone models during 2004 for the UK and other major European markets.

5. Please provide prices for a typical (eg best selling) entry level, mid-range and top-of-range fixed-line phone model for each of the months during July 2004 –March 2005.

6. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or retailers in the UK market (b) other factors. Please provide details in your answers.

7. In Amstrad’s view, was pressure from any one retailer or group of retailers to reduce wholesale prices materially stronger than from others during the period? If so what is the reason for this pressure to reduce prices (eg lower prices from other suppliers (if so which suppliers), to stimulate demand, to meet volume targets)


9. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

10. Do you consider Amstrad has had opportunities in the consumer telephone market to expand and to grow market share from 2004 onward? Please provide a clear explanation of the factors involved.

4 January to Geemarc

1. In which European countries does Geemarc Telecom supply cordless phones?
2. From Geemarc Telecom’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (eg design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries? If so, how and why?

3. Does Geemarc Telecom consider that companies in the UK market, such as retailers or other competitors, are in a particularly strong buying or negotiating position compared to other markets? Can Geemarc Telecom describe which companies are particularly strong and also how this negotiating or buying power (if any) is exercised?

4. Explain the key differences between the UK market and other European markets which Geemarc Telecom supplies. In particular,
   - Can Geemarc Telecom identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
   - How different are wholesale and retail prices for cordless phones across Europe?
   - How do other terms and conditions vary?
   - Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range cordless phone models during 2004 for the UK and other major European markets.

5. Please provide prices for a typical (eg best selling) entry level, mid-range and top-of-range cordless phone model for each of the months during July 2004 –March 2005.

6. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or retailers in the UK market (b) other factors. Please provide details in your answers.

7. In Geemarc Telecom’s view, was pressure from any one retailer or group of retailers to reduce wholesale prices materially stronger than from others during the period? If so what is the reason for this pressure to reduce prices (eg lower prices from other suppliers (if so which suppliers), to stimulate demand, to meet volume targets)

9. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

10. Do you consider Geemarc Telecom has had opportunities in the consumer telephone market to expand and to grow market share from 2004 onward? Please provide a clear explanation of the factors involved.

4 January to Motorola

1. In which European countries does Motorola supply cordless phones?

2. How did Motorola come to have a brand presence in the UK fixed line telephone market?

3. What was the commercial reason for choosing to have a brand presence in UK fixed line telephone market?

4. What were the key risks perceived when considering establishing a brand presence in this market, if any?

5. State the key terms and conditions that underpin the contractual relationship between suppliers in the market and Motorola, including revenue sharing arrangements and payments for franchise fees. Does Motorola face any price or volume risk in this market?

6. How does Motorola brand compare to others in the market (i.e. does the brands occupy or some or all price points). Please explain your answer.

7. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

4 January to Binatone, co-complainant

1. Provide evidence in support of the statement in your response to Ofcom’s draft decision dated 4 November 2005 that BT has 300,000 fixed line rental customers.

2. In which European countries does [supplier] supply cordless phones?

3. From [supplier]’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (eg design new packaging, instructions).
• Are the variable costs for producing a phone for the UK market any different to those for other European countries? If so, how and why?

4. Does [supplier] consider that companies in the UK market, such as retailers or other competitors, are in a particularly strong buying or negotiating position compared to other markets? Can [supplier] describe which companies are particularly strong and also how this negotiating or buying power (if any) is exercised?

5. Explain the key differences between the UK market and other European markets which [supplier] supplies. In particular,

• Can [supplier] identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
• How different are wholesale and retail prices for cordless phones across Europe?
• How do other terms and conditions vary?
• Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range cordless phone models during 2004 for the UK and other major European markets.

6. Please provide prices for a typical (eg best selling) entry level, mid-range and top-of-range cordless phone model for each of the months during July 2004 – March 2005.

7. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or retailers in the UK market. (b) other factors. Please provide details in your answers.

8. In [supplier] view, was pressure from any one retailer or group of retailers to reduce wholesale prices materially stronger than from others during the period? If so what is the reason for this pressure to reduce prices (eg lower prices from other suppliers (if so which suppliers), to stimulate demand, to meet volume targets)


10. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

11. Do you consider [supplier] has had opportunities in the consumer telephone market to expand and to grow market share from 2004 onward? Please provide a clear explanation of the factors involved.

On 9 January to [anonymous supplier]
1. In which European countries does [anonymous supplier] supply cordless phones?

2. From [anonymous supplier]’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (e.g., design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries? If so, how and why?

3. Does [anonymous supplier] consider that companies in the UK market, such as retailers or other competitors, are in a particularly strong buying or negotiating position compared to other markets? Can [anonymous supplier] describe which companies are particularly strong and also how this negotiating or buying power (if any) is exercised?

4. Explain the key differences between the UK market and other European markets which [anonymous supplier] supplies. In particular,
   - Can [anonymous supplier] identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
   - How different are wholesale and retail prices for cordless phones across Europe?
   - How do other terms and conditions vary?
   - Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range cordless phone models during 2004 for the UK and other major European markets.

5. Please provide prices for a typical (e.g., best selling) entry level, mid-range and top-of-range cordless phone model for each of the months during July 2004 –March 2005.

6. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or retailers in the UK market (b) other factors. Please provide details in your answers.

7. In [anonymous supplier]’s view, was pressure from any one retailer or group of retailers to reduce wholesale prices materially stronger than from others during the period? If so what is the reason for this pressure to reduce prices (e.g., lower prices from other suppliers (if so which suppliers), to stimulate demand, to meet volume targets)

9. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

10. Do you consider [anonymous supplier] has had opportunities in the consumer telephone market to expand and to grow market share from 2004 onward? Please provide a clear explanation of the factors involved.

On 13 January to Siemens:

1. Do you intend to remain in the consumer telephone equipment market in the UK? If not, when do you plan to exit that market? If you have already exited the market please indicate when. Explain Siemens’s commercial reasons to exit the consumer telephone equipment market in the UK. Please rank these factors and assess their significance.

2. Explain the impact of the commercial decisions of your competitors, your suppliers, your distributors and your retail customers (e.g. Argos, Comet, Dixons) on your company’s decision to exit the consumer telephone equipment market in the UK. In relation to your retail customers:
   - In Siemens’ view how important is it for a supplier to have its products retailed by any one particular retailer or group of retailers?
   - Typically how different are wholesale prices between the major retailers?
   - How different are the terms and conditions for different retailers?

3. Provide copies of the key documentation relating to the decision to exit the consumer telephone equipment market in the UK including, but not limited to:
   - Business plans
   - Board papers
   - “For Discussion” documents
   - Research, undertaken or commissioned by Siemens (e.g. such as market reports, consumer surveys, or other market analyses)

4. Which suppliers does Siemens perceive to be its direct competitors in the UK wholesale consumer telephone equipment market? Is this competition across all model phones or only some? Please specify which.
5. Provide prices for typical (eg best selling) entry level, mid-range and top-of-range cordless phone models for each of the months during July-December 2004.

6. In Siemens’s view, was demand from any one retailer or group of retailers to reduce prices materially stronger than from others during the period January 2004 - March 2005?

7. In which European countries does Siemens supply cordless phones?

8. Does Siemens consider that retailers in the UK are in a particularly strong buying position compared to other markets? Can Siemens describe which retailers are particularly strong and also how their buying power (if any) is exercised?

9. From Siemens’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (e.g. design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries?

10. Please provide prices for a typical (eg best selling) entry level, mid-range and top-of-range cordless phone model for each of the months during July 2004 –March 2005 (if available).

11. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or retailers in the UK market. (b) other factors. Please provide details in your answers.


13. Explain the key differences between the UK market and other European markets which Siemens supplies. In particular,
   - Can Siemens identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
   - How different are wholesale and retail prices for cordless phones across Europe?
   - How do other terms and conditions vary?
   - Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range cordless phone
models during 2004 for the UK (if available) and other major European markets

14. Would Siemens consider re-entering the wholesale consumer telephone market in the UK? If so, please identify which factors would be important to this decision.

15. In your view, is a strong consumer brand a pre-requisite for entry into the UK market? Do you see this as a barrier to entry (a) for Siemens (b) for other companies with no existing consumer or retail brand?

16. In your view, could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

On 24 January to Alcatel

1. Has Alcatel considered entering the UK consumer fixed-line telephone market? If so, when and what were the major competitive threats identified at the time. In particular did you consider the price levels at the retail or wholesale supply a risk? Please explain. What were the key reasons for Alcatel entering/not entering the market, including any barriers to entry? Please rank these and assess their significance to you in making your decision.

2. Please provide copies of any documentation that relates to the business considerations to not enter the consumer telephone equipment market in the UK including, but not limited to:
   - Business plans
   - Board papers
   - Management papers
   - Analyses commissioned by Alcatel (e.g. such as consultants reports)

3. In your view, is a strong consumer brand a pre-requisite for entry into the UK consumer fixed-line telephone market? Do you see this as a barrier to entry (a) for Alcatel (b) for other companies with no existing consumer or retail brand?

4. In which European countries does Alcatel supply cordless phones to consumers?

5. From Alcatel’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (eg design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries?
6. If known, explain the key differences between the UK market and other European markets which Alcatel supplies. In particular,

- Can Alcatel identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
- How different are wholesale and retail prices for cordless phones across Europe?
- How do other terms and conditions vary?

On 27 January to Sagem

1. In which European countries does Sagem supply cordless phones?

2. From Sagem’s perspective please describe the barriers to entry and exit in the consumer telephone equipment market in the UK. In particular:
   - Provide an estimate of the up-front costs to supply a model otherwise produced for the continental market for sale in the UK (e.g. design new packaging, instructions).
   - Are the variable costs for producing a phone for the UK market any different to those for other European countries? If so, how and why?

3. Does Sagem consider that companies in the UK market, such as retailers or other competitors, are in a particularly strong buying or negotiating position compared to other markets? Can Sagem describe which companies are particularly strong and also how this negotiating or buying power (if any) is exercised?

4. Explain the key differences between the UK market and other European markets which Sagem supplies. In particular,

   - Can Sagem identify any particular market conditions which enable it to operate profitably in other markets but which are absent in the UK?
   - How different are wholesale and retail prices for cordless phones across Europe?
   - How do other terms and conditions vary?
   - Provide a comparison of average net wholesale prices achieved for average entry level, mid range and top of range cordless phone models during 2004 for the UK and other major European markets.

5. Please provide prices for a typical (e.g. best selling) entry level, mid-range and top-of-range cordless phone model for each of the months during July 2004 – March 2005.

6. Please explain the rationale for any price reductions during the period. To what extent were your reductions driven by either (a) the negotiating or buying power held by other companies, such as competitors and/or
retailers in the UK market (b) other factors. Please provide details in your answers.

7. In Sagem’s view, was pressure from any one retailer or group of retailers to reduce wholesale prices materially stronger than from others during the period? If so what is the reason for this pressure to reduce prices (e.g., lower prices from other suppliers (if so which suppliers), to stimulate demand, to meet volume targets)


9. How important is retailer brand in the market for consumer telephones? Could new entrants with unknown branded phones be able to enter and expand in the market through sales at well-known retailers?

10. Do you consider Sagem has had opportunities in the consumer telephone market to expand and to grow market share from 2004 onward? Please provide a clear explanation of the factors involved.

On [date] from [suppliers] [confidential information requests requesting further information on obtaining supplies of cordless phones]

(1) [☐]

(2) [X]

(3) [☐]

(4) [☐]

(5) [☐]

Information requested informally from other parties

20 June by email from Chris Bowley to Binatone

Ofcom is interested in whether Binatone is an on-line subscriber to GfK (or has access to any other source of market data) on consumer telephone equipment sales, and if so what market data Binatone could potentially provide to Ofcom to progress its investigation into the allegation of predatory pricing made against BT in the consumer telephone market.

Ofcom is interested in obtaining sales volumes (i.e., units sold) and prices for all consumer telephone models and for all suppliers from January 2000 to the present. Ofcom would be interested to know if the data is flagged so that it could be identified which models were corded or cordless, analogue or digital, with and without answering machine, single and multiple handsets.
Ofcom is interested in viewing monthly data for each of these values.

Ideally, the raw data would be available in electronic format and would be in Excel (or a format that can be read into Excel such as Access).

I would be happy to discuss this query in more detail.

30 June email from Binatone to Ofcom

Hugh/Tanya
Please find below the following information that was requested by Ofcom at their meeting with Binatone:
1. BTP’s Financial Accounts history back to 1999.
2. Detailed Management Accounts against budget. Agreed to send April 05.

5 July Email from Tanya Rofani to Argos

Sorry for the delay in replying to your email. At tomorrow’s meeting we would like to start the discussion with the following general queries
How does buying process work?
  How does Argos decide what products it puts into catalogue?
  Is there a maximum number of suppliers of any one product type?
  Why does BT have such a high market share?
  How has the market evolved in the last 2 years?
  Are there other potential suppliers who could offer Argos phones of acceptable price/quality if Argos chose to include them?

Quantities purchased.
  Who decides how much stock to take?
  Is there any negotiation between the two sides on quantities ordered?
  Do suppliers ever suggest Argos purchase less than they initially request?
  Does Argos get quantity discounts?
  How many deliveries do you get per season?

Catalogue promotion.
  Do suppliers have to pay for special promotional placements in the Argos catalogue?
  Does Argos have a standard rate card for all their phone suppliers or is it individually negotiated?
  Do all phone suppliers purchase promotional placements in the Argos catalogue and are any suppliers refused?

Promotional support.
  Does Argos get promotional support from its phones suppliers? If so what form does this promotional support take (e.g. paid for TV or radio advertising, promotional flyers in addition to the two seasonal catalogues, in store placements/posters etc.)

Pricing and discounting policy:
  How does Argos determine the prices it charges for the phone products it stocks?
  Are suppliers involved in the Argos pricing of the phones they supply?
  How are phone products discounts determined?
  Do suppliers provide rebates for phones Argos discounts and when

Returns
  How does it work?
How does BT compare to others?

General
- Does Argos earn same margin from all suppliers?

Data:
- Monthly sales/returns for all DECT phones for last 3 years
- Gross margin details for each phone on a monthly basis for last 3 years

19 July Email from Tanya Rofani to Comet

Please see below a list of questions we would like to go through with Comet to start the discussions at Thursday’s meeting.

How does buying process work?
- How does Comet decide what products it sells?
- Is there a maximum number of suppliers of any one product type?
- Why does BT have such a high market share?
- How has the market evolved in the last 2 years?
- Are there other potential suppliers who could offer Comet phones of acceptable price/quality if Comet chose to include them?

Quantities purchased.
- Who decides how much stock to take?
- Is there any negotiation between the two sides on quantities ordered?
- Do suppliers ever suggest Comet purchase less than they initially request?
- Does Comet get quantity discounts?
- How many deliveries do you get per season?

Promotional support.
- Do suppliers have to pay for special promotional placements in the Comet promotions?
- Does Comet have a standard rate card for all their phone suppliers or is it individually negotiated?
- Do all phone suppliers purchase promotional placements in Comet and are any suppliers refused?
- Does Comet get promotional support from its phones suppliers? If so what form does this promotional support take (e.g. paid for TV or radio advertising, promotional catalogues, in store placements/posters etc.)

Pricing and discounting policy:
- How does Comet determine the prices it charges for the phone products it stocks?
- Are suppliers involved in the Comet pricing of the phones they supply?
- How are phone products discounts determined?
- Do suppliers provide rebates for phones Comet discounts and when

Returns
- How does it work?
- How does BT compare to others?

General
- Does Comet earn same margin from all suppliers?

Data:
- Monthly sales/returns for all DECT phones for last 3 years
- Gross margin details for each phone on a monthly basis for last 3 years
20 June by email from Hugh Kelly to Binatone

When we met last week we discussed asking you for some more cost data.

I would be grateful therefore if you could provide the following information:

1. The ex-factory price for Binatone’s top ten selling phones over the previous 2 years showing how this may have changed over the period. For each phone also show retail price, price to retailer and net revenue to Binatone after including warranties and returns
2. Produce a version of your management accounts which shows average unit costs per DECT phone and also on a % of DECT revenues basis- as we discussed the point of this exercise is to allow us to compare average costs with those of BT to identify key differences,

Please feel free to give me a call if you would like to discuss this

Can you let me know when you will be able to get this done, so we can plan incorporating into our analysis

4 August 2005 by email from Chris Bowley to Binatone

To outline our conversation this morning, I indicated that Ofcom was interested in obtaining clarification on the construction of market volume and value data for major consumer phone product groupings that were provided by Nick Andrews at Binatone to me on 8 July by email.

It was agreed that I should compile a list of questions that could then be sent to Binatone.

The list of questions is attached.

If possible, could we have the information by Friday 12 August. As you will appreciate, the accuracy and reliability of the information provided will be of considerable importance given the reliance Ofcom places on this information within the ongoing investigation.

Please contact me if you require further clarification in these points.

23 September by email from Hugh Kelly to Co-complainant

I have a query on the original complaint on which I would appreciate your help:

In Annex 2, [X] provided details of the financial performance of two models: [X] and [X]. Could [X] provide Ofcom with:

1. the relevant volumes sold for the models corresponding to the revenues and costs provided
2. the relevant dates to which the data applies

Many thanks

23 September by email from Hugh Kelly to Binatone

I have a query for Binatone regarding their financial submissions:

In the original complaint (29 March 2005) Binatone provided in Annex 1 a schedule setting out the profitability of the E3300 model, showing a negative Gross Margin. On 10 September
Morag forwarded to me a file prepared by Binatone titled “fig for hugh.xls” setting out a P&L statement split between DECT phones and other products and also a schedule of the profitability of phones form 2003/4 - 2005/6. For each period these showed a positive gross margin for the same E3300 model

Can Binatone provide a reconciliation between the two schedules, and also answer the following queries:

- what costs are included in the gross margins shown in the "fig for hugh.xls" schedules?
- provide details of volumes for each phone shown in the gross margin calculations
- provide relevant exchange rates for the gross margin calculations
- indicate how the gross margin shown in the schedules for each phone (shown as "After returns") reconcile to the gross margins shown in the P&L statement in the same file which are shown before returns and other cost of sales (line 23)

I am happy to discuss with Binatone directly or through a conference call if this helps

26 September by email from Hugh Kelly to Co-complainant

Annex 2 of the original complaint contained a calculation of the profitability of the [X] model. In the annex, the total for "Other Cost of Sales" is stated as £2.30 per phone. However, the sum of the individual costs is £1.29 (0.12+0.40+0.08+0.12+0.06+0.23+0.12+0.15+0.01) These individual costs appear to agree to the percentages given for each cost (eg Product Testing Cost 1%).

Can [X] please confirm whether the correct cost for "Total other cost of sales" is £1.29 and not £2.30 as stated

10 October

Conference call to discuss anomalies in gross margin calculations of Binatone E3300 model (in complaint and subsequent calculation)

24 January by email from Tanya Rofani to Binatone:

Further to my telephone message this afternoon, could Binatone please provide copies of its sales contracts with Argos and the 2 largest remaining customers (retailers) relevant to the period 2005/2006 by Monday 30 January? The contracts should relate to products which are at least within the top 5 selling phone models for your business.

Meetings during the investigation

28 April 2005 with Herbert Smith
12 May 2005 with Herbert Smith
13 May 2005 with BT
22 June 2005 with BT
6 July 2005 with Argos
21 July 2005 with Comet
26 July 2005 with Binatone
26 July 2005 with co-complainant
7 September with BT
23 September conference call with [X]
16 November 2005 with Herbert Smith
14 December 2005 conference call with [X]
4 July Conference call with Alba Plc