Price regulation of enhanced services

Non-confidential version

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1 Introduction

1.1 Enhanced or expedite[1] services are optional higher quality services that are priced at a higher level than the standard service (e.g. for faster new provide, faster fault repair). Ofcom has proposed in the FAMR / charge control that no pricing constraints apply to these services i.e. no charge control, no cost orientation obligation.

1.2 In this response we first consider whether an absence of price regulation is in consumers' interests. We believe that there is very compelling evidence that the absence of price regulation is harming consumers. We then assess what form of price regulation would be appropriate. As such it builds on submissions we have previously made in the ongoing FAMR (Quality of Service, QoS issues) and the LLU charge control.

1.3 The conclusions in this paper have implications for several of Ofcom's projects, including:

- the FAMR, since Ofcom may need to impose a cost orientation obligation through the WLA Market Review;
- the LLU/WLR charge control since either a charge control will need to be designed or, if a cost orientation obligation is imposed, there will be impacts on cost allocation and common cost recovery. Further, the question of price regulation of enhanced services has been directly considered in the LLU Charge Control consultation, for example at §4.312;
- the FAMR's conclusions on QoS, since the provision of a range of enhanced services will enable Ofcom to set appropriate minimum service standards that reflect consumer demands. It will therefore help avoid 'regulatory failure' which could occur by Ofcom setting a single minimum service standard that does not reflect customers' demands

2 Need for price regulation

2.1 Ofcom is proposing in the FAMR/charge control that there will be no effective price regulation (either charge control or cost orientation obligation) applying to enhanced services. We think that here is a very clear and compelling justification as to why introduction of price regulation would be consumers' interests:

[1] Enhanced and expedite both provide higher quality service but are paid for in different ways. Enhanced refers to a situation where the annual charge is elevated which entitles the customer to a higher quality (in other words higher quality is rented). Expedite refers to the situation where a one-off charge is paid in return, for instance, for a faster repair on one fault. For repair services either option is possible. For new provide/connection services enhanced service is not payable since there is no ongoing annual charge

- BT has SMP, the services are not contestable and thus BT has the incentive and ability to price excessively;
- As a matter of economic theory, the standard service options do not act as a sufficient constraint on the price of enhanced services;
- The empirical evidence shows that prices are not constrained since BT is pricing at more than 10 times incremental cost;
- Ofcom itself highlighted that price regulation would be appropriate if it could be shown that prices were not sufficiently constrained;
- Such high prices are not necessary or appropriate because the services are 'optional' or in order to provide the incentives for Openreach to innovate;
- The absence of price increases for enhanced services in recent years does not mean (as Ofcom seem to think) that prices are constrained.

2.2 We expand on these points below.

2.3 The starting point for any analysis of whether price regulation is justified is whether BT has SMP and whether there is any competitive constraint on prices. Ofcom itself accepts that BT has SMP in the provision of enhanced services[2]. Furthermore, the enhanced service element is not in any way contestable[3] – if a CP buys an MPF/WLR service from Openreach they have to use Openreach to install or repair that service whether it is the standard service level or an enhanced service level.

2.4 It is clear from economic theory that the pricing of standard service levels will not impose any competitive constraint on enhanced service levels. Openreach will earn profits at least equal to its cost of capital regardless of whether its customers choose that (price regulated) standard service or the (price unregulated) enhanced service.

2.5 When Openreach is deciding how high it should set the price of enhanced services, it will weigh up the benefits of the higher price (in terms of higher margins on customers who remain taking the enhanced service) with the costs of the higher price (in terms of lost enhanced sales volumes). Openreach should in principle set the price at the level where the marginal benefits of a higher price equal the marginal costs.

2.6 The marginal costs of setting the higher price will be affected by the proportion of customers who switch to other products, and whether those products are offered by Openreach or by another firm.[4] If these products are offered by Openreach, then it

[2] It is clear that BT has SMP in the provision of enhanced services. For example, cost orientation obligations previously applied to enhanced services which could only have been the case if BT had SMP in the provision of these services

[3] Some services related to the provision of MPF/WLR core services are contestable. For instance, certain TRC services may be contestable since CPs can self-provide the service using their own engineers because the activity is carried out in-home (i.e. not on BT's network). However, the same is not true of enhanced services

[4] In competition economics, these figures are known as the relevant 'diversion ratios'.

will be able to retain at least the competitive level of profits when customers switch products due to the high price of enhanced services.

2.7 In this case, it is clear that approximately all customers switching due to the excessive price of enhanced services would switch to another Openreach product (standard services).[5] Openreach has a monopoly on offering both standard and enhanced services. As such, the diversion ratio to other Openreach products will be near 100%; the diversion ratio to other providers will be very low.

2.8 It is standard economic logic that where two products have high diversion ratios to one another, and low diversion ratios to other products, then combining them within the same company will lead to prices being set well in excess of the competitive level. This logic is frequently used in merger analysis; for example, a diversion ratio approach was used by the Competition Commission as the core economic rationale for demanding divestments of various stores in *Somerfield/ Morrisons.*[6]

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[5] The only exception to this would be if some customers, due to the lack of competitively priced enhanced services, chose either to take Virgin Media, or take no telecoms services at all, rather than switching to standard services. In reality, TalkTalk considers both of these scenarios to be highly unlikely.

[6] Competition Commission (2005), *Somerfield plc/ Wm Morrison plc merger inquiry*, at Annex D.

2.9 As well as looking at the economic pricing incentives to assess whether there is sufficient constraint it is also valuable to look at the empirical evidence of whether BT's prices are set at competitive levels (i.e. are they set at or near cost). Below we provide some examples of the (incremental) cost and price of various enhanced services which shows that prices are 10-30 times incremental cost[7].

Service	Incremental cost	Price	Price : cost
Care level 1 (CL1)[8] to CL2 rent	£0.60[9] pa	£6.32	10 times
CL2 to CL3 rent	£2[10] pa	£37.20	16 times
CL2 to CL3 expedite	£16[11] one off	£500	31 times
3-6 day provision[12]	£5[13]	£50[14]	10 times
1-2 day provision	£10[15]	£100[16]	10 times

2.10 It is notable that for the expedite services that there is no service level guarantee and therefore Openreach can choose to only provide this expedite service when

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[7] We may be able to update some of these when the further FAMR consultation is published

[8] Care level 1 Clear by 23.59 day after next, Monday to Friday. For example, report Tuesday, clear Thursday. This means typically clear in 48-60 hours

Care level 2 Clear by 23.59 next day, Monday to Saturday. For example, report Tuesday, clear Wednesday. Typically clear in 24-36 hours

Care level 3 Report by 13.00, clear by 23.59 same day. Report after 13.00 clear by 12.59 next day, seven days a week, including Public and Bank Holiday. Typically clear in 12-24 hours

Care level 4 Clear within 6 hours, any time of day, any day of the year. Clear in 6 hours

[9] Ofcom assumed in 2012 Charge Control that CL2 cost 5.7% more than CL1 (2012 LLU Charge Control §A4.306ii). We estimate that the cost of fault repair per line is about £12 per year for care level 2 derived from Component cost stack per product 2011/12 in model – faults are included in e-side current, d-side current, drop current and frame current (total £15.23 less £3.16 cumulo).
This cost is FAC so LRIC will be less (we assume LRIS is 90% FAC). £0.60 = £12 x 5.7% x 90%

[10] The annual costs of improving from CL1 to CL2 (i.e. 24-36 hours not 48-60 hours) is £0.60 (see above). We have assumed that the cost to improve from CL2 to CL3 (i.e. 12-24 hours not 24-36 hours and 7 days a week coverage rather than 6 days a week) is three times the cost for CL1 to CL2 i.e. £2.00 (which is highly conservative)

[11] Given fault rates are 3m a year for 24m lines this implies 0.12 faults per line per year. Given 12% lines fault each year the additional cost of repairing a fault must be 8 times (= 1 / 12%) the annual cost of fault repair

[12] This refers to appointment availability

[13] Figure 5.1 in the FAMR indicates moving from 13 to 12 days increase resources require by around 1% (at 85% within target). If we assume LRIC costs of £25 for MPF New Provide then the added cost for a one day reduction is around 25p. For a reduction from 13 days (today) to 3-5 days (8-10 days) would cost £3. The cost per day of improvement might increase slightly as the number of days reduces thus assume £5 not £3

[14] This was price verbally suggested by Openreach in early 2012 as the price for its 'Premium Appointing' services. The service was not actually launched

[15] Conservatively assume twice additional cost to move to 1-2 days

[16] This was price verbally suggested by Openreach in early 2012 as the price for its 'Premium Appointing' services. The service was not actually launched

there is free resource and so there is effectively very little incremental cost to it.[17] Thus the genuine incremental cost for CL2 to CL3 expedite is probably lower than the £16 shown.

2.11 Whilst this evidence relies in part on certain assumptions, even modifying the assumptions significantly will still result in prices that are substantially higher than incremental costs.

2.12 Whilst some mark-up for common costs might be considered reasonable the mark-up is likely to be low – the mark-up on MPF/WLR *rental* services is about 80% whereas on *engineering* intensive services such as connections the mark-up is less than 10%[18]. The implicit mark-up on enhanced services of 1,000% or more is excessive, and is direct evidence that BT both possesses, and is exercising, market power in the provision of enhanced services.

2.13 It might be argued that these higher prices (and extremely high common cost mark-ups) are justified since they recover proportionately large amounts of common costs from these enhanced services. Such a pricing approach would only be in consumers interests if two conditions were both met:

- There was an offsetting recovery of <u>less</u> common cost on other products. There is no evidence to support this proposition at all. Further, there is no mechanism whereby higher enhanced services prices would result in lower prices for other services[19]
- It was allocatively efficient for such large levels of common cost to be recovered from enhanced services[20]. No such evidence has been advanced. The fact that the high prices appear to have suppressed demand and resulted in low take-up[21] implies that the pricing is not allocatively efficient

2.14 Given that neither condition is met it appears clear that there is no justification for prices so far in excess of incremental cost and that the prices are not set at a competitive level.

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[17] Openreach can effectively choose to only repair in the shorter time when it has spare (and therefore close to free) capacity available. This can be considered in theoretic terms by treating an order for enhanced service as providing BT with a free real option which it can exercise at zero price. It will meet the demand for enhanced service whenever the marginal cost of doing so is less than the incremental revenue earned from meeting enhanced rather than standard provision. As such, the optional nature of enhanced provide means that, whatever the price is set at, the price will always exceed LRIC costs.

[18] The mark-up on LRIC can be determined form the FAC:LRIC ratios. For MPF/WLR rental LRIC is 54% of FAC (LLU Charge Control §6.160) implying an 80% mark-up (= [100% - 54%] / 54%). For migrations it is 93% implying a mark-up of 8% (= 7% / 93%)

[19] One such mechanism would be if enhanced services were priced at FAC (including a large common cost recovery) and so the FAC of other services was lower. However, there is no evidence that there is any allocation of common costs to enhanced services in BT's cost allocation. In fact in 2009 LLU Charge Control Ofcom provided evidence that BT allocated zero cost to enhanced services (Annex Table A6.6) i.e. no common cost at all (and no incremental cost either)

[20] This would only be true if the demand elasticity for enhanced services was close to zero

[21] for instance, we believe that no or very few residential WLR or MPF take an enhanced service

2.15 In our view it is clear that there is good reason to regulate prices to prevent such excessive returns. Ofcom has itself accepted this – in the 2012 LLU Charge Control consultation Ofcom said "*Nevertheless we think basket control would be a credible option for enhanced care services in the event that other options are found to provide insufficient constraint on price behaviour*"[22]. As we have explained above there is a wealth of *a priori* economic logic and empirical evidence that there is insufficient constraint on BT's prices.

2.16 Another compelling benefit from regulating enhanced service prices to be cost reflective is that it will provide consumers with greater choice, helping the market to work efficiently and driving better service performance[23].

2.17 Regulating enhanced service prices will also avoid Ofcom having to make a difficult decision about what minimum service standard it should set. Rather than having to set a single standard (e.g. 90% delivered within 12 days for MPF/WLR New Provide) by having a range of options priced at cost the market can decide what services demanded (e.g. 70% of customers chose 12 day standard option, 30% chose 5 days fast option) and the minimum service standards can reflect this (i.e. need to deliver 90% of standard option and 90% of fast option on time). This will reduce the chance of 'regulatory failure' whereby Ofcom would have to ordain a single service level which is likely to be inappropriate.

2.18 Below we address three other secondary considerations that relate to the decision whether to apply price regulation.

2.19 <u>First</u>, it might be argued in the past that price regulation is not appropriate since enhanced services are optional, 'value-added' services. Just because a service is optional it does not follow that price regulation is not appropriate. Having an ADSL broadband service is optional (a customer could take no broadband service or a broadband service from Virgin) but it does not mean that LLU or WBA price regulation is inappropriate. More generally, the fact a service is 'optional' has no relevance in an economic analysis. The degree of market power is dependent upon the competitive constraints faced by a provider, which is determined by how willing customers would be to substitute in response to small but significant price increases. Calling a particular product 'optional' is a value judgement which says little or nothing about the economics of that product. Furthermore, for some customers an enhanced service is not an optional 'nice to have' but an essential service.[24]

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[22] LLU Charge Control Consultation Mar 2011 §4.158

[23] given that the standard service is price regulated (since part of the relevant new provide or rental charge) then requiring that the prices of these additional services reflect the cost differences will effectively mean that the prices of these additional services are regulated.

[24] It is also important to note that the (fuzzy) distinction between essential and optional will change between geographies and over time. For example, in the early twentieth century electricity to a home and running water might have been considered as optional facilities; now most observers would consider them essential. Similarly, in some parts of the world even today phone lines to the home would not be considered essential. This would not prevent local telephone monopolies holding market power. Probably as recently as 10 years ago broadband might have been considered as 'optional'. This did not mean that BT did not hold market power in the provision of broadband services – and in fact they were found to have market power (in WLA and WBA).

2.20 Second, it may be suggested that high prices and returns are necessary in order to provide the incentives for Openreach to innovate[25]. We do not think that this argument is valid. Openreach has been allowed to make substantial returns yet there has been almost no innovation in enhanced/expedite services in the last 3-4 years[26]. In any case, providing service options is not a difficult innovation and Ofcom can impose regulation that would require Openreach to offer new enhanced services (or meet reasonable requests).

2.21 Third, in respect of whether prices are excessive Ofcom seems to be of the opinion that since enhanced/expedite prices have not increased over recent years then regulation is effective. It says: (§4.312)

> *We have assessed BT's prices for LLU and WLR enhanced care services, and note that these have not changed since the March 2012 Statement (or indeed prior to that review). We therefore consider that the current regulation appears to be effective and that there is no evidence to suggest further more onerous regulation would be necessary or proportionate.*
>
> *In light of this, we propose that the existing obligation on BT to align LLU Enhanced Care service charges with WLR Enhanced Care service charges should be retained and consider it would be unnecessary for a more interventionist approach as suggested by TalkTalk. We propose to continue to monitor the charges for LLU Enhanced Care services, and will look carefully at any significant increases, over the course of the charge control.*

2.22 To suggest that there are sufficient price constraints and price regulation is not needed because prices have not increased (or won't in future) is illogical and wrong.

- First, just because prices have not increased does not mean that prices aren't excessive. Whether prices are excessive depends on whether price are above costs (not whether they are higher than they were previously). Prices can be steady even when they are set at the monopoly level since, for instance, a monopolist would not shift its monopoly price unless there were changes in incremental costs or demand conditions.
- Second, if prices have been static (in nominal terms) then will have increased compared to cost (since, for instance, costs fall due to efficiency improvements). That is, even if prices were not excessive in 2009 (which was not the case), they may have become excessive by 2013 due to reductions in cost. Monopolists will reduce their prices as incremental costs fall.

2.23 Ofcom can therefore only make a judgement about whether prices are excessive based on an analysis of costs at each point in time. To reach any conclusion regarding excessive prices or sufficient price constraint based on a lack of increase in prices is invalid and flawed.

[25] LLU Charge Control Statement Mar 2012 §4.391 "*We also considered whether LLU Enhanced Care services should be charge controlled in baskets or using a safeguard cap (Option 3 in the March 2011 Consultation). However, we felt that this approach could result in inflexibility and/or stifle innovation"*

[26] Around 2009 Openreach harmonized the availability and pricing of different care levels across its various products. This is not really genuine innovation but rather 'tidying up'. There has been no meaningful innovation in terms of new service options

2.24 We note that there is regulation that requires that prices for enhanced care services are aligned as between WLR and LLU (e.g. upgrade form CL2 to CL3 repair is priced the same for WLR and MPF). This is welcome as it prevents discrimination. However, it does nothing to prevent excessive prices (for both WLR and MPF).

3 Form of price regulation

3.1 We explained above why we think that price regulation to ensure prices are aligned with costs is justified and in consumers' interests. There are though a number of forms of price regulation that could be introduced. The key options are:

- The type of obligation:
  - A charge control[27] which is typically based on gliding prices from their current level to a level which equals forecast costs at the end of the charge control period.
  - A cost orientation obligation whereby prices are required to be below out-turn actual costs.

  A charge control or cost orientation obligation could either be set for a basket of products (where the average prices on an aggregate of products are capped, rather than each individual price) or for individual products
- The cost standard could be:
  - FAC (fully allocated cost)
  - LRIC
  - Or some variant on these e.g. FAC+10%, LRIC+EPMU or LRIC+20%

3.2 We describe below what form of price regulation we consider would be most effective and in consumers' interests.

3.3 In term of the type of obligation we consider that it would be most appropriate to impose a cost orientation obligation. This could either be imposed on the basket of enhanced services or on individual ones. There are a number of reasons why this is the most appropriate available option:

- Forecasting costs as required for a charge control might be difficult since the cost of each enhanced service may not be fully clear and the mix of different services is difficult to anticipate (particularly if, as is likely, prices reduce substantially)
- It is difficult to introduce and include new services (e.g. a faster provision service) under a charge control obligation. A charge control obligation is based on the price change from the previous year (and using previous year

[27] A sub-option for this would be to include the enhanced services in the relevant rental basket e.g. MPF enhanced services in MPF rental charge control and WLR enhanced services in WLR rental charge control. We do not consider this appropriate since it will change the overall structure of the charge control, make rental services less predictable, possibly be open to gaming and possibly make ensuring consistent enhanced prices as between MPF and WLR more difficult

volume weightings). Yet the new service will have no previous price and a zero weighting.

- a basket approach will allow potential discrimination e.g. BT may price up enhanced services used more by its competitors than itself. Ofcom should consider how this risk could be ameliorated if it adopts a basket approach.

3.4 Two other issues relating to the type of obligation are:

- In the case that a cost orientation obligation is applied (and particularly if FAC is used) then it is essential that the cost allocation methodology[28] remains consistent between that used to set the charge control and that used for compliance with this cost orientation obligation. For instance, if the costs used to set the MPF/WLR rental charges includes certain overhead costs but then subsequently some of these overhead costs are reallocated to enhanced services then it will mean that Openreach will effectively be able to recover the same cost twice[29]
- It may be that in next market review period a charge control may be suitable and/or tighter constraints on individual products may need to be imposed;

3.5 In terms of the appropriate cost standard we favour LRIC as the basis. Of course if LRIC is used any common costs that were previously recovered from enhanced services should be recovered from MPF/WLR rental (the amount would be the enhanced services FAC less enhanced services LRIC). There are a number of reasons for preferring LRIC:

- It is consistent with the 'ethos' of the approach to pricing whereby all customers bear the same amount (in £) of common costs irrespective of the service provided[30];
- It will be consistent with the approach used in the LLU/WLR charge control whereby the difference in MPF and WLR standard rental prices reflects the difference in LRIC costs (with one of these differences being the difference in standard care level – MPF being CL2 and WLR being CL1). We consider that it is logical to use the same cost standard to set the price of enhanced services as is used to set the price difference between rental products that have different quality levels. This will mean, for instance, that an operator using WLR could purchase the CL1 to CL2 upgrade and effectively pay the same price for CL2 as an operator using MPF;
- Setting price differences equal to LRIC is likely to promote productive efficiency through customers opting for the optimal service level;
- It is likely to reduce the risk of BT under- or over-recovering costs (in the case of a charge control) or reduce the chance of mis-forecasting its costs (in the

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[28] It would also be useful for the method for deriving LRIC to be identified and maintained through the market review period

[29] In 2009 LLU Charge Control Ofcom provided evidence that BT allocated zero cost to enhanced services (Annex Table A6.6) i.e. no common cost at all (and no incremental cost either)

[30] For example, LLU Charge Control §3.77 "*… we propose to set charges so that services that include the provision of a fixed line make an equal per line contribution to the recovery of common costs.*"

case of a cost orientation obligation) since it is easier to forecasts LRIC costs than FAC costs which depend on the volume of other products.

3.6 It may be appropriate to set the cap at LRIC (as shown in RFS) plus (say) 10% in this market review period since BT may not have a full grasp of its costs. Though this will allow excessive pricing consumers will gain compared to the situation today where prices are as much as LRIC + 3,000%.