



# The review of the market for standalone landline telephone services

Provisional conclusions

Consultation

Publication date: 28 February 2017

Closing Date for Responses: 9 May 2017

# About this document

We are consulting on our review of the retail market for standalone landline telephone services, that is the sale of telephone services to those people who buy such services in a standalone contract and not as part of a bundle with other services such as broadband or pay-TV. This affects around 2.9 million households in the UK.

The review was prompted by concerns over rapidly rising prices for these services, despite falling wholesale costs suggesting that these customers have not benefited from competition in the same way as those buying bundles.

We consider whether we can define a distinct market for such services and whether in this market there is one or more companies with significant market power, i.e. that they are able to act without sufficient constraint from competitors.

We provisionally conclude that there is a distinct market, with BT holding significant market power and we set our proposal to address this. We will take all responses to this consultation into account before reaching our final conclusions which we plan to publish in a statement at the turn of the year.

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## Section 1

# Executive summary

## Strategic context

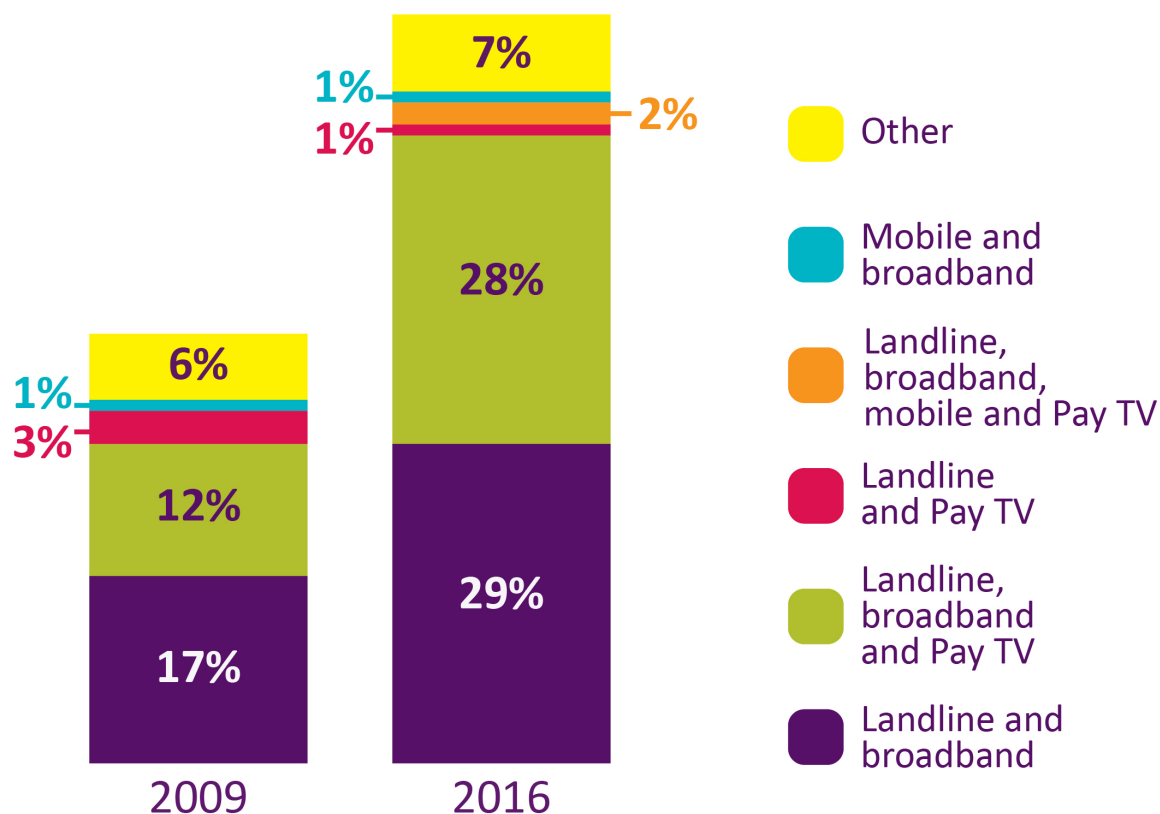
- 1.1 Over the past decade, the landscape for fixed line telecommunications in the United Kingdom has been transformed. Competition has brought new services, increased choice and delivered real benefits to consumers.
- 1.2 Fifty-nine per cent of homes now buy a bundle including a landline telephone service and a broadband service. The majority of these customers bundle their landline and broadband services (29% of homes); followed by customers who bundle their landline, broadband and Pay TV services (28% of homes); and customers who bundle their landline, broadband, mobile and pay-TV services (2% of homes).
- 1.3 People who buy bundled services are getting more for their money than before. Average broadband speeds have increased over time from 8 Mbit/s in 2011 to 29 Mbit/s<sup>1</sup> in 2015. Similarly, average broadband data use has increased from 8GB per connection in 2008 to 97GB in 2015. Over the same period, bundles have been expanded to include on-demand television and related content services, often at little or no extra cost.
- 1.4 Consumers have recognised these benefits, and take-up of bundles including three or more services has increased significantly over the period (see Figure 1.1).

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<sup>1</sup> Average speed November 2015 – see Ofcom, *Communications Market Report 2016*, 4 August 2016, <https://www.ofcom.org.uk/research-and-data/cmr/cmr16>.

Figure 1.1: Take up of bundled services<sup>2</sup>

## Consumer bundling, 2009 vs 2016



Source: Ofcom, Technology Tracker. Data from January-February fieldwork, both 2009 and 2016.

- 1.5 However, customers that do not take bundled services have not benefited from competition in the same way. We are particularly concerned about people who only buy a landline from a provider – either because they do not want broadband or pay-TV, or because they take these services separately, usually from different companies.
- 1.6 Our concerns are that relative to those who purchase services in a bundle, these consumers have less choice of suppliers, are not benefiting from strong price competition or promotional offers and their loyalty to their suppliers is leading to ever higher prices. Further, while price increases up to 2013 might have been explained by the rebalancing of revenue from calls and the line rental, since then we have observed a more rapid inflation and it is now clear we need to act.

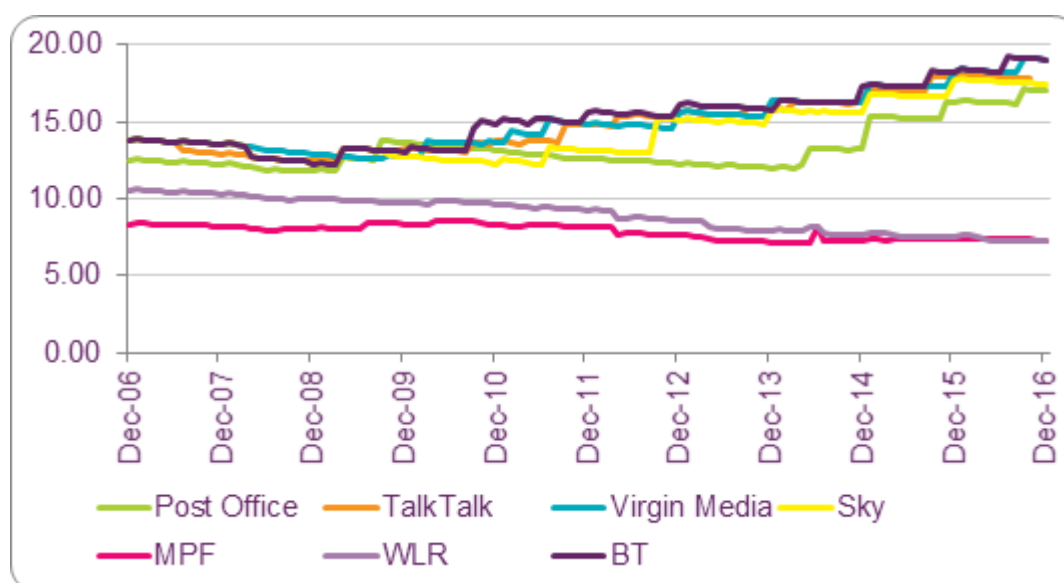
<sup>2</sup> Data relates to the proportion of customers self-reporting a bundle of services, and understates the proportion purchasing multiple services from a single provider. We use this to allow for comparability with 2009 data. Revised analysis for 2016 based on the main provider used for each service is reported in Figure A8.1. This analysis also defines those who pay line rental in addition to their broadband service, as a bundle.

- 1.7 We have found that these customers – often elderly people who have remained with the same landline provider for many decades – are getting increasingly poor value for money. They are particularly affected by price increases, and, we consider, are in need of additional protection in a market that is not serving them well enough.
- 1.8 To address this situation, we are now proposing to cut the price of BT's standard line rental by at least £5 per month for customers with standalone landline contracts. Thereafter BT would only be allowed to increase its average prices for line rental and calls in line with inflation.<sup>3</sup>

## Retail and wholesale landline prices

- 1.9 As we set out in our Digital Communications Review (“DCR”)<sup>4</sup>, and as shown in Figure 1.2 below, line rental prices have increased significantly. From December 2009 to December 2016, line rental prices have risen by between 25% and 49% in real terms. At the same time, the wholesale costs for providing landline services have fallen by up to 26% in real terms. Wholesale costs are represented by the WLR and MPF lines in Figure 1.2. These two wholesale products are used by providers to offer retail line rental services to consumers.
- 1.10 This fall in the wholesale costs has allowed more competitive pricing in the bundled market but for landline only has simply meant that the profit in the provision of this service has grown significantly.

**Figure 1.2: Wholesale and retail line rental price movements (£/month at December 2016 prices)**



Source: PurePricing broadband updates

Notes: Adjusted for CPI; excludes line rental saver pre-payment tariffs

<sup>3</sup> Any increase over the rate of inflation in either line rental, calls or ancillary services would need to be offset by price decreases in some of the other services.

<sup>4</sup> [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0016/50416/dcr-statement.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0016/50416/dcr-statement.pdf)

- 1.11 This trend is observable across all major providers of landline services – not just BT. We are therefore concerned that standalone landline telephone consumers are increasingly worse off compared to consumers of bundled services.
- 1.12 There are currently about 2.9 million standalone landline consumers which account for 11% of total residential landline customers.<sup>5</sup> They fall into two categories:
- About 1.7 million consumers buy landline services but do not purchase fixed broadband. We refer to this group as “voice-only” consumers.
  - Approximately 1.2 million consumers buy both landline and broadband services but on a standalone basis outside of a bundle. They have faced the same line rental price increases as voice-only consumers and have not benefited from competition in bundles. We refer to this second group as “split purchasers”.
- 1.13 Standalone landline customers generally do not engage with the market: 70% of standalone landline customers have never switched provider or considered doing so. They tend to be older and less likely to shop around for a better deal. Approximately 43% of standalone landline customers are at least 75 years old, and 35% live in DE socio-economic group households (for comparison, 4% of dual-play customers are 75 or over, and 20% are in DE group households).<sup>6</sup>

## Our market assessment

- 1.14 We have carried out a review of the retail market for standalone voice services to determine the problems and what can be done to address any consumer detriment which has arisen. A market review involves us carrying out an assessment of competition in specific markets. Where we identify competition issues we can impose specific regulatory obligations on providers that we find to have significant market power (SMP). This consultation document sets out our provisional conclusions of our review of retail standalone landline telephone service markets.
- 1.15 On the basis of our analysis, we have provisionally concluded that there is a separate market in the UK<sup>7</sup> for the provision of standalone landline telephone services (or as we term them in the review, standalone fixed voice services<sup>8</sup>). This market does not include landline telephone services when they are provided as part of a bundle (landline telephone and broadband or landline telephone, broadband and pay-TV). The market also does not include mobile services as the evidence suggests that these remain at most a complementary service for most consumers.<sup>9</sup> While we acknowledge that the market may be transformed in the future as the current copper

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<sup>5</sup> The number of standalone landline customers is declining at a rate of about 15-20% per year.

<sup>6</sup> Ofcom, s135 requests. Additionally, Ofcom’s Consumer Experience 2015 report suggested voice-only customers (i.e. standalone landline customers who do not buy fixed broadband) seem to be older on average than split purchase customers (i.e. standalone landline customers who buy fixed broadband outside a bundle). Almost 60% of voice-only consumers are over-75, and nearly half (47%) live in DE socio-economic group households.

<sup>7</sup> Specifically, in the UK excluding the Hull Area, as the market conditions there are different since there is only one major provider in Hull – KCOM.

<sup>8</sup> We have actually defined two standalone fixed voice service markets – the market for the purchase of access, i.e. the line rental, and the market for the purchase of calls.

<sup>9</sup> We note that many customers of standalone fixed voice services also have mobile phones, though a substantial number (around 30%) do not.

network moves to fibre based services, any transformation will be outside the period of our review (3 years).

- 1.16 We have also provisionally concluded that BT has significant market power (i.e. has a dominant position) in the market for standalone landline telephone services. This allows it to act in setting the terms and conditions of sales in this market without facing significant competitive constraint from other providers. This is particularly true when it comes to setting prices.
- 1.17 BT benefits from a very high market share; over 70%, in a market where many customers are not actively engaged. This in turn has allowed BT to act as a price leader, steadily increasing the price of standalone landline services. Further, given the difficulty in winning new customers from BT, the range of choice from competing providers has declined as prices have increased.
- 1.18 As illustrated in Figure 1.2 above, BT has been able to raise prices to its standalone landline telephone customers despite falling costs.
- 1.19 A key reason for the decline in costs has been reductions in regulated charges for wholesale inputs. However, while wholesale regulation has supported competition in bundles, as we have discussed, it has clearly not been able to sufficiently protect these standalone customers.
- 1.20 Consequently, we consider we need to act directly in the retail market through regulation of BT's retail landline services.

### Retail price control

- 1.21 We are proposing to impose a price control on BT covering both line rental and calls as well as ancillary services for standalone landline telephone services.
- 1.22 This control – a price cut on the standard line rental of between £5-7 per month – will immediately reduce the gap between wholesale costs and retail prices we have seen emerge over the last few years. Thereafter BT will only be allowed to increase its charges for line rental and calls in line with inflation.<sup>10</sup>
- 1.23 The price cut will apply to all BT customers using standalone landline telephone contracts (whether or not they buy fixed broadband from BT or other telephone companies outside of a bundle). It does not apply to landline services sold by BT as part of a bundle of services, which include broadband or other services as we consider competition in this market is delivering good outcomes for consumers.

### Promoting competition

- 1.24 We believe that competition has the potential to deliver benefits for consumers in terms of price and choice. In order to stimulate competition, consumers must be sufficiently engaged to make well-informed decisions about switching to get a better deal. For this to happen, we believe that consumers need to have access to helpful, easy to understand information so that they can make more informed choices.

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<sup>10</sup> We discuss the options for the design of the price control in more detail at Section 8 of this document.



- 1.25 Therefore, we propose to require BT to work with us to trial – and, if appropriate, ultimately deliver – consumer information which will encourage its standalone landline customers to look for better value deals. There are significant challenges in effectively communicating with consumers who are not actively engaged in the market. Experience in other sectors, such as energy and banking, has shown that the degree to which the provision of consumer information affects consumer behaviour depends on details of exactly how it is presented and by whom. We therefore propose to trial various ways of providing consumer information which will help customers understand what they are buying and what alternatives they have to get better value for money.
- 1.26 Our aim in imposing these measures is to allow other providers to compete more vigorously in this market and to win customers. If the engagement remedies we are proposing are effective, we would expect consumers to benefit in terms of price and choice.

## Consultation and next steps

- 1.27 We invite comments on the proposals in this document. The consultation runs for 10 weeks and the deadline for responses is **9 May 2017**. Annex 1 provides further details of how to respond.
- 1.28 We are also considering whether there is a need for additional regulatory accounting obligations. If we decide this is necessary, we will consult on these separately.
- 1.29 We aim to publish our conclusions at the turn of the year.

## Section 2

# Introduction and background

- 2.1 In this section we introduce the Review of Standalone Landline Telephone Services 2017. We discuss briefly our concerns in retail fixed narrowband markets, the regulatory background of the fixed narrowband market in the UK, the scope of this review, the regulatory framework, including the process of market definition and assessing market power, and the impact assessments carried out in the context of this Review.

## Our concerns leading to this review

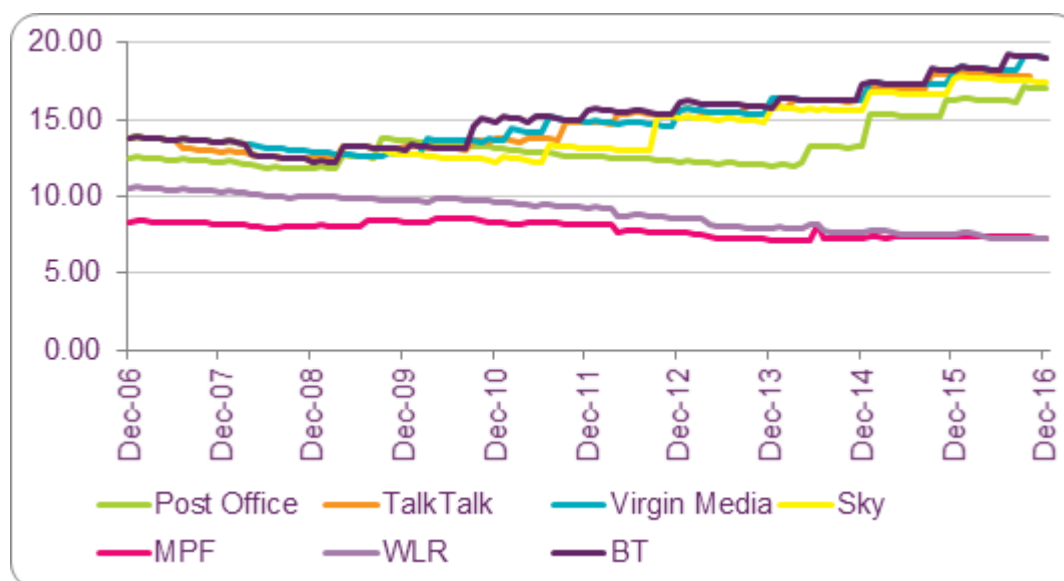
- 2.2 Since 2009, when we removed all regulation on BT in the retail voice telephony markets, many consumers have moved towards buying services in bundles, and this is where we have seen the focus of competition. In 2016, 68% of households reported buying at least two of their communication services in a bundle, with dual-play packages of landline and broadband and triple-play packages of landline, broadband and pay-TV being the most popular.<sup>11</sup> This percentage keeps rising.
- 2.3 Consumers purchasing bundled products have benefitted from competition in terms of prices and choice of products available. Whilst, until October 2016, consumers purchasing bundled products paid the same line rental charges as all other customers, the prices of the bundles they purchase did not increase in the same way. Indeed, in October 2016, the Advertising Standards Authority issued a ruling requiring communications providers (CPs) to no longer separate out line rental for bundles.<sup>12</sup> Broadband suppliers' price claims must therefore now show all-inclusive, up-front and monthly costs. Consumers purchasing bundled products including voice services therefore no longer pay a separate line rental charge.
- 2.4 We have identified concerns that competition is not benefiting standalone voice customers (i.e. those that do not purchase bundled products) to the same extent. There are currently 2.9 million households which take voice services outside a bundle, representing 11% of all residential landline users (i.e. including those that purchase landline services in a bundle). Whilst the number of such customers is declining over time, it is nevertheless likely to remain significant for the foreseeable future.
- 2.5 As Figure 2.1 shows, these customers have been progressively exposed to increasing line rental prices since 2010. This has been occurring despite wholesale charges for products used to provide line rental falling by up to 26% in real terms. Wholesale costs are represented by the WLR and MPF lines in Figure 2.1. These two wholesale products are used by providers to offer retail line rental services to consumers.

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<sup>11</sup> Ofcom, *The Communications Market Report 2016*, 4 August 2016, <https://www.ofcom.org.uk/research-and-data/cmr/cmr16>

<sup>12</sup> <https://www.asa.org.uk/News-resources/Media-Centre/2016/Changes-to-broadband-price-claims-in-ads-comes-into-force-today.aspx#.WK69c8FviCs>

**Figure 2.1: Wholesale and retail line rental price movements (£/month in December 2016 prices)**



Source: Ofcom/Pure Pricing UK Broadband Updates.

Notes: Adjusted for CPI; excludes line rental saver pre-payment tariffs

- 2.6 While some of the price increases may be due to rebalancing prices as fixed voice call revenue falls, declining wholesale costs suggest that CPs serving this market have been increasing their profitability.
- 2.7 We are particularly concerned that this trend affects a significant number of consumers who are elderly. As Figure 2.2 below shows, over half of these consumers are over 70.<sup>13</sup> Moreover, this group of consumers is generally more disengaged; Ofcom research has shown that 71% of consumers who use standalone landline services have never switched providers or considered doing so.<sup>14</sup> We are concerned that these customers are receiving poor value for money given the rising line rental charges which they face.

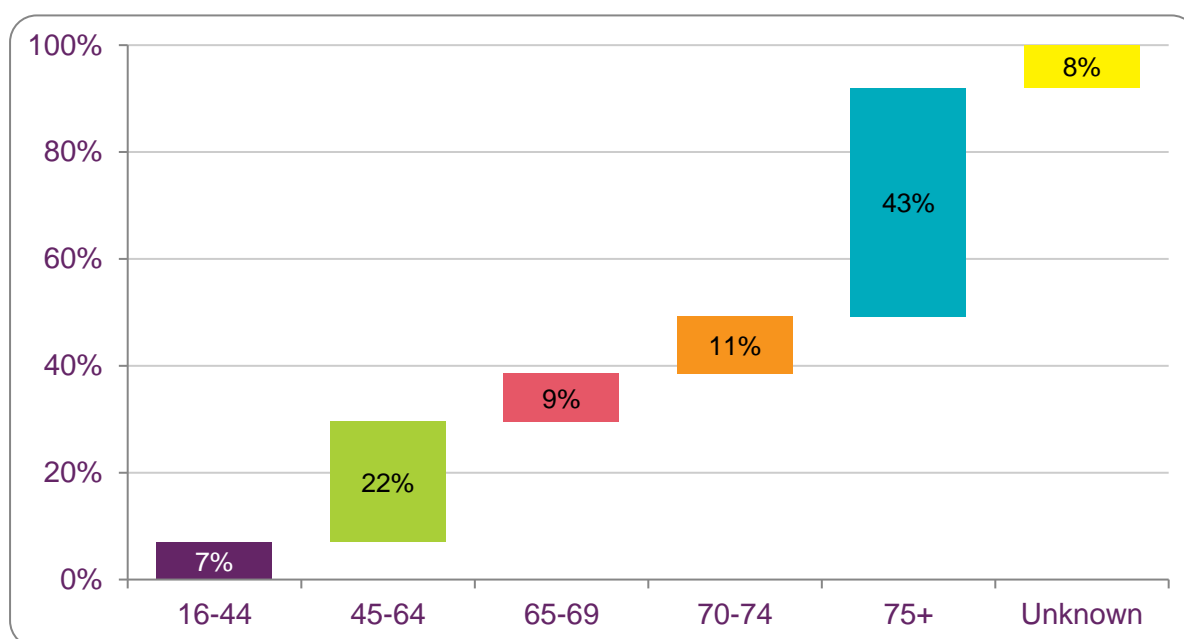
<sup>13</sup> Ofcom, *The Consumer Experience 2015*, 10 February 2016

[https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0012/51105/cer\\_2015\\_final.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0012/51105/cer_2015_final.pdf)

<sup>14</sup> Ofcom, *The Consumer Experience, 2015: Research Annex*, 10 February 2016

[https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0023/38543/annex.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0023/38543/annex.pdf)

**Figure 2.2: Residential standalone fixed voice consumers by age group**



Source: s.135 responses.

## Background to this consultation

### Retail regulation

- 2.8 Up until 2006, BT was subject to retail price regulation. In 2006, Ofcom<sup>15</sup> decided to allow retail price controls to lapse.<sup>16</sup> In doing so, we recognised, however, that certain groups of vulnerable consumers might require more protection than the average consumer who could switch easily.<sup>17</sup> In particular, we acknowledged that there may be some consumers for whom competition was weaker, leaving them vulnerable to price rises.
- 2.9 In 2009, we concluded that relevant retail markets were effectively competitive and BT no longer held a position of SMP in those markets. In light of that conclusion, we removed the remaining regulation which applied. We indicated that we would continue to monitor consumers' experience of these services and would intervene, if appropriate, in the future.

### Wholesale regulation

- 2.10 One of the ways in which an operator can offer services which compete with BT's retail fixed line voice services is through the purchase of wholesale line rental and wholesale call origination. Those services allow an operator to offer retail voice services over BT's infrastructure.

<sup>15</sup> Ofcom replaced Oftel as the regulator with responsibility for electronic communications markets from 29 December 2003.

<sup>16</sup> Ofcom, *Retail Price Controls*, Statement of 19 July 2006 ("2006 Retail Price Control Statement"), [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0012/42114/rpcstatement.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0012/42114/rpcstatement.pdf)

<sup>17</sup> 2006 Retail Price Control Statement, paragraph 1.13.

- 2.11 Ofcom imposes regulation requiring BT to offer such wholesale products to its competitors through market reviews to allow them to compete effectively at the retail level. BT has been required to provide wholesale line rental and wholesale call origination over a number of market reviews and that remains the case.
- 2.12 In December 2016, we published a consultation document setting out the initial findings of our current review of the wholesale narrowband markets (the 2016 NMR Consultation).<sup>18</sup> The closing date for responses for the wholesale narrowband market review is 29 March 2017. The markets relevant to this review are:
- Wholesale fixed analogue exchange lines (WFAEL): standard fixed lines used by residential consumers; and
  - Wholesale call origination (WCO): a complementary service to the provision on narrowband access lines, which enables consumers to make calls over those lines.
- 2.13 In the 2016 NMR Consultation document, we proposed that BT continues to have SMP in the WFAEL and WCO markets in the UK excluding the Hull Area. However, we have proposed not to impose charge controls, in favour of a fair and reasonable charges obligation, in recognition of the growing alternatives to traditional fixed voice services.

## Scope of the review

- 2.14 The concerns identified above have led us to conduct this review to determine if there are features of the retail market which mean that competition is not working well for consumers who take standalone fixed voice services and do not benefit from competition in bundled services. The starting point for this market review is therefore to consider the state of competition for residential consumers who take landline services but do not purchase them in a bundle (Standalone Fixed Voice (SFV) customers).
- 2.15 Our aim is to determine whether there is effective competition in the relevant markets, and if not, how best to regulate the behaviour of any companies that we find to have SMP.

## Hull area

- 2.16 We have always recognised that the retail markets in the Hull Area were distinct from those in the rest of the UK. The material differences in the sizes of these markets, the prospect of competitive entry and the relative cost of regulation on the incumbents (and the potential those costs are passed onto their customers) have led to differences in the nature of regulation. We have not extended this review to include an assessment of competition in the Hull area (and we explain in Section 3 why the relevant geographic market for the rest of the UK excludes Hull).
- 2.17 We note that KCOM has consistently set matching or lower prices than BT for fixed voice line rental and calls packages. We might therefore expect the impact of any regulatory intervention in the rest of the UK to flow through to retail conditions in Hull to the benefit of its consumers. If, subsequent to this review, we had evidence of

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<sup>18</sup> Ofcom, *Narrowband market review* ("2016 NMR Consultation"), 1 December 2016, [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0016/95011/Narrowband-Market-Review.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0016/95011/Narrowband-Market-Review.pdf)

significant detriment to consumers in the Hull area, we would consider what further action is required, including the possibility of a separate review for the Hull area.

## **Regulatory framework**

- 2.18 Sections 78-86 of the Communications Act 2003 (“the Act”) set out the procedure to be followed by Ofcom when undertaking market reviews. Section 91 of the Act contains additional provisions which apply to the conduct of market review in retail markets and is therefore relevant here.
- 2.19 We set out the applicable regulatory framework in Annex 7. In this section, we set out, in summary, what the market review process involves and the specific requirements that apply in relation to the regulation of retail markets.

## **Market review process**

- 2.20 The market review process is designed to assess the state of competition within a relevant market for the purposes of deciding whether or not regulation is required. Broadly, the market review process is carried out in three stages:
- we identify and define relevant markets in which regulation may be warranted;
  - we assess the state of competition in those markets to decide whether they are effectively competitive, which involves assessing whether any operator has significant market power (SMP); and
  - where we find SMP, we must impose remedies to address the competition problems identified in the relevant markets.
- 2.21 A finding of SMP is equivalent to a finding of dominance under competition law and means that an operator is able to act independently of its customers and competitors in a market. Where we identify SMP, we seek to impose appropriate remedies to address competition concerns, taking into account our duties in the Act, in particular our duty to act in the interests of consumers, where appropriate by promoting competition, and the need for regulation to be targeted only at cases in which action is needed.
- 2.22 Where we identify SMP in a retail market, the SMP Conditions which we can impose are set out in section 91. Such obligations may include requirements that the SMP operator does not charge excessive prices, inhibit market entry or restrict competition by setting predatory prices, show undue preference to specific end-users or unreasonably bundle services. We may therefore impose appropriate retail price cap measures, measures to control individual tariffs, or measures to orientate tariffs towards costs or prices on comparable markets, in order to protect end-user interests whilst promoting effective competition.

## **Relevant legal tests and statutory duties**

- 2.23 Any SMP condition we impose must satisfy the tests set out in section 47 of the Act, namely that the condition is:
- objectively justifiable in relation to the networks, services, facilities to which it relates;

- not such as to discriminate unduly against particular persons or against a particular description of persons;
  - proportionate to what the condition or modification is intended to achieve; and
  - transparent in relation to what is intended to be achieved.
- 2.24 In addition to the above requirements, section 91(2) requires us to only impose retail remedies where we are satisfied that the setting of conditions in wholesale markets would not address the concerns we have identified in the retail market. In Section 9 we set out how our proposed SMP Conditions satisfy the legal tests in sections 47 and 91 of the Act.
- 2.25 We set out in this document our analysis of competition in the relevant markets in accordance with the framework above. In doing so, we are required to have regard to a number of documents produced by the European Commission and the Body of European Regulators for Electronic Communications (BEREC), in particular the European Commission's Recommendation on Relevant Markets and SMP Guidelines.

## Impact assessment and equality impact assessment

### Impact assessment

- 2.26 The analysis presented in this document constitutes an impact assessment as defined in section 7 of the Act.
- 2.27 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of good practice policy-making. This is reflected in section 7 of the Act, which sets out that we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out impact assessments in relation to the great majority of our policy decisions. For further information about our approach to impact assessments, see our guidelines *Better policy-making: Ofcom's approach to impact assessment*.<sup>19</sup>

### Equality Impact assessment ('EIA')

- 2.28 Annex 4 sets out our EIA for this market review. Ofcom is required by statute to assess the potential impact of all our functions, policies, projects and practices on race, disability and gender equality. EIAs also assist us in making sure that we are meeting our principle duty of furthering the interests of citizens and consumers regardless of their background or identity.
- 2.29 We have considered whether these proposed remedies would have an adverse impact on promoting equality. In particular, we have considered whether the remedies would have a different or adverse effect on UK consumers and citizens with respect to the following equality groups: age, disability, sex, gender reassignment, pregnancy and maternity, race, religion or belief and sexual orientation, and, in Northern Ireland, political opinion and dependants. We consider that our proposals will not have a detrimental impact on any equality group.

<sup>19</sup> [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0026/57194/better\\_policy\\_making.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0026/57194/better_policy_making.pdf)

- 2.30 Further, we do not propose to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This is because we anticipate our proposed regulatory intervention would not have a differential impact on people of different genders or ethnicities, consumers with protected characteristics in Northern Ireland or on disabled consumers compared to consumers in general.
- 2.31 Rather, we consider that the proposals set out in this consultation would further the aim of advancing equality of opportunity between different groups in society by furthering the interest of all consumers in the retail fixed voice markets.

## **Document structure**

- 2.32 The structure of this document follows the structure of our analysis and is set out as follows:
- First we define the relevant retail markets and identify SMP within those markets (Sections 3, 4 and 5), and;
  - Set out a suite of potential remedies (Sections 6, 7 and 8), before;
  - Detailing our proposals (Section 9).
- 2.33 We are also publishing Annexes to this consultation document which support our main conclusions. These include the draft legal instruments which would implement our proposed remedies.

## **Next steps**

- 2.34 The questions we are seeking responses are set out at each of the relevant section. For ease we have listed all the consultation questions at Annex 3. Details about how to respond to the consultation are set out at Annex 1. Responses must be sent to Ofcom by 9 May 2017.



## Section 3

# Retail market definition

## Introduction and summary

- 3.1 This Section sets out our provisional market definition assessment for residential Standalone Fixed Voice (SFV) services in the UK. As explained in Section 2, SFV services are landline services that are not sold as part of a bundle with non-voice services. This includes access (i.e. line rental) and calls.
- 3.2 In the 2009 Review we defined the following relevant fixed narrowband markets in the UK (excluding the Hull Area):
  - 3.2.1 Residential Fixed Narrowband Analogue Access;
  - 3.2.2 Residential Fixed Narrowband Calls;
  - 3.2.3 Business Fixed Narrowband Analogue Access;
  - 3.2.4 Business Fixed Narrowband Calls.
- 3.3 Consistent with our conclusions in the 2009 Review, we have provisionally concluded that:
  - 3.3.1 A relevant market exists for the provision of SFV access in the UK, excluding the Hull Area. This includes sales to voice-only customers and split purchasers and is limited to residential services.
  - 3.3.2 A relevant market exists for the provision of SFV calls (i.e. fixed voice calls sold to SFV access customers) in the UK, excluding the Hull Area. As for access, this includes sales to voice-only customers and split purchasers and is limited to residential services. We take account of substitution to mobile calls as an out-of-market constraint at paragraphs 3.85-3.96 below.
- 3.4 After considering the two relevant markets identified against the three criteria test, we have provisionally concluded that they are both susceptible to *ex ante* regulation.
- 3.5 We present the analysis and findings underlying our proposals in the following order:
  - 3.5.1 Approach to market definition;
  - 3.5.2 Retail product market definitions;
  - 3.5.3 Retail geographic market definitions;
  - 3.5.4 Provisional conclusions on market definitions;
  - 3.5.5 Application of the EC's three-criteria test to the relevant market(s).

## Approach to market definition

- 3.6 The market review procedure requires us to analyse markets in order to determine whether they are effectively competitive, and then to decide on appropriate remedies

if necessary. Before an assessment of competitive conditions is possible, it is necessary to define the relevant market.

- 3.7 The market definition exercise is not an end in itself, but a means to assessing whether there is effective competition and thus whether there is a need for *ex ante* regulation. It is in this light that we have conducted our market definitions in this review.
- 3.8 We set out our approach to market definition in Annex 7. This approach includes two principal stages. First, we identify the products that will be the starting point of our analysis (i.e. the focal product). Next we consider whether there is a case for broadening the market to include other products. In doing so, we:
- 3.8.1 Apply the “Hypothetical Monopolist Test” (HMT, also called the SSNIP test), which considers whether a hypothetical monopolist could profitably impose a small but significant non-transitory increase in price (a SSNIP) above competitive prices in the candidate market. If demand-side substitution to, or supply-side substitution from, alternative services is sufficient to render the price increase unprofitable, then the market should be widened to include these services, and the HMT should be repeated on this broader candidate market.
- 3.8.2 Consider whether other products exist which face the same competitive conditions as the focal product, and/or a common pricing constraint. If so, it will generally be appropriate to include such products within the candidate market.

## Product market definition

### Focal product

- 3.9 In defining relevant product markets, we start by considering the narrowest set of services which might fall within a relevant market and add additional products or services depending on whether competition from those products or services constrains the price of the main product or service in question.<sup>20</sup> First, we therefore determine the focal product for the analysis. The concerns which have given rise to this review concern the supply of standalone landline services.<sup>21</sup> We have therefore taken this as a starting point in our consideration of the appropriate focal products.

### Our focal products include residential services only

- 3.10 The concerns expressed in the DCR relate to the purchase of standalone landline services for residential customers. The starting point for our consideration is therefore SFV services that are available to residential customers, excluding services that are only available to businesses.
- 3.11 We note that a significant proportion of SMEs, particularly smaller businesses, purchase residential lines. Around 30% of all SMEs do not have a business-specific contract: 31% for those with 1-9 employees, 10% for those with 10-49 employees and 5% for those with 50-249 employees. In total, 9% of SMEs purchase a

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<sup>20</sup> SMP Guidelines, paragraph 41.

<sup>21</sup> DCR, paragraph 7.9.

(residential) SFV service.<sup>22</sup> With 5.4 million SMEs in the UK, this would suggest around 490,000 out of 2.9 million SFV customers are SMEs – around 17%. We include these customers in our focal product.

- 3.12 In paragraphs 3.53-3.55 below we consider whether or not the relevant market should be broadened to include SFV services offered to businesses.

### Separate markets for access and calls

- 3.13 The Explanatory Note to the 2014 EC Recommendation states that at the retail level “fixed calls services ... are more often bundled with the access to the fixed network/narrowband service”.<sup>23</sup> This is consistent with evidence for the UK market.<sup>24</sup>

- 3.14 There has been a marked decline in consumers using different suppliers of calls and access lines over the last decade. Rather, access and calls are almost invariably bought in a bundle. Survey evidence suggests that:

3.14.1 The proportion of residential consumers purchasing residential access and calls services from separate suppliers has diminished to negligible levels. In 2015, only 1% of residential survey respondents said that they had a landline to make calls and used separate suppliers for calls and access. This is compared to 14% of respondents reporting that they used different suppliers in 2009.<sup>25</sup> However, to the extent that SMEs purchase residential SFV services, they may use separate suppliers to a greater extent. Between 18% and 25% of SMEs continue to purchase access and calls from separate CPs.<sup>26</sup>

3.14.2 We do not have survey evidence for customers purchasing residential SFV services only, however, our analysis shows that a significant majority purchase calls and access from the same supplier. If we assume that a) 1% of all customers who purchase residential services have separate suppliers for calls and access and b) all of these customers have SFV lines, this would account for only 9% of total SFV lines.<sup>27</sup>

- 3.15 However, while consumers typically purchase a bundle of access and calls, there is scope for differences in competitive conditions between the two, and in particular SFV calls may face stronger price constraints than SFV access.

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<sup>22</sup> Based on data provided to Ofcom by Jigsaw as part of *The SME experience of communications services: research report*. Note that this statistic does not appear in the report.

[https://www.ofcom.org.uk/data/assets/pdf\\_file/0030/96348/Ofcom-SME-consumer-experience-research-2016-Report.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0030/96348/Ofcom-SME-consumer-experience-research-2016-Report.pdf)

<sup>23</sup> EC, *Explanatory Note to the 2014 EC Recommendation*, p. 25, <https://ec.europa.eu/digital-single-market/en/news/explanatory-note-accompanying-commission-recommendation-relevant-product-and-service-markets>

<sup>24</sup> The evidence we have on the bundling of access and fixed call services is for the total market for residential fixed voice services, rather than specifically for voice-only consumers.

<sup>25</sup> Ofcom, 2016 Narrowband Market Review Consultation (“2016 NMR Consultation”), footnote 110, found at [https://www.ofcom.org.uk/data/assets/pdf\\_file/0016/95011/Narrowband-Market-Review.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0016/95011/Narrowband-Market-Review.pdf)

<sup>26</sup> 2016 NMR Consultation, paragraph 4.26, found at [https://www.ofcom.org.uk/data/assets/pdf\\_file/0016/95011/Narrowband-Market-Review.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0016/95011/Narrowband-Market-Review.pdf)

<sup>27</sup> 1% of all residential lines in the UK (26.4 million in Q3 2016) refers to approximately 264k lines. If we assumed all these were SFV lines, they would account for only 9% (i.e. 264k / 2.9 million) of all SFV lines.

- 3.16 A customer might respond to prevailing prices for calls in a number of ways, such as making fewer out-of-bundle calls, or switching to a less generous call allowance and limiting the fixed voice calls they make in order to stay within this allowance (e.g. by avoiding making calls at times of the week when they are not “free” under the allowance). It is possible that some SFV customers could respond to the price of calls in this way while making fewer, or shorter, calls overall.
- 3.17 In addition, the potential for call-by-call substitution means the nature of substitution has the potential to differ significantly between access and calls. In particular, around 70% of SFV customers have mobile phones, and there is scope for these customers to make more calls on their mobile phone instead of their fixed line. In many cases this may be at zero marginal price because post-pay mobile packages often include an allowance of free calls.
- 3.18 In contrast, the price of the landline may not be subject to the same degree of pricing constraint, because for many consumers giving up their landline would be a bigger decision than deciding whether to make more calls on their mobile phone. For example, consumers may have concerns about missing calls from people who only have their landline number, the cost of making international calls via mobile, or the reliability of mobile phone connections in emergencies.
- 3.19 Survey evidence also suggests that, while the majority of residential landline customers said they think about the costs of line rental and calls together, a sizable minority (21% of residential survey respondents) still report considering them separately.<sup>28</sup> In addition, we noted above that some SMEs continue to purchase access and calls from separate CPs.
- 3.20 Overall, we therefore consider it is appropriate to analyse access and calls as separate markets, because there is scope for a difference in competitive conditions between them. This is consistent with the approach that we adopted in the 2009 Review.

#### Our starting point does not include services offered to split purchase customers

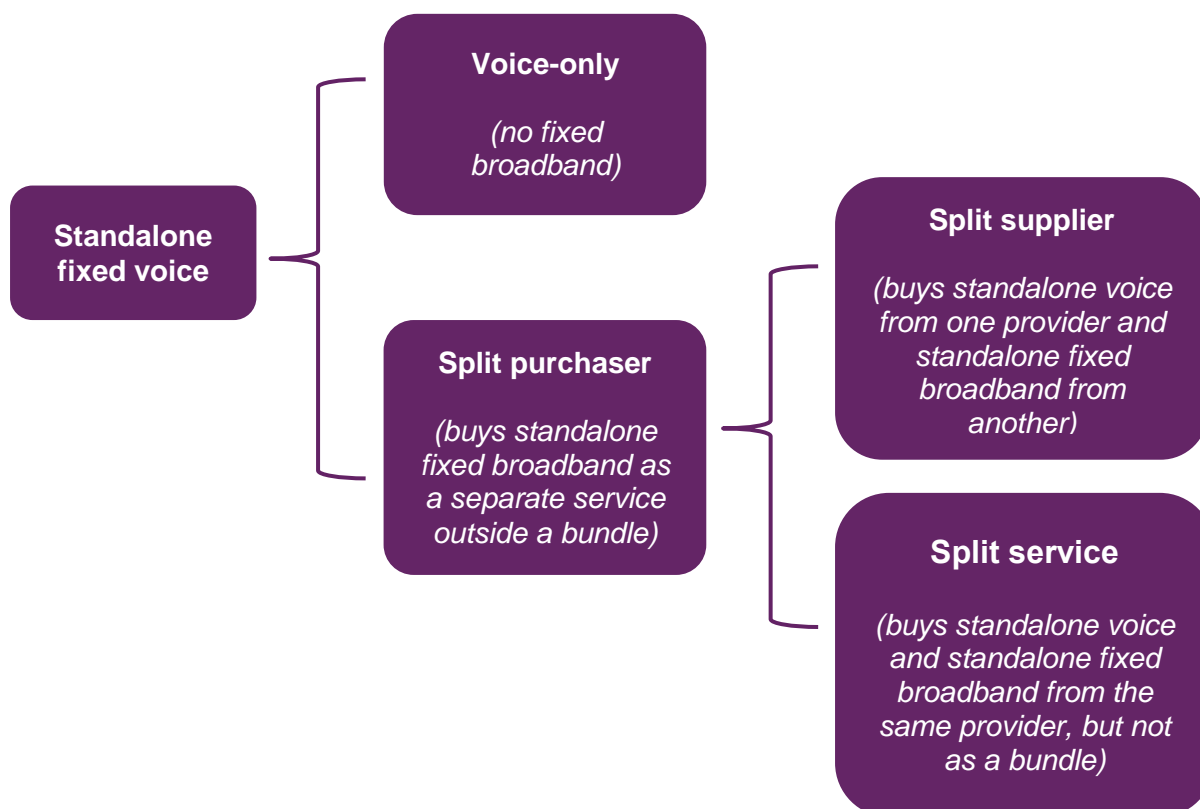
- 3.21 SFV services are sold to three customer segments (see Figure 3.1):
- 3.21.1 Voice-only customers, who have no fixed broadband service;<sup>29</sup>
  - 3.21.2 Split purchase customers, who have fixed broadband but not as part of a bundle, and who are either:
    - a) Split-supplier customers, who buy fixed broadband from a different provider than their SFV service; or
    - b) Split-service customers, who buy fixed broadband from the same provider as their SFV service (but not as part of a bundle).

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<sup>28</sup> 2015 Jigsaw residential survey (wave 1).

<sup>29</sup> These customers may or may not have access to mobile and/or pay TV services.

**Figure 3.1: Customer groups within SFV<sup>30,31</sup>**



3.22 As set out above, in determining the starting point of our analysis, we are seeking to determine the narrowest set of products and services which may form part of the relevant market. Whilst our concerns leading to this review are around the supply of landline services on a standalone basis, including all three customer segments, we have taken a narrower group of voice-only customers for our focal product. This is so that we explicitly address the question below of whether or not split-purchase customers should be included in the same market as voice-only customers.

### Focal product for access

3.23 We note that access services are typically offered to SFV customers as part of packages which include line rental and a call allowance.

3.24 BT, for example, does not offer a standalone line-rental product - its standard line rental has an inclusive call allowance for calls at weekends at no additional price ("Unlimited Weekend Calls" package). BT also offers a number of optional packages which include different call plans at an incremental price to line rental (e.g. "Unlimited Evening & Weekends Calls") and the "Home Phone Saver" product which offer access, calls and some ancillary services for a single package price. BT customers can pay their line rental annually in advance and receive a 10% discount for doing so (BT call this Line Rental Saver). Other CPs similarly offer a range of call plans, with

<sup>30</sup> 'Voice-only' is equivalent to the 'fixed voice-only' category discussed in our 2016 NMR Consultation (footnote 76 in Section 3), [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0016/95011/Narrowband-Market-Review.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0016/95011/Narrowband-Market-Review.pdf)). In the NMR Consultation, we at times use the term 'split purchaser' to mean 'split supplier' customers (footnote 118 in Section 4). In this document, we use 'split purchaser' to mean the combination of 'split-supplier' customers and 'split-service' customers.

<sup>31</sup> A small proportion of split-service customers buy SFV and a separate dual-play service, rather than a separate standalone broadband service.

small differences to BT's products (although we are not aware of any CP offering a product that is comparable to BT's Home Phone Saver).

- 3.25 The focal product of our analysis includes the line rental services which are provided as part of these packages. Any call services provided as part of these packages (whether they are provided at an incremental price to line rental or not) are included in our focal product for calls.<sup>32</sup>
- 3.26 BT also offers BT Basic, which is a product that is only available to a limited number of eligible customers.<sup>33</sup> The BT Basic package offers line rental and a limited call allowance for a much lower price than BT's other packages (see Annex 8, paragraph A8.111-A8.113). Given that BT Basic is a somewhat different product, available to only a small subset of households at a considerably lower price, we have not included it in our focal product. We nonetheless consider below (paragraphs 3.50-3.53) whether BT Basic should be included in the market on the basis of being a substitute for standard packages.
- 3.27 We discuss the focal product for calls as part of our product market definition for calls (see paragraphs 3.72-3.74)

### **Product market definition for access**

- 3.28 In assessing whether the relevant market is broader than our starting point of voice-only access, we consider the following questions:
- 3.28.1 Are dual play services in the same market as SFV services bought by voice-only customers?
  - 3.28.2 Are dual play services in the same market as SFV services bought by split purchase customers?
  - 3.28.3 Are SFV services bought by split purchase customers in the same market as SFV services bought by voice-only customers?
- 3.29 We then consider whether the relevant market includes:
- 3.29.1 BT Basic;
  - 3.29.2 business services;
  - 3.29.3 mobile services; and
  - 3.29.4 fibre based services.

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<sup>32</sup> We note that calls that are inclusive with the line rental cannot be bought separately from access, so there is an argument to include them in the focal product for access. However, for simplicity, we have instead included them in the focal product for calls. This has no material effect on our analysis of SMP for access and calls.

<sup>33</sup> As far as we are aware, no other CP in this market offers an equivalent to BT Basic (KCOM, which operates in the Hull area, also has a Social Access Package available to customers in receipt of certain state benefits). Virgin's Talk Protected tariff has some similar features in offering additional inclusive calls and other features to eligible customers. However, the eligibility criteria differ from BT's package, being based on age or certain disabilities. More detail on this tariff is set out in paragraph A8.118 in Annex 8.

### Dual-play services are not in the same market as SFV services bought by voice-only customers

- 3.30 CPs offer fixed voice services bundled with other communication services, e.g. broadband, pay TV or mobile. These multi-play bundles are usually sold at a discount compared to the price of purchasing the individual components separately from different providers (or the same provider). As illustrated in Figure 1.1 in Section 1, dual-play (voice and broadband) and triple-play (voice, broadband and pay TV) bundles are particularly common. We focus on dual-play as the closest candidate substitute to SFV services bought by voice-only customers.
- 3.31 We consider whether the availability of dual-play bundles imposes competitive constraints on the provision of voice-only access. The strength of any such constraint will depend on whether enough voice-only customers are likely to switch to dual-play in response to a SSNIP to make the SSNIP unprofitable.
- 3.32 As set out in Annex 7 the relevant question for the SSNIP test is whether a price increase could be sustained above competitive levels. Our analysis is that current SFV access prices are in fact substantially above competitive levels, on the basis that:
- 3.32.1 Prices have increased materially year on year since 2009, and these increases cannot be attributed to higher input costs (indeed the largest input cost, WLR, has fallen over this time period) or falling call volumes (Figure A8.23 in Annex 8).
- 3.32.2 Our analysis is that provision of SFV services by CPs is highly profitable and profitability has been increasing over time (see Annex 5).
- 3.33 In these circumstances, the application of a SSNIP test starting from the current SFV access prices does not provide a reliable indicator as to whether dual play services are in the same relevant market. This is because, a SSNIP applied to the current prices of SFV services could be unprofitable if such prices are substantially above competitive levels, whereas it could be profitable if the SSNIP were applied to competitive prices.
- 3.34 We also note that the price of SFV services (line rental and calls) has generally been increasing at a faster rate than ADSL dual-play prices.<sup>34</sup> We compared average prices between Q1 2013 and Q3 2016 in real (inflation-adjusted) terms. On this basis, the price of SFV services increased by 17% (£3.20), compared to a 15% (£4.92) increase in standard (non-promotional) ADSL dual-play prices, but a 7% (£2.10) decrease in ADSL dual-play prices including promotions.<sup>35</sup> Prices of dual-play bundles have historically included the same line rental prices as for SFV customers, and an incremental broadband price, which generally has been the focus of competitive activity for bundles. Comparing the price of SFV services against promotional prices for ADSL bundles, the average incremental cost of upgrading from SFV to a promotional ADSL dual-play package has decreased, on average, by 53% (£5.30).<sup>36</sup>

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<sup>34</sup> For more details, see Annex 8, paragraphs A8.130-A8.137.

<sup>35</sup> *Simplify Digital*.

<sup>36</sup> *Simplify Digital*.

- 3.35 We have considered whether, in principle, dual play services could impose competitive constraints on prices to voice-only customers, on the basis that:
- 3.35.1 It is possible for consumers to make a price-quality trade-off, i.e. responding to a SSNIP by switching to a product with a higher price, if the additional services included in that product (i.e. broadband) make it worth the higher price.
  - 3.35.2 Accordingly, voice-only customers could potentially switch to dual play, even if they did not place much value on broadband, if the incremental price of broadband were small enough. As set out in Annex 8 paragraph A8.130, the promotional price of an ADSL dual-play service is, on average £6.18 (35%) more expensive than the line rental price offered by the main SFV providers. In this context, we note that the incremental price of broadband in a dual-play offer, above the current price of standalone voice, has decreased materially in recent years.
- 3.36 Our assessment is that voice-only customers are unlikely to be making a price-quality trade-off between their current service and dual-play, in sufficient numbers to provide a competitive constraint on SFV prices:
- 3.36.1 While price-quality trade-offs can in principle put differently-priced products in the same market, substitution requires customers to derive a utility from the higher quality or additional features sufficient to compensate them for the higher price.
  - 3.36.2 In practice both standalone voice and dual-play are mature markets. To conclude that dual-play was part of our relevant market on a forward-looking basis, we would need to expect that a material number of voice-only customers, who have not taken up fixed broadband yet, would do so in response to a moderate increase in the price of SFV services. From our survey research, 68% of voice-only respondents said that the reason they do not take a bundle which includes broadband was that they do not use broadband. A much smaller proportion (8%) said they did not take a bundle including broadband due to the price of fixed broadband.<sup>37</sup> This suggests the relative price of a service with and without broadband is not the driving factor for not taking up broadband for the majority of voice-only customers.
  - 3.36.3 We have received internal pricing documents from BT and other CPs relating to their decisions to increase line rental in recent years. [redacted].<sup>38</sup>
  - 3.36.4 From the perspective of a provider of SFV access, any pricing constraint could be increased by the possibility that once a customer has switched to dual-play they may be unlikely to return to standalone voice in response to a change in the relative price (e.g. a reduction in the price of standalone voice).
  - 3.36.5 We also note that all providers of SFV access to voice-only customers also offer dual-play bundles. A hypothetical monopoly provider of SFV access to voice-only customers could therefore expect that if any of these customers switched to dual-play in response to a SSNIP, some of these would switch

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<sup>37</sup> 2015 Jigsaw residential survey (wave 1).

<sup>38</sup> [redacted].



to its own (the hypothetical monopolist's) dual-play service.<sup>39</sup> Offering competitive dual-play prices alongside line rental price increases may be a more effective way for SFV suppliers (or a hypothetical monopolist in SFV) to compete for voice-only customers who are considering buying fixed broadband as well, compared to keeping line rental prices lower. This would be consistent with the historical pattern of price changes.

- 3.36.6 In addition, as explained above, the availability of dual-play has not prevented SFV price rises from taking place in practice.
- 3.37 In some instances, dual-play bundles have been sold at prices that are close to or below landline-only packages.<sup>40</sup> If such offers were widely available, SFV service customers could save money by switching to a dual-play bundle at a lower price, even if their valuation of the broadband element of dual-play were zero. However, we do not consider that dual-play offers priced below landline-only packages place a competitive constraint on the price of SFV services in practice, because:
- 3.37.1 To the extent that such offers have been available, this has been in the context of introductory or promotional prices which were available for a limited period.
- 3.37.2 While it is possible that former SFV access customers have responded to such dual-play offers (i.e. those priced close to or below landline-only packages) by switching to dual-play, the evidence we have does not provide support for this point. While the number of SFV access customers has been declining over time, the rate of decline has slowed from 20% year on year up to Q4 2015, to around 15% year on year up to Q3 2016 (see Figure A8.4 in Annex 8), which does not appear to provide clear support for the proposition that SFV customers respond in large numbers to specific dual-play offers.
- 3.37.3 As we have set out in paragraphs 6.3-6.6, our view is that prevailing line rental prices are well above competitive levels for SFV access. We estimate later in this document that competitive line rental prices for SFV access would be more than £5-£7 per month below current levels (see paragraphs 8.19-8.30). With line rentals at these levels, no currently or recently available dual-play offers would be cheaper than SFV prices.
- 3.38 We provisionally conclude that dual-play services are not in the same market as SFV services bought by voice-only customers. In particular, this is supported by our assessment that SFV access prices (and profits) are substantially above competitive levels, which would not be sustainable if they were constrained by competition from dual-play.

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<sup>39</sup> The extent of this would depend on (a) the competitiveness of the hypothetical (SFV) monopolist's dual-play offers and its prominence in the dual-play market, and (b) the extent to which its voice-only customers contacted it before switching, giving it the opportunity to upsell them to dual-play as a retention activity.

<sup>40</sup> For example, in Ofcom's Consumer Experience Report 2015 (p. 26) we noted that Sky offered ADSL broadband free for a year (with line rental payable) increasing to £10 a month thereafter. [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0023/38543/annex.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0023/38543/annex.pdf)

### Dual-play services are not in the same market as SFV services bought by split purchase customers

- 3.39 As set out above (paragraph 3.21), SFV access is bought by two different types of customers: voice-only customers, and split purchase customers – i.e. customers who also purchase broadband services either from a different supplier (split-supplier customers) or on a standalone basis outside a bundle from the same supplier (split-service customers). Although split purchasers buy the same SFV access product as voice-only customers, the combination of products that they purchase (SFV and broadband services) could be considered as functionally equivalent to dual-play services. We have therefore considered these two services in reaching our view on the boundaries of the relevant product market.
- 3.40 There is evidence that split-supplier customers<sup>41</sup> are on average younger and of higher socioeconomic grade than voice-only customers (see Figure A8.49 of Annex 8), and, by definition, have internet access (unlike the majority of voice-only customers<sup>42</sup>). For these reasons, they are arguably more likely to be aware of alternative offers and/or engaged in the market. Consistent with that, we set out in Annex 8 some survey-based evidence that split-supplier customers may be more engaged than voice-only customers (15% compared to 6%),<sup>43</sup> with broadly similar levels of engagement to dual-play customers (20%) (see figure A8.51).
- 3.41 However, we consider that observed outcomes are not consistent with the existence of a competitive constraint from dual play services to the prices for standalone services paid by split purchasers:
- 3.41.1 Our analysis (see Annex 8, Figure A8.43) shows that on average a split purchaser paying a combined price for standalone voice from BT<sup>44</sup> and standalone broadband from BT, Sky or TalkTalk could save £8 per month (more than 20%) by switching to an equivalent dual-play service from their broadband provider at standard prices, and just over £14.50 per month (more than 35%) at promotional dual-play prices. If dual-play was a close enough substitute to competitively constrain the combined prices for functionally equivalent voice and broadband services purchased on a standalone basis by split purchasers, we would not expect these price differences to be sustainable.<sup>45</sup>

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<sup>41</sup> As explained in Annex 8 when discussing survey evidence, we refer to split-supplier customers, who account for around 80% of split purchasers.

<sup>42</sup> 4% of voice-only customers reported having mobile broadband in the Jigsaw residential survey. See paragraph A8.128, in Annex 8.

<sup>43</sup> This difference is statistically significant (at the 95% confidence level). Unless otherwise stated, all direct comparisons of survey evidence between customer groups in this section are statistically significant.

<sup>44</sup> The evidence (discussed in more detail in Section 4, paragraph 4.22-4.23 and Annex 8 – supporting evidence is that nearly all split purchasers buy standalone voice from BT, whereas they buy standalone fixed broadband from a range of broadband suppliers.

<sup>45</sup> The number of SFV service customers has been declining over time, at a broadly consistent rate (although a slower rate in recent quarters). While we do not have clear evidence on this point, it is possible that a substantial number of split purchase customers have switched to dual-play services. However, this has not led to a competitive outcome of the remaining split purchasers paying similar combined prices to dual play customers. If we consider split purchasers taking SFV from a hypothetical monopolist, if some of those customers are marginal – i.e. willing to switch in response to a SSNIP on SFV – one of their choices is to switch to a dual-play service from their supplier of SFV,

- 3.41.2 In addition, as noted above, prices for SFV access have been increasing on an annual basis. This has not been prevented by the potential for, and existence of, split purchasers switching to dual play bundles over this period (such switching is likely to explain, to some extent, the material decline over time in the number of SFV customers).
- 3.41.3 While the number of SFV customers has been falling over time, and this is likely to include a proportion of former split-purchase customers switching to dual-play, there remains a sizeable group of split purchasers (about 1.2 million) who have not responded to these price increases by switching to dual-play. Reported annual switching rates are equally low for both voice-only and split supplier customers (3%) compared to dual play (12%) (see Annex 8, Figure A8.55). In view of this, on a forward-looking basis we consider that the remaining split purchasers are unlikely to switch to dual-play in response to a SSNIP in sufficient numbers to constrain SFV prices to competitive levels.
- 3.42 We also note that:
- 3.42.1 We have attempted to compare the changes over time in the combined price paid by split purchasers for standalone voice and broadband with the changes over time in prices for comparable dual-play bundles. However, we do not have data on the change in prices of standalone broadband services over time.<sup>46</sup> Based on the available evidence (see paragraph 3.34 above), we note that the prices of SFV services have increased by a faster rate than the price of ADSL dual-play services. Whether the combined price to split purchasers has increased at a faster rate than comparable dual-play services turns on the change in standalone broadband prices, on which we do not have evidence. However, we note that, unless standalone broadband prices to split purchasers have been (at most) increasing at a somewhat slower rate than dual-play prices over this period, the services bought by split purchasers may be increasingly poor value relative to dual-play services;
- 3.42.2 As set out in Section 8, our analysis indicates that SFV services for both voice only and split-purchase customers have been highly profitable. We would not expect providers of SFV services to split purchasers to be able to sustain such a high level of profitability if they were facing competitive constraints from dual-play services; and
- 3.42.3 [redacted].<sup>47</sup>
- 3.43 For these reasons, we consider that SFV services bought by split purchasers are not in the same market as dual-play services.

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instead of switching their SFV service. A possible implication of this is that, from the perspective of the hypothetical monopolist, the more effective way of retaining any marginal split purchase customers may be to offer them a competitive dual-play bundle, rather than holding down the price of SFV services.

<sup>46</sup> However, we note that TalkTalk's standalone broadband price has recently increased from £20.30 to £22.30 – a 10% increase.

<sup>47</sup> [redacted].

SFV access bought by split purchasers is in the same market as SFV access bought by voice-only customers

- 3.44 The provision of access as part of a SFV service is the same product at the same price regardless of whether the customer is a voice-only consumer or a split purchaser buying standalone broadband separately. Given that they purchase identical products under identical terms, voice-only customers and split purchasers would in principle fall under the same market.
- 3.45 We recognise, however, that there might be reasons to exclude different customer groups from the relevant market even where such groups purchase the same service. For example, the OFT market definition guidelines mention that “*Where a hypothetical monopolist would (or would be likely to) price discriminate significantly between groups of customers, each of these groups may form a separate market. If so, a relevant market might be defined as sales of the relevant product in the relevant geographic area to a particular customer group.*” (para 3.19). In such circumstances of price discrimination, the two groups of customers would not face a common pricing constraint.
- 3.46 CPs are not generally sure which of their customers are voice-only customers or split-supplier customers (i.e. they do not necessarily know whether customers are getting a standalone broadband service from elsewhere). Accordingly, to date BT and other CPs have not charged different prices for SFV services depending on whether the customer is voice-only or a split purchaser.
- 3.47 In the case of split-service customers, who take both SFV and standalone broadband services from the same provider, the CP should be aware that they are split-purchase customers. However, we understand that to date these customers have paid the same price for SFV services as voice-only customers.
- 3.48 It is possible that CPs could take steps to identify which of their SFV customers also buy broadband separately, and price discriminate between these customers and voice-only customers. However, to date CPs have not done this, nor have they price discriminated where they already know this (i.e. in the case of split-service customers). While we cannot rule out the possibility of such price discrimination taking place in future, we do not consider that this evidence indicates that a hypothetical monopolist of SFV services would, or would be likely to, price discriminate significantly between voice-only and split purchase customers.<sup>48</sup>
- 3.49 We therefore provisionally conclude that the relevant market is at least as broad as the provision of SFV services (i.e. to both voice-only and split purchase customers).<sup>49,50</sup>

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<sup>48</sup> If there was such price discrimination between voice-only and split purchase customers, it might imply two narrower, separate markets for SFV access services, one for voice-only and the other for split purchasers (noting our provisional conclusions above that dual play bundles are unlikely to competitively constrain SFV to either voice-only or split purchase customers).

<sup>49</sup> In the case of BT, this includes the Standard Line Rental, Standard Line Rental Saver and Home Phone Saver 2019 as per the current BT Consumer Price List (effective from 10 February 2017).

<sup>50</sup> As customers of standalone voice services comprise two distinct groups – voice-only and split purchasers – it is possible in principle that enough marginal customers from either group (or both groups in combination) would be willing to switch to dual-play in order for us to include dual-play in the relevant market. We have considered separately the willingness of each group to switch to dual-play. However, on the basis of the above analysis, our view is that not enough marginal customers in either

### The relevant market does not include BT Basic

- 3.50 BT Basic is a product that is available to consumers who are on specific low income government benefits and offers a limited service at a much lower price than a comparable service at standard prices. It is offered at £5.10], which is 27% of BT's standard monthly line rental of £18.99 – see paragraph A8.112, Annex 8). This includes a £1.50 monthly call allowance, which would allow the customer to make around ten one-minute calls or one thirteen-minute call in a month. Subsequent calls are charged on a per-minute rate, up to a £10 per month cap for calls to UK geographic and UK mobile numbers which is subject to a fair-use policy.
- 3.51 There are a number of barriers to SFV customers switching to BT Basic in response to a SSNIP:
- 3.51.1 Many SFV customers would not be able to switch to BT Basic due to the eligibility criteria.
  - 3.51.2 The restricted features of BT Basic, in comparison to other packages, are likely to make it unattractive or unsuitable for at least some of those who are eligible but have not yet switched.<sup>51</sup>
  - 3.51.3 Awareness of BT Basic is limited. Ofcom research in 2014 found that 70% of those eligible for BT Basic were unaware of it.<sup>52</sup>
- 3.52 To the extent that there are any SFV customers who (a) are eligible for BT Basic, (b) are aware of it, and (c) do not consider it unsuitable for their needs, such customers already have a strong incentive to switch to it in the large price discount available relative to other SFV services, and hence the large savings they could potentially make by switching.<sup>53</sup> The fact that they have not responded to this incentive by switching makes it unlikely that they would respond to a SSNIP by switching to BT Basic, to an extent that would constrain the price of SFV services. Even if awareness and take-up of BT Basic increases in future, any potential constraint on SFV prices will be limited by the sharp differences in terms and conditions from SFV packages and the associated barriers to switching due to eligibility and suitability.
- 3.53 In light of this, we do not consider that the price of SFV access is constrained by the ability of consumers to switch to BT Basic in response to a SSNIP on the price of their package.

### The relevant market does not include business SFV access

- 3.54 SFV access services are available to business customers with broadly comparable line rentals but different call packages – for example, BT offers 100 free UK calls per month or unlimited UK calls for an extra £10, rather than having free calls at evenings and/or weekends (which would be unsuitable for many businesses). We also note

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group, or across both groups in combination, are willing to switch to dual-play to constrain SFV prices to competitive levels.

<sup>51</sup> The £10 per month cap, which was introduced in December 2016, may make the service suitable for some eligible consumers for whom it was not previously suitable.

<sup>52</sup> See Ofcom, *Results of research into consumer views on the importance of communications services and their affordability*, 22 July 2014

[https://www.ofcom.org.uk/data/assets/pdf\\_file/0010/40231/affordability\\_report.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0010/40231/affordability_report.pdf)

<sup>53</sup> If most eligible customers had switched, there would be little scope for prices to be constrained by the prospect of further switching in future.

differences in competitors, with the largest competitors to BT in the residential market those leveraging a retail brand (such as SSE and Post Office), in contrast to specialist CPs in the business market.

- 3.55 However, there is limited scope for demand-side substitution from residential to business services because in order to purchase a business access line from BT a customer is required to submit a company registration number, which would prevent a residential user from acquiring a business line.<sup>54</sup>
- 3.56 Overall, we do not consider we have a basis for believing that a SSNIP in SFV access would lead to material numbers of SFV customers switching to business services. We therefore do not include business SFV services in the market.<sup>55</sup>

### The relevant market does not include mobile access

- 3.57 We consider whether mobile access imposes competitive constraints on the provision of SFV access service. The strength of this constraint will depend on the willingness of SFV customers to abandon their fixed voice service and rely entirely on mobile access (i.e. become mobile-only customers).<sup>56</sup> The many consumers that continue to buy both fixed and mobile access are demonstrably willing to pay access prices for both, suggesting that, for these customers, mobile access does not provide a competitive constraint on fixed access prices.
- 3.58 Around 70% of SFV customers have access to mobile phones; however, this is lower for voice-only customers compared to split-supplier customers 58% and 95%, respectively).<sup>57</sup> The relevant question is whether, at competitive landline prices a SSNIP would lead enough SFV customers to switch to becoming mobile-only customers.
- 3.59 It is challenging to define and compare typical retail access prices because both fixed and mobile access are generally bundled with calls. However, survey evidence and actual past behaviour of SFV customers suggest that they have low willingness to switch to mobile-only in response to changes in relative prices:
- a) Willingness to give up landline: Survey evidence suggests that 61% of SFV respondents slightly or strongly disagreed that they would be willing to give up their landline under certain circumstances. If broken down by customer type, results are 63% for voice-only customers, and 54% for split-supplier customers.<sup>58 59</sup>

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<sup>54</sup> As set out above, a number of SMEs purchase residential SFV services, raising the possibility that they could switch to a business SFV service in response to a SSNIP on residential SFV services. As noted above, around 30% of SMEs report that they use a residential fixed line.

<sup>55</sup> We also note that BT is the main line rental provider to around half of UK SMEs, which would further reduce any pricing constraint on SFV access from switching to business services. (See Jigsaw Market Research Report, *Narrowband Market Review 2016*, <https://www.ofcom.org.uk/consultations-and-statements/category-1/narrowband-market-review>)

<sup>56</sup> We consider substitution between mobile calls and fixed calls later under our analysis on product market definition for the calls market.

<sup>57</sup> Ofcom, Technology Tracker H2 2016.

<sup>58</sup> There may be some small differences in the voice-only figures reported from the 2015 Jigsaw residential survey between this chapter and the 2016 NMR Consultation, due to a revised approach to isolating these customers (see Annex 8).

<sup>59</sup> 2015 Jigsaw survey (wave 1).

- b) Response to hypothetical SSNIP: Only 9% of SFV survey respondents reported that they would be 'certain or very likely' to give up their landline and switch to using mobile only in response to a 10% price increase in their total landline bill.<sup>60</sup>
  - c) Past behaviour: Despite the significant increase in retail line rental prices over the past six years and decreasing mobile price,<sup>61</sup> the share of mobile-only consumers in the UK has remained stable (15% of adults).<sup>62</sup> As set out in Annex 8 (Figure A8.23), fixed line rental from most CPs has been increasing by more than 5% annually (about £1 per year). Despite these price increases, take-up of fixed telephony has remained relatively stable (at between 84% and 87% of households from 2009 to 2016)<sup>63</sup> – and has not experienced as marked a decline as we might expect if mobile were a close substitute (especially given the decrease in mobile prices noted above). In addition, the proportion of adults in mobile-only homes did not change over the same period at 15%. This also suggests more generally that residential consumers only display limited responsiveness to price changes for fixed lines.
- 3.60 This analysis of past behaviour provides evidence on actual customer responses to the recent changes in relative prices. We recognise that this evidence relates to all types of fixed voice services. Nevertheless, it is appropriate to use it as a proxy for past behaviour of SFV customers. This is because survey evidence suggests that they are likely to be less price sensitive compared to the average residential fixed voice customer. For example, 9% of SFV customers reported they would be certain or very likely to give up their landline in a response to a 10% price increase in their total landline bill. This compares to 19% of all fixed voice customers (i.e. standalone and bundle customers).<sup>64</sup>
- 3.61 Overall, evidence suggests that while there is a degree of substitutability between fixed and mobile access, standalone consumers predominantly view the two types of access as meeting different needs and do not regard them as close substitutes.
- 3.62 Therefore, we provisionally conclude that it is more appropriate to consider that fixed and mobile access are in separate markets.

### Fibre based services

- 3.63 At present the roll-out of fibre based broadband services has largely been as an adjunct to the existing copper based telephone network. BT and other CPs continue to use the copper lines for the delivery of voice.
- 3.64 There is likely to be an increased trend to the provision of voice services over broadband as we see the roll-out of fibre connections which are either not reliant on the copper network (Fibre to the Premise) or do not provide voice connections over the copper network.

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<sup>60</sup> 2015 Jigsaw survey (wave 1).

<sup>61</sup> The 'weighted average' price of a mobile connection with 50 minutes of voice, 0 SMS and 0 data has fallen by 5% for a mobile connection (excluding handset cost), and up to 12% on prepay, between 2012 and 2016. Mobile packages including more data have fallen by a greater amount over this period. Source: Ofcom using data supplied by Teligen.

<sup>62</sup> Ofcom, *Communications Market Report 2012* and *Communications Market Report 2015*.

<sup>63</sup> Ofcom Technology Tracker. Data from Q1 for 2009-2014, then H1 for 2015-16. See Figure 4.35 of Ofcom's *Communications Market Report 2016* ("CMR 2016"), available here: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0026/26648/uk\\_telecoms.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0026/26648/uk_telecoms.pdf).

<sup>64</sup> 2015 Jigsaw survey (wave 1).

- 3.65 BT envisages that by 2025 it will move to replace the traditional copper based voice network with a next generation service based on fibre. It is likely that this could mean a material transformation of the nature of standalone voice provision – it may not be practical to limit service provision purely to voice.
- 3.66 However, we are not aware of any plans for a significant programme of traditional voice service replacement within the forward look of this review. Equally, existing SFV customers are unlikely to seek out a fibre based service unless they were planning to move to a bundle which includes broadband.<sup>65</sup> Accordingly, we do not consider that this is a material consideration for our market definition in this review.

### No supply-side substitution

- 3.67 In this sub-section, we consider whether there is scope for supply-side substitution from other services – i.e. suppliers of those services switching to supply of SFV services in response to a price increase.
- 3.68 As noted in Annex 7, paragraphs A7.17 – A7.18, for supply-side substitution to be relevant suppliers must be able to enter the market quickly and at low cost by virtue of their existing position in the supply of other products or geographic areas, and there must also be an additional competitive constraint arising from such entry into the supply of the service in question, beyond that imposed by demand-side substitutes which those firms already produce.
- 3.69 The wholesale products needed for the physical supply of SFV access and calls services are widely available in the UK. Current providers of fixed telecoms services, and potentially new entrants, could use these wholesale products – or in Virgin’s case its own network – to supply SFV access and calls. In fact, the main telecoms providers already supply some SFV customers.
- 3.70 However, the scope for expansion by these firms, or new entry, in the supply of SFV services is limited by the barriers to, and high cost of, acquiring new customers. We discuss these barriers to entry further in Section 4, paragraphs 4.29-4.46. Due to these barriers, in our view it is not possible for new firms to enter, or for current providers to expand in, the market quickly and at low cost by virtue of their existing position in the supply of other products or geographic areas.
- 3.71 We do not therefore propose to broaden the market based on supply-side substitution.

### **Product market definition for calls**

- 3.72 As discussed above, our focal product for access was the supply of SFV to voice-only customers, and we then extended this to include SFV to split purchase customers. We consider that for similar reasons split purchase customers should be included in the market for calls:
- 3.72.1 The only way for a voice-only or split purchase customer to receive calls within a dual-play bundle would be to switch to receiving access within a dual-play bundle. In light of our analysis that dual-play bundles are not in the same market as voice-only or split-purchase services for access, we consider it appropriate to treat them similarly for calls.

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<sup>65</sup> [38].



- 3.72.2 To date voice-only and split-purchase customers have been charged the same prices for calls, and we do not have evidence that a hypothetical monopolist of SFV calls would, or would be likely to, price discriminate significantly between voice-only and split-purchase customers.
- 3.73 Accordingly, the starting point for our analysis of the product market definition for calls is fixed voice calls sold to SFV access consumers, i.e. including voice-only and split-purchase customers. However, as we discuss below, there may be differences in the scope for voice-only and split purchase customers to substitute between SFV calls and other services.
- 3.74 We consider whether there is a case for including any of the following in the relevant market:
- Different call plans;
  - Different types of calls;
  - Fixed voice calls sold to dual-play/multi-play customers;
  - Mobile calls;
  - VoIP services;
  - Other means of communication (e.g. email, text);
  - Business services.

The relevant market includes all call plans and out-of-plan calls

- 3.75 As noted above, a range of call plans are available to voice-only customers which differ in their call allowances, as well as out-of-plan calls. This raises a question of whether they are all part of the same product market for calls purchased by voice-only customers. CPs broadly offer three different types of call plan. These are plans that include unlimited weekend calls, unlimited evening and weekend calls, and unlimited anytime calls. The main difference between them is the restrictions around the allowance of 'free' calls included in the plan (i.e. type and number of minutes included and the timings allowed to make calls).
- 3.76 We consider different call plans to be close demand-side substitutes for each other and for out-of-plan calls. Marginal SFV customers may trade-off between the price and quality of different plans or out-of-plan calls in response to a SSNIP. For example, if the price of the most restrictive plan increases by a 5-10% relative to other plans, it is likely that some marginal consumers may switch to less restrictive plans, and vice versa.
- 3.77 This is consistent with CPs' pricing strategies, which suggest that different call plans face similar pricing constraints. The increases in prices for calls over time were equally applied to all packages, leading to broadly similar absolute increases in the prices of the plans (albeit with larger proportionate increases for cheaper plans than for more expensive plans). We also note that [§<].

### The SFV market includes all types of calls

- 3.78 Retail consumers use their fixed lines to make various types of calls, including calls to other geographic numbers, mobile numbers, international numbers and non-geographic numbers. We propose defining a single relevant market including all types of calls (i.e. geographic, fixed to mobile calls, international and other calls) made by SFV customers as the starting point for our analysis.
- 3.79 The main reason for this is that consumers, with very limited exceptions, choose a single fixed line provider to meet all of their call type needs. Therefore, they will select their calls provider on the basis of which one provides the best value for money tariff given their particular pattern of calls.
- 3.80 To illustrate this, suppose a provider were to increase the price of calls to mobile numbers by 5-10%. A consumer who wished to switch to another provider of calls to mobile can only do so either by switching all of their call needs, or by purchasing additional fixed line access. The latter would tend to incur a substantial additional connection and rental cost and is unlikely to provide a realistic alternative for the consumer. Competition therefore takes place primarily on the basis of the overall value for money of the call package.
- 3.81 While retailers compete by offering a tariff package, the competitive conditions may vary to some extent across different call types. For example, high volume users of international calls will often choose to use a calling card or VoIP, while the price of calls to mobile will be limited to a significant extent by the ability of consumers to use a mobile phone for the same call. We take this into account in the SMP assessment at Section 5, paragraphs 5.31-5.35.

### The relevant market does not include dual-play/multi-play calls

- 3.82 We have already noted that for suppliers to compete for calls generally means them competing for access to the relevant consumers, because access and calls are mostly bought from the same provider in a package. As explained above, in our view, SFV access is in a separate market from dual-play and other multi-play bundles. It would seem therefore that competition for SFV calls is similarly distinct from calls offered to other customers such as in bundles. However, we consider here whether there is a reason to define a broader market on the basis of a common pricing constraint.
- 3.83 The potential for a common pricing constraint is that CPs offer similar call plans to all types of fixed voice consumers. Customers who buy SFV access services and those who buy dual-play/multi-play access packages purchase the same call plans and under similar terms. This raises the question of whether the relevant market for calls includes all types of voice customers.
- 3.84 We consider that a hypothetical monopolist of the fixed calls market would be able to price discriminate significantly between SFV access consumers and other types of fixed voice consumers. As most consumers purchase access and calls from the same supplier, the provider can distinguish whether a customer purchases fixed voice access on a standalone basis or bundled. There is no reason why the CP could

not accordingly offer different prices for call plans and out-of-plan calls to different customers based on this and there is at least one example of this.<sup>66</sup>

- 3.85 Therefore, given the reasons to limit the scope of the market for SFV calls, distinct from calls by other customers in dual or multi play bundles, similarly as for SFV access, we provisionally conclude that the relevant market for SFV calls does not include calls by customers on dual-play/multi-play bundles.

### The relevant market does not include mobile calls

- 3.86 The 70% of SFV access consumers in the UK who also have mobile access have a degree of choice as to whether to make a call on their mobile or fixed line.<sup>67</sup> To define the relevant market for calls, we consider whether SFV access users are likely to substitute enough calls from landline to mobile services in order to make a SSNIP by a hypothetical monopolist of voice calls unprofitable.
- 3.87 In our Narrowband Market Review consultation<sup>68</sup> (paragraphs 4.136 to 4.156) we considered whether retail prices of fixed voice calls were constrained by competition from mobile.
- 3.88 We noted that the constraint from mobile would depend on the willingness of consumers to do the following:
- Partially or completely substitute from fixed voice calls to mobile calls. This may include reducing the calls made within the inclusive calls allowance, downgrading the calls package, making fewer out-of-bundle calls, or some combination of these.
  - Give up the bundle of fixed voice access and calls and become mobile-only. For those who have fixed broadband this would involve giving it up and relying either on mobile broadband or other alternatives to fixed internet access.
- 3.89 We noted that call-by-call substitution alone can provide a degree of indirect constraint, particularly if consumers are also willing to downgrade a calls package. However, a significant share of total fixed voice minutes are made within an allowance. In addition, some consumers will already have the most basic calls package and so are unable to downgrade further. We therefore considered that the competitive constraint would depend to some extent on consumers' willingness to give up their bundle of fixed access and calls altogether (and broadband if they have it) and become mobile only.
- 3.90 We noted that mobile calls made at a fixed location (the home for residential customers, or the place of work for business customers) respond to the same need as fixed calls, which indicates there is potential (one-way) substitutability from fixed to mobile. However, survey evidence suggested that some consumers continue to view mobile calls as inferior in quality or less reliable. For example, a significant minority of SFV respondents said they do not make all their calls by mobile when at home

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<sup>66</sup> There are examples of such discrimination today – BT's Home Phone Saver product is only available to SFV customers and includes a unique calls offering.

<sup>67</sup> Ofcom, *Technology Tracker, H2 2016*.

<sup>68</sup> Ofcom Narrowband Market Review consultation, 1 December 2016, [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0016/95011/Narrowband-Market-Review.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0016/95011/Narrowband-Market-Review.pdf).

because of 'Reliability of connection' (14%), 'Quality of line/calls' (15%), 'Inconvenient/Difficult to use' (9%), 'Coverage/can't get a signal' (8%).<sup>69</sup>

- 3.91 We noted that 11% of voice-only survey respondents reported that they would be certain or very likely to give up their landline in response to a SSNIP of their landline, while 14% would be certain or very likely to switch some calls to mobile in response to a SSNIP of their landline calls<sup>70</sup> (in these responses, voice-only customers appeared to be less price-responsive than fixed voice customers generally). We said that overall, the evidence was consistent with residential consumers showing a degree of attachment to their landlines and only a limited willingness to give up the bundle of access and calls and become mobile-only consumers, but that there may be a strong degree of substitutability on a call-by-call basis. We noted a significantly lower degree of reported substitutability by SMEs than residential consumers.
- 3.92 We observed a marked decline in the volume of voice calls originated on fixed lines and an increase in calls originated on mobiles by both residential consumers and businesses. However, we said that, overall, calling patterns suggested that fixed and mobile were more typically used for different types of calls rather than as substitutes for the same type of calls. Most calls to mobiles were from other mobiles whereas landlines were used more heavily for calls to other landlines, calls to Freephone numbers and calls to non-geographic numbers. For example, in 2015, 60% of calls terminating on fixed lines originated from a fixed line whereas only 7% of calls terminating on a mobile device originated from a fixed line.
- 3.93 We compared residential fixed and mobile prices, and noted that the price of calls has been decreasing for both fixed voice and mobile, although there was a greater decrease for mobile. The current analysis does not show a clear decrease in fixed voice call prices (see Annex 8 paragraphs A8.80 – A8.108). However, the pence per minute price of out-of-plan mobile calls was still materially higher than the price of out-of-plan fixed calls. The leading reason cited by 37% of respondents to our residential survey for not making all calls by mobile at home was the price of calls being too high.<sup>71</sup>
- 3.94 In conclusion, we considered that, from a forward looking perspective, the evidence on the strength of fixed-to-mobile substitutability was mixed. Consumers had a limited willingness to abandon their landline (i.e. access and calls) and this is likely to limit the overall indirect constraint from mobile. Nevertheless, mobile appeared to be a relatively close substitute on a call-by-call basis with respect to some call types by certain groups but a more limited substitute for others. Mobile call prices had fallen in relative terms and call volumes had increased, and this appeared to be at least a partial driver of the fall in fixed voice volumes.
- 3.95 Balancing these various factors, we considered that mobile calls are not a sufficient indirect constraint on fixed calls to be included in the relevant product market (at the wholesale level), although we recognised the increasing competitive constraint for calls – if not in access – in our assessment of market power.
- 3.96 Much of our assessment in the NMR consultation related to fixed calls generally, rather than SFV calls in particular. However, we consider that the considerations

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<sup>69</sup> 2015 Jigsaw survey (wave 1), Figure 9 and 46.

<sup>70</sup> We do not have robust evidence on split-purchase customers 2015 Jigsaw residential survey (wave 1).

<sup>71</sup> 2015 Jigsaw residential survey (wave 1).

supporting our position in NMR also apply in the case of SFV customers, noting that SFV customers are less likely than fixed voice customers generally to have mobile phones, and that in the survey evidence discussed above they appear to be less price-responsive than fixed voice customers generally.

- 3.97 Consistent with our assessment in the NMR consultation, we consider that mobile calls are not a sufficient constraint on SFV calls to be included in the relevant product market. However, we consider the potential for mobile calls to provide an increasing (out-of-market) constraint for SFV calls – if not in SFV access – in our assessment of market power. The relevant market does not include VoIP
- 3.98 VoIP calls can be a potential substitute for fixed voice calls, where they are made over broadband access (or a mobile device) rather than an analogue fixed voice service.
- 3.99 We do not propose to include VoIP using broadband or mobile devices in the product market for SFV calls based on the following survey evidence:
- a) The majority of SFV customers do not have fixed broadband access (i.e. voice-only customers who account for 60% of SFV customers), hence they are unable to use VoIP over broadband at home.
  - b) Only a minority of SFV customers reported having VoIP at home (2%).<sup>72</sup>
  - c) Only 5% of SFV survey respondents said they would be certain or very likely to switch some calls to VoIP in response to a SSNIP for calls.<sup>73</sup> Results were broadly similar for voice-only and split supplier customers (5% and 6%, respectively).<sup>74</sup> This suggests a limited degree of substitutability between SFV calls and VoIP.
- 3.100 Based on this evidence, it appears that a minority of SFV customers use VoIP and it is mainly for a limited range of call types (international calls and calls to other VoIP users).

#### The relevant market does not include other means of communication

- 3.101 The fall in fixed voice call volumes has been accompanied by a rise in alternative modes of communication. The average adult reported spending more time per day using email (60 minutes), instant messaging (48 minutes) and social networking (45 minutes) than making phone calls (27 minutes) in 2016.<sup>75</sup> The share of adults using mobile messaging rose slightly from about 80% of adults in 2012 to about 83% in 2016.<sup>76</sup>
- 3.102 However, the number of outgoing SMS and MMS fell from its peak of 151 billion in 2012 to 101 billion in 2015<sup>77</sup> and the number of minutes spent texting per day fell by 14 minutes (40%) between 2014 and 2016. The share of residential consumers using email weekly fell from 77% to 70% between 2014 and 2016 and the share using SMS weekly fell from 71% to 63% in the same period.

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<sup>72</sup> 2015 Jigsaw survey (wave 1).

<sup>73</sup> 2015 Jigsaw residential survey (wave 1).

<sup>74</sup> 2015 Jigsaw residential survey (wave 1).

<sup>75</sup> Ofcom, *CMR 2016*, figure 1.18.

<sup>76</sup> Ofcom, *CMR 2012*, figure 5.18; Ofcom, *CMR 2016*, figure 4.36.

<sup>77</sup> Ofcom, *CMR 2016*, figure 4.1.

- 3.103 These activities may have been displaced by increased use of OTT instant messaging applications. The share of residential consumers using instant messaging rose by 15% to 43% between 2014 and 2016.<sup>78</sup>
- 3.104 However, survey data suggests that substitutability for SFV calls is likely to be limited:
- SFV customers value voice calls for the personal contact involved, with SMEs also valuing their convenient and real-time nature compared to text-based communication. Survey respondents were asked why they do not use SMS/Email/Instant Messaging often at home, instead of making calls on their landline. The top two responses were that 20% of SFV respondents said they prefer to talk to the other person and 14% said they are not suitable for certain types of conversation.<sup>79</sup>
  - A small proportion of SFV residential survey respondents (9%) said they would be certain or very likely to switch some landline calls to email, mobile phone texts or instant messages in response to a SSNIP for landline calls.<sup>80</sup>
- 3.105 Based on the above, we do not consider that retail switching to text-based messaging (including SMS via a mobile device, instant messaging and OTT-based messaging services), email and social media would be sufficient to make a price increase in SFV calls unprofitable. We consider that such services are outside the relevant product market.

#### The relevant market does not include business SFV calls

- 3.106 In paragraphs 3.54-3.56 we set out a number of differences in the prices and quality characteristics of residential and business services and the limited scope for substitution of residential products with business products. We concluded that in light of this, we do not consider that business SFV access services should be included in the relevant market. For the same reasons, we consider that business SFV call services should be excluded from the relevant market for SFV calls.

#### **Provisional conclusion for product market definition**

- 3.107 We have provisionally concluded that there are two relevant markets; residential SFV access and fixed voice calls sold to SFV access customers.
- 3.108 We have considered whether there are any effective substitutes:
- For SFV access: we have provisionally concluded that dual-play access packages, mobile access and business services are not effective demand-side substitutes. Therefore, they are not part of the market.
  - For calls to SFV access customers: we have provisionally concluded that all call packages and all types of calls fall within the same relevant market. We have also provisionally taken the view that the provision of calls to customers who purchase multi-play packages is not in the same market. In addition, we do not consider that mobile access, VoIP or other communication services are part of

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<sup>78</sup> Ofcom, *CMR 2016*, page 16.

<sup>79</sup> 2015 Jigsaw residential survey (wave 1).

<sup>80</sup> 2015 Jigsaw residential survey (wave 1).

the same market. However, we take into account out of market constraints from mobile calls in our SMP assessment.

- 3.109 We note that our proposals are consistent with other regulatory practice. Historically, retail fixed voice access was identified by the EC as one of the relevant markets susceptible to *ex-ante* regulations (Market 1). The Commission for Communications Regulations (ComReg) reviewed this market in August 2014 as part of its duties under the European Framework for Economic Communications at the time. ComReg defined two relevant markets for residential consumers; which are equivalent to SFV access and SFV calls markets (i.e. both include split purchasers and excluded other potential substitutes such as dual-play packages, mobile services and VoIP).<sup>81</sup>

## Retail geographic market definition

- 3.110 According to the 2014 EC Recommendation, when defining relevant markets “national regulatory authorities should identify a geographic area where the conditions of competition are similar or sufficiently homogeneous and which can be distinguished from neighbouring areas in which the prevailing conditions of competition are appreciably different, having particular regard to the question whether the potential SMP operator acts uniformly across its network area or whether it faces appreciably different conditions of competition to a degree that its activities are constrained in some areas but not in others”.<sup>82</sup>
- 3.111 In the UK excluding the Hull Area, we consider that competitive conditions are broadly similar and there is a clear national dimension in competition for SFV services. In particular, evidence shows that price is the main mode of competition and CPs have national uniform pricing policies:
- 3.111.1 Survey data suggests that price is a significant factor when customers switch telecoms providers<sup>83</sup>;
  - 3.111.2 the USC requires BT to provide retail telephony services that are priced uniformly, irrespective of geographic location. Furthermore, we observe that competing CPs price uniformly across the UK.
- 3.112 We recognise that CPs can also compete on non-price factors (e.g. quality of retail customer service). However, we do not have evidence of material geographic variation in non-price elements of SFV services.
- 3.113 In the Hull Area, the absence of BT means that competitive conditions differ from the rest of the UK. While BT is the largest SFV provider in the UK, KCOM is the largest provider in the Hull Area with a share of 97% of fixed analogue lines as of March 2016.<sup>84</sup>

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<sup>81</sup> <https://www.comreg.ie/publication/market-review-retail-access-to-the-public-telephone-network-at-a-fixed-location-for-residential-and-non-residential-customers-2/>

<sup>82</sup> The 2014 EC Recommendation, Point 7.

<sup>83</sup> 2015 Jigsaw residential survey (wave 1).

<sup>84</sup> See 2016 NMR

## Provisional conclusions on geographic markets

3.114 In light of the above, we propose defining the relevant geographic area for this review as the UK excluding the Hull Area.<sup>85</sup>

3.115 This is consistent with the findings of 2009 Retail Narrowband Review, which is summarised in Section 2.

## Three criteria test for retail standalone fixed voice market(s)

3.116 In carrying out a market review, we are required to take due account of the European Commission's (EC) Recommendation on relevant product and service markets ("the 2014 EC Recommendation") and its SMP Guidelines. More broadly, in carrying out a market review (including assessing appropriate remedies), we are required to take utmost account of all applicable opinions, common positions, recommendations, guidelines, advice or regulatory best practice adopted by BEREC.<sup>86</sup>

### The 2014 EC Recommendation

3.117 The 2014 EC Recommendation, which replaced the 2007 EC Recommendation, sets out a list of those product and service markets which the Commission has identified, at an EU level, as being susceptible to *ex ante* regulation. These markets are identified on the basis of the cumulative application of three criteria:<sup>87</sup>

- a) the presence of high and non-transitory structural, legal or regulatory barriers to entry;
- b) a market structure which does not tend towards effective competition within the relevant time horizon, having regard to the state of infrastructure-based and other competition behind the barriers to entry;
- c) competition law alone is insufficient to adequately address the identified market failure(s).<sup>88</sup>

3.118 NRAs may identify markets other than those listed in the 2014 EC Recommendation, on the basis of the application of the above criteria. In what follows, we apply the three-criteria test to the standalone fixed voice access and calls markets.

## Presence of high and non-transitory barriers to entry

3.119 Our analysis of barriers to entry and expansion are set out in the SMP assessments for SFV access and SFV calls in Sections 4 and 5, respectively.

3.120 In summary, our analysis shows that there are high barriers to entry (and particularly to expansion) in both markets, which are likely to remain over the period of this review (in the absence of regulation). Service providers face difficulties and high

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<sup>85</sup> We explain why at this time we are not also reviewing relevant markets in the Hull Area in Section 2.

<sup>86</sup> Body of European Regulators for Electronic Communications. See Article 3(3c) of the Framework Directive. See also Article 3(3) of the BEREC Regulation (Regulation (EC) No 1211/2009 of the European Parliament and of the Council of 25 November 2009 establishing the Body of European Regulators of Electronic Communications and the Office).

<sup>87</sup> Recital 19 to the 2014 EC Recommendation.

<sup>88</sup> Paragraph 2 of the 2014 EC Recommendation.



acquisition costs to reach SFV customers and to convince them to switch away from their current suppliers (see full assessment in Section 4, paragraphs 4.29 - 4.46 and Section 5, paragraphs 5.23 - 5.26).

- 3.121 We note that, if we were to define separate markets for SFV services (both access and calls) for voice-only and split purchase customers, this criterion would be met in each of the resulting markets, as we have not identified substantial differences between the level or duration of barriers to entry and expansion for different customer groups.

### **A market structure which does not tend towards effective competition**

- 3.122 We have assessed competition in the SFV access market as part of our SMP analysis in Section 4. In particular:

3.122.1 the SFV access market is highly concentrated. BT has a high market share of 79%. The next largest provider has a share of 5%-15 (see paragraphs 4.18);

3.122.2 there is limited scope for strong potential competition as other CPs face significant barriers to entry and expansion as discussed above (see paragraphs 4.29 – 4.46);

3.122.3 the declining market size is likely to reinforce BT's market power as it creates a further barrier to entry – CPs have less incentive to enter the market if it is declining (see paragraphs 4.4 – 4.6); and

3.122.4 an absence countervailing buyer power (see paragraphs 4.72 – 4.73).

- 3.123 For these reasons, we consider that the market structure for the provision of SFV access will not tend towards effective competition in the review period (in the absence of regulation).

- 3.124 We note that, if we were to define separate markets for SFV access for voice-only and split purchase customers, we would reach a similar conclusion in each case (i.e. of neither tending towards effective competition in the review period), and in particular: (a) we estimate BT accounts for 66% of SFV access for voice-only customers and 97% of SFV access for split-purchase customers; (b) barriers to entry and expansion apply to both groups in a broadly similar way; (c) our understanding is that the number of customers in both groups is declining; and (d) neither group has countervailing buyer power.

- 3.125 We have also assessed competition in the SFV calls market as part of our SMP analysis in Section 5 and reached similar views. In particular:

3.125.1 despite the decline in the SFV calls market, BT has a high market share of [X]%. The next largest provider has a share of 5%-15% (see paragraphs 5.12-5.18);

3.125.2 there are barriers to entry and expansion, which are reinforced by the market decline for calls (see paragraphs 5.19-5.22);

3.125.3 although there is some substitution from fixed to mobile and VoIP by some types of users for some types of calls, the overall constraint imposed by such switching is limited (see paragraphs 5.31-5.35); and

- 3.125.4 an absence of countervailing buyer power (see paragraph 5.11).
- 3.126 For these reasons, we consider that the market structure for the provision of SFV calls will not tend towards effective competition in the review period.
- 3.127 Again, if we were to define separate markets for SFV calls for voice-only and split purchase customers, we would reach a similar conclusion in each case, of neither tending towards effective competition in the review period, for similar reasons to those set out in paragraph 3.124 above in relation to access.

### **Competition law alone would not adequately address the market failure(s)**

- 3.128 As set out in Section 6, we have concerns about the increasing direct and indirect harm that results from the lack of competition due to BT's SMP. We consider that competition law alone would not adequately address the market failures that we have identified for the following reasons:
- 3.128.1 *Ex ante* regulation allows for the imposition of specific and targeted SMP remedies to address the competition problems identified and for the ongoing monitoring of those remedies. This is particularly relevant in relation to the concerns we have identified in this review and the package of SMP remedies we consider appropriate (as discussed in later sections).
- 3.128.2 As set out in Section 4 and 5, we consider that one of the sources of SMP in this market is low consumer engagement. Part of the package of remedies we are proposing to impose is therefore designed to promote competition, rather than dealing with specific anti-competitive practices. These types of remedies would be difficult to introduce under a competition law analysis.
- 3.129 In the light of this, we cannot be confident that *ex post* competition law alone would be sufficient, particularly given the high barriers to entry and expansion and a market structure which does not tend towards effective competition.

### **Provisional conclusions**

- 3.130 In accordance the analysis set out above, we provisionally conclude that
- 3.130.1 There is a relevant product market for SFV residential access services in the UK (excluding Hull).
- 3.130.2 There is a relevant market for SFV residential calls service in the UK (excluding Hull).
- 3.130.3 Our proposed market definitions satisfy the three-criteria test set out in the 2014 EC Recommendation such that these markets are suitable for *ex ante* regulation.

### **Consultation questions**

*Question 3.1: Do you agree with our provisional conclusion that there is a separate market for Standalone Fixed Voice residential access which includes both voice-only and split purchase consumers? Please provide reasons and evidence in support of your views.*

*Question 3.2: Do you agree with our provisional conclusion that there is a separate market for Standalone Fixed Voice residential calls? Please provide reasons and evidence in support of your views.*

## Section 4

# Retail market power assessment: Access

## Introduction and summary

- 4.1 As set out in Section 3, we have identified a separate market for residential Standalone Fixed Voice (SFV) access.<sup>89</sup> This Section sets out our market power assessment for that market.
- 4.2 Our assessment follows the market analysis framework set out in Annex 7. We provisionally conclude that BT has SMP in this market, based on our analysis of market shares, barriers to entry and expansion, pricing, profitability and countervailing buyer power.

## Introduction to our assessment of competition in the residential SFV access market

- 4.3 We begin by setting out an overview of:
  - 4.3.1 The evolution of the SFV market;
  - 4.3.2 Key characteristics of SFV customers; and
  - 4.3.3 Characteristics of SFV suppliers.

## Ongoing decline in SFV

- 4.4 As broadband take-up has grown (from 65% of households in 2009, to 79% in 2016<sup>90</sup>), there has been a general move from a focus on offering separate voice and broadband services to one in which these services are predominantly offered in a bundle, in some cases also including TV and/or (to a lesser extent to date) mobile in the same bundle. Now the large majority of consumers buy landlines in a bundle with other services.
- 4.5 The number of SFV access lines, i.e. bought outside a bundle, is in a steady long-term decline. This is primarily driven by customers who upgrade to bundled communication services (e.g. dual-play). In addition, since the customer base purchasing retail SFV access consists of a large number of older customers, this base has declined over time.
- 4.6 As set out in Annex 8, paragraphs A8.15-A8.17, the number of residential SFV lines is currently declining at a rate of around 15% per annum, and we estimate that by September 2016 it had fallen to 2.9 million, or around 11% of the 26.4 million residential lines in the UK (excluding Hull). This comprised about 1.7 million voice-

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<sup>89</sup> As set out in Section 2 and 3, SFV access refers to the provision of standalone fixed voice access (i.e. line rentals) to residential consumers in the UK, excluding Hull. This includes three consumer groups; namely voice-only, split-service and split-supplier.

<sup>90</sup> Ofcom, *Technology Tracker*.

only customers, 0.9 million split-supplier customers and 0.2 million split-service customers.<sup>91</sup>

## Key features of SFV customers

- 4.7 SFV customers have, by definition, not adopted dual-play bundles in recent years. Our research indicates that these customers differ – on average – from the larger group of dual-play customers in a number of ways. Taken together, we consider that these differences present obstacles to SFV customers optimising their telecoms purchases and shopping around for the best deal:
- 4.7.1 **Demographics:** As noted SFV customers tend to be older, and may have a lower household income than dual-play customers.<sup>92</sup> This is particularly the case for voice-only customers, but our evidence is that split purchase customers are also older than average (See Annex 8, Figures A8.49 and A8.50).
  - 4.7.2 **Experience of switching:** Around 70% of SFV<sup>93</sup> customers report that they have never switched provider. Many of these respondents are likely to have been with BT since it was the monopoly provider of fixed line services (see paragraph 4.39.1 below). In contrast, dual-play services are relatively new, and 26% have switched provider in the past 3 years.
  - 4.7.3 **Online access to information on competing offers:** Among SFV customers, a substantial proportion of voice-only customers (as opposed to split purchase customers) do not have direct broadband access, although some have internet access via mobile phones and some may have access via family, libraries or internet cafés.
- 4.8 Survey evidence suggests that SFV customers have relatively low levels of engagement in the market. For example:
- 4.8.1 Around 70% of SFV customers report that they have never switched their landline provider, and only 14% report switching supplier within the past 3 years. These figures compare to 45% and 26% of dual-play<sup>94</sup> respondents, respectively.<sup>95</sup>
  - 4.8.2 In our switching tracker survey only 9% of SFV customers are classified as engaged, compared to 20% of consumers purchasing bundles. Comparing

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<sup>91</sup> These three segments do not sum to 2.9 million due to rounding.

<sup>92</sup> For SFV customers, 23% have a household income of less than £11,500 per annum, compared to 10% of dual-play (source: Ofcom Technology Tracker H2 2016). However, we note the non-response rates to questions around household income are high (48% for SFV and 37% for dual-play) and so these results should be interpreted with caution.

<sup>93</sup> As explained in Annex 8 Figure A8.46, in the context of survey evidence, SFV refers to voice-only customers and split-supplier customers (92% of all SFV lines).

<sup>94</sup> As explained in Annex 8, Figure A8.46, in the context of survey evidence, dual-play refers to respondents who take landline and broadband from the same CP. This includes an immaterial number of split-service customers, which does not affect our analysis of this group.

<sup>95</sup> These differences are statistically significant (at the 95% confidence level). Unless otherwise stated, all direct comparisons of survey evidence between customer groups in this section are statistically significant.

the customer segments, 6% of voice-only consumers and 15% of split-supplier<sup>96</sup> customers are classified as “engaged”.

- 4.8.3 SFV customers are particularly likely to cite trust in their current supplier as a reason not to switch (62%, compared to 46% of dual-play customers) (Figure A8.59 in Annex 8).<sup>97,98</sup>
- 4.9 Survey evidence also suggests that SFV access customers show a high level of satisfaction with their landline provider. Figure A8.62 in Annex 8 describes the reported levels of satisfaction with the overall landline service provided. It suggests that voice-only customers are generally more satisfied, the majority of voice-only and split-supplier customers reported being very satisfied (74% and 58% respectively, compared to 54% for dual-play).<sup>99</sup>
- 4.10 Further, many split purchase customers could make significant savings by bundling their fixed voice and fixed broadband services into a single package with the same (or a different) provider. On average a split purchaser buying SFV from BT<sup>100</sup> and standalone broadband from BT, Sky or TalkTalk could save £8 per month (more than 20%) by switching to an equivalent dual play service from their broadband provider at standard prices, and just over £14.50 per month (more than 35%) at promotional prices (see Annex 8 for more details).
- 4.11 In Annex 6, we discuss the elements of consumer engagement and our understanding of the underlying reasons for SFV customers being relatively disengaged, such as characteristics of the customers themselves, and their perception of barriers to switching.

## Market players

- 4.12 BT is the largest supplier of SFV lines and accounts for a large majority, with no other provider having a share above 5-15% (as we discuss below). Reflecting the different nature of competition in the SFV access market and in bundles, different types of market players are more prominent in each.
- 4.13 BT’s largest competitors in the SFV access market, such as Post Office and SSE, are not significant players in the market for bundled services.<sup>101</sup> Those who compete most strongly in providing bundled services have often invested in LLU and so try to leverage this to their advantage in providing a range of services. Providers such as Post Office do not have LLU assets, but may have advantages for the specific SFV access consumer such as brand recognition.

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<sup>96</sup> As explained in Annex 8 Figure A8.46, when discussing survey evidence, we refer to split-supplier customers, who account for around 80% of split purchasers.

<sup>97</sup> As noted in paragraph A6.9 this high level of reported trust in the current provider could have a number of interpretations.

<sup>98</sup> The base is of those who have not switched or considered switching; not looking for a new provider; do not agree their landline provider is the best.

<sup>99</sup> The comparison between split supplier and dual-play is not statistically significant (at the 95% confidence level).

<sup>100</sup> The evidence (discussed in more detail in paragraph 4.22-4.23 and Annex 8 is that nearly all split purchasers buy SFV from BT, whereas they buy standalone broadband from a range of broadband suppliers.

<sup>101</sup> [3<].

- 4.14 On the other hand, the larger providers in bundled services are much less significant in SFV access. Sky, Virgin and TalkTalk all compete strongly in providing bundles. However, in the case of SFV services these operators are less active as shown by their low market shares (discussed in paragraphs 4.17-4.19 below) and the fact [X] does not offer SFV services to new customers (as noted in paragraph 4.78).

## SMP assessment

- 4.15 Our approach to market power assessment is set out in Annex 7. In assessing SMP we base our analysis on a forward-looking evaluation of competition in the SFV access market, taking into account existing wholesale regulations (i.e. *ex ante* wholesale regulations arising from an SMP finding at the wholesale level).<sup>102</sup>
- 4.16 We assess SMP in SFV access using the following criteria:
- Market shares;
  - Barriers to entry and expansion;
  - Pricing;
  - Profitability; and
  - Countervailing buyer power.

## Market Shares

- 4.17 We set out in Figure 4.1 the market shares of the main suppliers of SFV services by number of lines purchased over the period 2013-2016.<sup>103</sup>

**Figure 4.1: Market shares of SFV lines by CP (in ranges)**

	BT	Post Office	SSE	TalkTalk	Virgin Media	Sky	Phone Co-op
<b>2013</b>	85%	5% - 15%	< 5%	< 5%	< 5%	< 1%	< 1%
<b>2014</b>	83%	5% - 15%	< 5%	< 5%	< 5%	< 1%	< 1%
<b>2015</b>	81%	5% - 15%	< 5%	< 5%	< 5%	< 1%	< 1%
<b>2016*</b>	79%	5% - 15%	< 5%	< 5%	< 5%	< 1%	< 1%

Source: S135 data response

\* Market shares for 2016 are averaged across January-September

- 4.18 BT has a very high market share of 79%, while the next largest provider has a share of 5-15%. BT's market share has remained at 79% or above throughout the period

<sup>102</sup> The wholesale regulation currently in place is set out in the 2013 Narrowband Market Review Statement (<https://www.ofcom.org.uk/consultations-and-statements/category-2/nmr-13>) and 2014 FAMR Statement (<https://www.ofcom.org.uk/phones-telecoms-and-internet/information-for-industry/telecoms-competition-regulation/narrowband-broadband-fixed/fixed-access-market-reviews-2014/statement>). Our proposed regulation for the next three-year market review period is set out in our 2016 NMR Consultation (<https://www.ofcom.org.uk/consultations-and-statements/category-1/narrowband-market-review>).

<sup>103</sup> Details of which CPs were included and excluded from this analysis is set out in Annex 8 and represent the providers of SFV services of which we are aware. We recognise that there may be some smaller providers that are not captured within these market share figures, however, we are not aware of any other CP with a significant SFV base that would affect the market share figures set out to any meaningful extent.

2013-2016. Whilst BT's market share has fallen by six percentage points and those of Post Office and SSE have increased by [x] percentage points respectively, (to [x]% and [x]% respectively), the fall in BT's market share is primarily due to BT customers leaving the market (through taking dual play or decline of overall customer base) at a faster rate than customers of other CPs, rather than being due to switching away from BT to other firms. As set out in Annex 8, acquisition of switching customers by these other CPs accounts for at most a small proportion of BT's customer losses. BT's share remains far higher than its nearest rival, and we expect this to remain the case over the review period, absent significant changes to the market.

- 4.19 BT's market shares (by number of lines and by revenue)<sup>104</sup> are consistent with a finding of dominance in the absence of other factors. As set out in the SMP Guidelines, very large market shares, in excess of 50%, are in themselves evidence of the existence of a dominant position, and therefore SMP.<sup>105</sup> Whilst this is not the sole basis on which a finding of SMP may be reached, it provides an indicator of the market power which BT may enjoy in the SFV access market.

### Analysis of market segments

- 4.20 As we set out at paragraph 4.6, there are different customer groups within the SFV access market – split-supplier customers, split-service customers and voice-only customers. While we include these customers within the same market, we have also considered BT's share of supply within each of these segments of the market.
- 4.21 For voice-only lines (about 1.7 million), BT has a share in excess of 60% (allowing for sensitivity checks as set out in Annex 8). Post Office, SSE, TalkTalk and Virgin Media have a share of 15% or below each. Sky and the Phone Co-op also have a small number of voice-only customers (less than 1% share).
- 4.22 In respect of split-supplier SFV access lines (about 0.9 million), BT has a share approaching 100% with less than 5% of such SFV access lines provided by other providers.
- 4.23 Similarly, for split-service customers (about 0.2 million), BT has a share approaching 100%, with the only other provider of SFV access lines to split-service customers being [x], with a share of less than 1% of these lines.<sup>106</sup>

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<sup>104</sup> We set out an analysis of revenue market shares in Annex 8. As noted in Section 3, paragraph 3.25 we recognise that our revenue market shares for access includes some revenues which are attributable to calls (and our revenue market shares for calls do not include these revenues). However, this does not make a material difference to our analysis of market shares. (particularly as a similar effect will apply to BT and other CPs), or to our overall SMP findings.

<sup>105</sup> SMP Guidelines, paragraph 75.

<sup>106</sup> We included different estimates for the total numbers of voice-only and split purchase customers in the NMR Consultation, and this also implied different market shares for BT (although in all cases, BT's market share was above 50%). We set out in Annex 8 our approach to estimating the size of the different segments and supplier shares in each. In terms of total size of the different segments, we consider this data to be more reliable than that used in the NMR Consultation, as it is based on information provided by CPs (instead of survey evidence). With regard to the estimation of supplier shares of the different segments, we note that both the survey data and our estimates could potentially have different issues. For example, in our estimates we assume that there is an immaterial number of split-supplier customers who purchase neither SFV services or standalone fixed broadband services from BT. As noted in Annex 8 paragraph A8.39, we conducted sensitivity checks regarding



- 4.24 Further detail of shares in these market segments is set out in Annex 8 paragraphs A8.39-A8.43.

#### Comparison to overall residential fixed line provision

- 4.25 The number of residential lines in the UK has consistently increased since Q4 2009, from 23.4 million in Q4 2009 to 26.4 million in Q3 2016 (see Figure A8.2 in Annex 8).
- 4.26 BT, however, has seen a decrease in residential lines (from 13.3 million in Q4 2009 to 9.4 million in Q3 2016),<sup>107</sup> with its share falling from 57% in Q4 2009 to 36% in Q3 2016.<sup>108</sup> BT's share of all residential lines has fallen from 41% in Q1 2013 to 36% in Q3 2016.

#### Provisional view on market shares

- 4.27 BT has maintained a market share at or above 79% in SFV access. While its market share has declined to some extent in recent years, it is still by far the largest supplier in the market and is likely to remain so over the market review period. Its market shares remain well in excess of 50% within all segments of the market.
- 4.28 We now consider whether barriers to entry or expansion prevent others from challenging this high market share.

#### **Barriers to entry and expansion**

- 4.29 In principle, ease of entry, or expansion by rivals, can deter a company with high market share from raising prices above competitive levels. Barriers to entry or expansion can limit the competitive pressures faced by a CP with a high market share; whether from potential entrants or smaller CPs in the market.
- 4.30 We set out in this section the factors we have taken into account in assessing the extent to which there are barriers to entry and expansion in the SFV access market.

#### Low investment costs due to wholesale regulations

- 4.31 There are two ways to provide SFV access in the UK. A CP can either build its own network (i.e. self-supply) or provide the service over BT's network using regulated wholesale products.
- 4.32 To self-supply, a new entrant would incur significant costs to create an efficient telecommunications network. This is a high cost and risky means of entry, particularly as a large part of the investment would be sunk costs (i.e. cannot be recovered if the entrant decides to exit the market). In addition, telecommunications networks benefit from significant economies of scale, which means that average costs fall as output increases. Therefore, it is difficult for new, smaller firms to enter the market and be competitive as they will have a higher cost base compared to the incumbent CP. This

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the total number of split-supplier customers, and the proportion that take a SFV line from BT. Altering this assumption would affect BT's market shares within different segments, though under a range of sensitivities, BT's market share across segments remains high (> 60%). This is also the case for the Jigsaw survey data, although we place less weight upon this.

<sup>107</sup> Virgin Media has had a relatively stable number of residential lines (from 4.2 million in 2009 to 4.4 million in Q2 2016) (Source: Ofcom telecoms data updates).

<sup>108</sup> Shares of access revenues show a similar trend.

is particularly true for SFV, where the addressable base is declining (as discussed in paragraphs 4.4 - 4.6).

- 4.33 On the other hand, the use of wholesale inputs over BT's network provides a relatively easy route to entry as retailers do not have to incur any sunk costs in infrastructure. Wholesale products have been successfully developed and deployed and retailers no longer need to have their own access infrastructure.
- 4.34 CPs can rent lines by using Openreach's wholesale product; namely Wholesale Line Rental (WLR). This has enabled retailers to emerge over time. They can either buy WLR directly from Openreach or buy a "white label" access product from another CP.<sup>109</sup> We also observe that in the event that wholesale customers are not satisfied with the terms of the Openreach regulated WFAEL market wholesale line rental product, there are alternatives including seeking wholesale services from other network operators such as those that use local loop unbundling services.
- 4.35 Wholesale inputs, in particular WLR, are available to competing CPs as a result of regulation which has been in place for a number of years. BT has been required to provide WLR to competing providers since 2002<sup>110</sup> and we are proposing to retain a requirement on BT to offer WLR in our latest market review.<sup>111</sup> CPs would therefore continue to be able to benefit from the availability of regulated wholesale products to offer retail SFV access products to consumers.

#### Barriers to customer acquisition

- 4.36 However, whilst entry and expansion may be possible in principle through the use of wholesale inputs, the intensity of competition depends to a large extent on a CPs' ability in practice to win more retail customers and grow in the market. We have identified barriers to the acquisition of new customers in the SFV access market which may limit the ability of providers to compete effectively and expand in the market.

#### *Ability to reach customers*

- 4.37 CPs face barriers to effectively market their services to SFV customers for the following reasons:
- 4.37.1 The relatively small size of the SFV access market compared to the total number of households in the UK. A relatively small minority of UK households purchase SFV access services (around 3 million out of 26 million households).<sup>112</sup> Therefore, in order to run an efficient marketing campaign, a supplier would need to find a cost-effective way of identifying customers within the SFV access market.

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<sup>109</sup> By white label access product, we mean buying a wholesale product from another CP (who is buying WLR from Openreach) and rebranding it. It allows the CPs to offer a retail service at low risk and they can focus on other elements of either the service or their business.

<sup>110</sup> On 20 June 2002, the Director General of Telecommunications (the "DGT") published the statement entitled *Protecting consumers by promoting competition: Ofcom's conclusions* in which he modified BT's licence to, inter alia, require BT to provide WLR services and also set the charges for certain WLR services. The first basic WLR product (WLR1) was available from September 2002.

<sup>111</sup> See 2016 NMR Consultation, Figure 1.1.

<sup>112</sup> Our estimates of UK households with SFV services is shown in Annex 8 paragraph A8.15. For the number of UK households, see Ofcom, *CMR 2016*.

- 4.37.2 One of the common marketing channels – namely online marketing – is unlikely to be suitable for targeting these customers. A substantial proportion of SFV customers have limited internet access. While split purchasers have fixed broadband access at home, voice-only consumers – who represent almost 60% of the SFV access market – do not. Whilst some voice-only consumers may use the internet outside home (e.g. in libraries or internet cafés) and around 58% of voice-only consumers have mobile phones, there is limited evidence that internet marketing would be an effective way of reaching these customers.

*Ability to convince customers to switch suppliers*

- 4.38 CPs other than BT are also likely to face particular barriers in convincing SFV access customers to switch away from their current supplier.
- 4.39 Firstly, the evidence we have suggests that SFV access customers typically show low levels of engagement and low willingness to switch suppliers (see Annex 8 paragraphs A8.153-A8.176). Of those customers, BT's customers appear to be even less engaged:
- 4.39.1 Before the introduction of competition, BT had a near monopoly on fixed voice access. Whilst some of its customers have switched away over time, those that have not may have never switched suppliers, and consequently may be particularly disengaged, whereas those that have switched to other CPs will have engaged with the switching process at least once (i.e. from BT);<sup>113</sup> and
- 4.39.2 Results from the 2016 Switching tracker and the 2015 Jigsaw survey indicate that BT's SFV customers have lower switching rates and levels of engagement compared to non-BT customers. We set out the evidence in detail in Annex 8 paragraphs A8.153-A8.171 as above.
- 4.40 There may also be scope for BT to engage in targeted retention activities that limits other CPs' ability to attract new customers.<sup>114</sup> A smaller provider of SFV services ([S&C]) noted this as a barrier to gaining market share, as discussed in paragraph 4.79.4. While this may be a relatively good outcome for the customer concerned, such retention activity further raises the costs to rivals of acquiring new customers, and hence the barriers to market expansion.
- 4.41 Third, evidence suggests that BT may enjoy a higher degree of brand loyalty compared to other CPs. The 2015 Jigsaw survey shows that a large proportion of BT consumers perceive their supplier as a more trusted brand. Respondents were asked about the reasons for choosing their current supplier. 30% of BT voice-only customers cited "Trusted brand" compared to only 6% for non-BT. In addition, 42% of BT voice-only customers cited 'Always been my landline provider' as the reason compared to 8% for non-BT. We currently have limited evidence on the underlying reasons for these survey results (although we intend to conduct further research).

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<sup>113</sup> [S&C].

<sup>114</sup> As we discuss below, BT has a Home Phone Saver tariff which is substantially cheaper than its Anytime tariff. Home Phone Saver is not prominently advertised (for example, it is not one of the three main tariffs on offer on BT's website), but it can be used by BT selectively as a retention tool – i.e. offered to a customer who is considering switching.

- 4.42 Taken together, we consider that the factors identified result in particularly high acquisition costs for BT's rivals to win new SFV customers from BT. Those CPs face barriers in being able to target these customers effectively as well as difficulties in persuading them to switch away from BT as a result of low consumer engagement, BT's retention strategies and BT brand loyalty.

#### Declining market and competition for bundles

- 4.43 The fact that the SFV access market is declining over time is likely to be a further disincentive to a CP thinking of investing in marketing to expand its SFV access customer base. CPs' willingness to incur acquisition costs depends on the relative value of the acquired customer. The higher the expected value of the customer, the higher the willingness to compete. The nature of the SFV access base is likely to have a negative impact on a CP's willingness to invest for the following reasons:
- 4.43.1 There may be relatively limited scope for upselling additional services to SFV customers. This may particularly be the case for voice-only customers who may not have a need for broadband, although less relevant in the case of split purchase customers who could potentially be persuaded to switch to dual play.
- 4.43.2 As the SFV market shrinks, customer acquisition costs are likely to increase as remaining customers are likely to be even less engaged than those who ultimately choose to upgrade to dual-play and other bundled services.
- 4.43.3 The length of the supply relationship could be shortened by the age profile of SFV customers.

#### Provisional conclusion on barriers

- 4.44 Our analysis shows that potential competition from new entrants or expansion by existing CPs does not impose a strong constraint on BT.
- 4.45 The main barrier to entry and expansion is the ability of other CPs to reach customers and convince them to switch away from BT. SFV customers in general are relatively disengaged and unwilling to switch compared to other types of fixed voice customers. CPs other than BT face additional obstacles in that BT customers appear to be particularly loyal and less engaged than non-BT SFV customers.
- 4.46 In the absence of SMP remedies, we do not expect potential competition from other CPs to get significantly stronger over this market review period. If anything, it is more likely to be weaker as a result of the decline in the size of the market. As the addressable customer base declines, CPs will have a reduced incentive to incur the acquisition costs and compete for SFV access customers since the returns on investment available to them will be further reduced.

#### **Price Analysis**

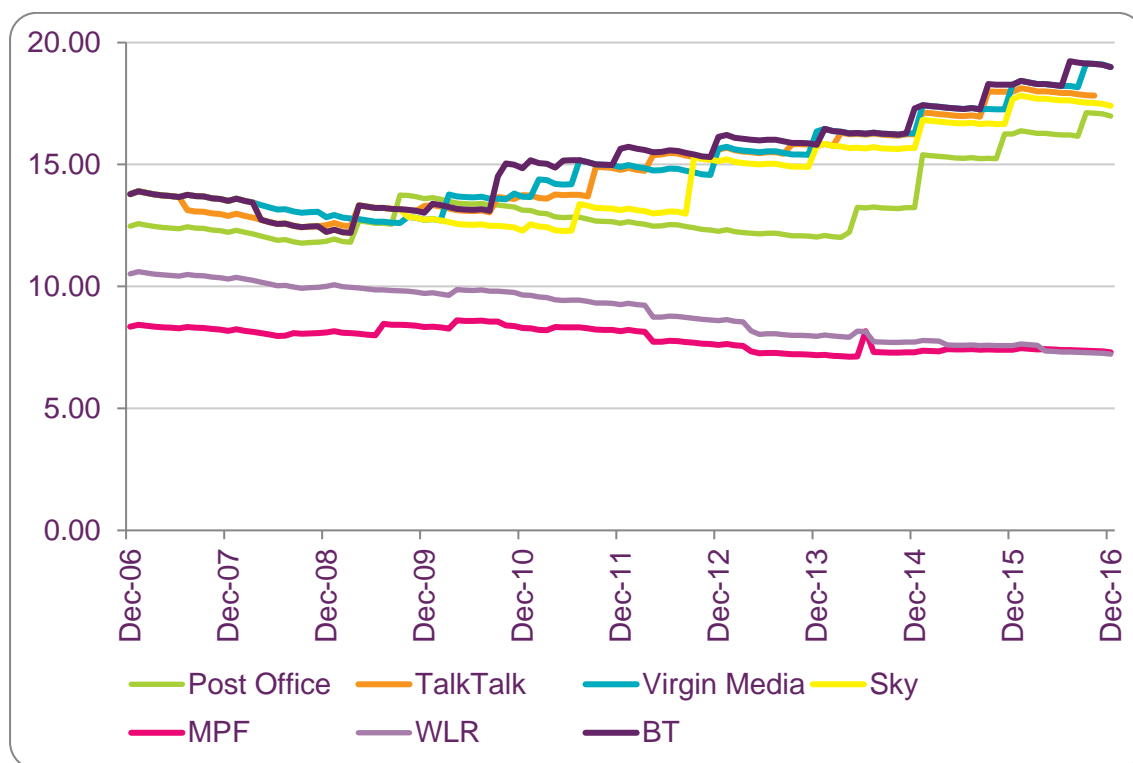
- 4.47 The ability to price persistently and significantly above the competitive level is an indicator of market power. In a competitive market, individual firms should not be able to persistently maintain prices above costs (including a normal return) and thus sustain excessive profits.

4.48 We first examine changes in the price of retail access i.e. line rental prices, and the evidence of other CPs following BT in changing these prices. We then consider whether these changes result from a rebalancing of revenues from calls to line rental, given changes in the usage of fixed calls. We also consider whether price changes may have been driven by changes in costs – either variable costs (such as WLR) or fixed costs. We then consider BT’s argument that it continues to add value for SFV customers, before considering the implications of price discrimination for our analysis.

### Line rental prices

4.49 We have examined residential line rental prices compared to (regulated) wholesale costs. Figure 4.2 shows the residential line rental prices charged by CPs from December 2006 to December 2016. This also shows the wholesale charges for MPF LLU and WLR. A CP generally needs one or other of these wholesale inputs to provide retail voice services to customers (if the CP does not have its own access network).<sup>115</sup>

**Figure 4.2: Wholesale and retail line rental price movements (£/month at December 2016 prices)<sup>116</sup>**



Source: PurePricing broadband updates

Notes: Adjusted for CPI; excludes line rental saver pre-payment tariffs

4.50 As can be seen, each CP has increased line rental prices a number of times over the period shown. For example, since December 2009 BT has increased prices 10 times over the seven-year period. The extent of BT’s increases to monthly prices has

<sup>115</sup> Most SFV services, particularly for voice-only customers, are provided using WLR (see 2016 NMR Consultation, paragraph 4.40).

<sup>116</sup> This chart is also shown in nominal terms in Figure A8.24 in Annex 8.

varied, from c.£0.30 up to £1.25 in nominal terms. More recently, starting in 2014, there is a pattern of annual price increases of £1 in the monthly line rental. As noted in paragraph 4.52 below and in Annex 8, these are generally followed both in timing and magnitude by other CPs.

- 4.51 BT's prices have generally been higher than those of other CPs. In 71 of the 85 months shown since December 2009, BT was either singly or jointly offering the most expensive line rental (although Virgin's line rental is currently £0.01 more expensive than BT). However, line rental prices offered by these suppliers have converged to some degree in recent years, having diverged after 2009, due mainly to significant increases in price by Sky and Post Office.<sup>117</sup>
- 4.52 The fact that prices appear to be converging as a result of price increases (rather than more expensive providers reducing their prices to match lower priced competitors) suggests that this is not the result of the market moving to a more competitive equilibrium. Figure A8.25 in Annex 8 maps the dates different CPs have announced price changes over the past 3 years (from April 2014 to January 2017) and shows a clear pattern of other CPs following BT in changing prices. In addition, the value of the price increase is typically the same across providers at approximately £1.00 per month.<sup>118,119</sup> [X].
- 4.53 Overall, on average line rental prices have increased by between 25% and 49% in real terms between December 2009 and December 2016. These price increases were highest for Virgin (49%) and BT (46%).
- 4.54 Figure 4.3, below, presents the access revenue per SFV line by operator (in real terms).

#### Figure 4.3: Access revenue per SFV line (£/month in December 2016 prices)

[X]

Source: s.135 responses

- 4.55 Access revenue per line has [X] between [X]% for [X] and [X]% for [X] in real terms between 2009/10 and 2015/16. Overall, however, [X] had the highest access revenue per line in the six financial years between 2010/11 and 2015/16.

#### Total revenue per line

- 4.56 While we have identified separate markets for access and calls, line rental is generally sold as a package including calls. As noted in Annex 8 paragraph A8.18, the number of calls made per fixed line has fallen by 55% between the year to Q3 2010 and the year to Q3 2016. While the reduction does not appear to be as significant for SFV customers, call volumes are also declining from SFV landlines. CPs could potentially be rebalancing their revenues to reflect this reduction in call usage.
- 4.57 If this were the case, we would expect to see combined revenues across calls and access remaining broadly flat over time. We have therefore looked at trends in

<sup>117</sup> We discuss this further in Annex 8 paragraph A8.57-A8.79.

<sup>118</sup> Sky did not increase their line rental price in 2016.

<sup>119</sup> TalkTalk did not actively offer SFV services in 2016 and, following the ASA ruling outlined in paragraph 2.3, stopped advertising a distinct line rental price in November 2016. For this reason, TalkTalk have been excluded from Figure A8.28.

access and call revenues per line over time to establish the extent to which a rebalancing has occurred which results in similar revenues across calls and access, taken together. This analysis is set out in Figure A8.39 of Annex 8.

- 4.58 This analysis covers all voice subscribers, not just those taking SFV. As set out in A5.34, BT does not hold revenue or cost data on its standalone fixed voice customers, instead it provided data for all of its fixed voice customers regardless of whether they also bought fixed broadband.<sup>120</sup> Other CPs also did not provide revenue data differentiated between SFV and other voice customers. While it is possible that there are differences in call usage between the groups, we do not have clear evidence on this point. We note that there appears to be only a relatively small difference in revenue per line between all voice customers and SFV customers. As set out in A5.43-A5.52, BT's revenue per line for SFV customers is £[redacted] compared to its average revenue per line across all voice customers in financial year 2015/16.<sup>121</sup> We therefore consider revenues across all voice customers are likely to be a reasonable proxy for the revenue per line earned from SFV customers.
- 4.59 Overall, the comparative levels of revenue per line for different CPs, and changes in this over time, suggest that [redacted]. Given that [redacted], we do not consider that it is likely that the increase in line rental can be attributed purely to a rebalancing of revenue between access and calls (even if this may be a contributing factor).

#### Changes in cost and added value services

- 4.60 Turning to costs, WLR charges have fallen by 26% in real terms between December 2009 and December 2016. This contributed to [redacted]. [redacted].<sup>122</sup> [redacted].
- 4.61 In addition, BT claims that it continues to add value for voice customers by including additional services in the package (e.g. including more call types in packages, and features to reduce nuisance calls) or improving service quality.<sup>123</sup> BT provided an estimate of the costs to it of various improvements it is making, such as moving all customers from Care Level 1 to Care Level 2 to shorten repair times, introducing new services including measures to allow consumers to avoid nuisance and scam calls, and investing in customer care (including answering more calls in UK call centres and improving the systems agents use). It estimated these would lead to an effective incremental monthly cost per line of £[redacted] (excluding VAT).<sup>124</sup> Therefore, this does not account for the size of BT's price increases or increased profit margin per line. [redacted].<sup>125</sup>
- 4.62 We recognise that, while WLR costs have gone down, [redacted], and there is some cost associated with new features. However, the net effect of the wholesale and retail cost

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<sup>120</sup> We note that revenue per line for dual-play customers takes the nominal line rental included in a dual play bundle as the access element of revenue. We recognise this is to some degree artificial, and from the CP's perspective the overall revenue for the bundle is more important.

<sup>121</sup> This takes into account the adjustment to remove BT Basic customers and to account for SFV customers making slightly [redacted] volumes of calls than BT's other fixed voice customers (see Annex 5 paragraph A5.43-A5.50). Given that BT Basic was a [redacted] proportion of BT's customer base in the past, the difference between revenue per line for SFV customers and all voice customers was likely [redacted] in previous years.

<sup>122</sup> Details of how costs have been allocated for this analysis are set out in Annex 5. We do not have similarly granular data for other operators.

<sup>123</sup> BT presentation to Ofcom 17 November 2016 and 30 November 2016.

<sup>124</sup> [redacted].

<sup>125</sup> [redacted]. This is discussed further in Annex 8, paragraphs A8.69-A8.74.

changes is that [3<]. Cost changes do not therefore explain the price increases observed. With the combination of cost changes and price increases, the evidence suggests that the provision of SFV services is highly profitable, and profitability per line has been increasing.

### Effect of price discrimination and discounting

- 4.63 In 2009, we argued that an attempt by BT to raise prices might result in significant switching to alternative providers. We suggested that as those who were less active in the market did not belong to any clearly defined social, economic or demographic grouping, BT might have difficulty targeting these consumers through price discrimination. In addition, we argued that some consumers who were inactive but aware of competition might well respond if prices increased significantly. These arguments supported our conclusion in 2009 that BT did not have SMP in retail fixed voice services.
- 4.64 However, we now observe that the number of SFV customers is falling, and those who remain as SFV customers are less engaged (see paragraphs 4.38-4.42). This is likely due to more engaged customers having progressively moved to bundled tariffs, which generally offer price savings. As discussed in Section 2 paragraph 2.3, traditionally, BT and other CPs stated that they charged the same line rental price to customers taking dual-play bundles as those taking voice on a standalone basis. However, the price to those customers taking dual-play bundles was the sum of the line rental and incremental broadband price (and the stated split of this total between these two parts had no effect on the price they paid). Therefore, dual-play bundle customers generally benefited from competition over the incremental price for broadband (see Annex 8). This offset increases in line rental prices for such dual play customers. By contrast, those taking SFV services just experienced the rising line rental prices without offsetting benefits on other prices.
- 4.65 More recently, as set out in Section 2 paragraph 2.3, the ASA has ruled that from 31 October 2016 broadband suppliers' price claims must show all-inclusive, up-front and monthly costs.<sup>126</sup> This means that CPs must show in their advertising the price charged for line rental and incremental broadband as a single overall price. This has led providers to start moving away from separating dual-play prices into separate line rental and broadband charges. As a result, it is possible that there may be less pressure on CPs to increase line rental prices for SFV services to match increases in line rental prices for dual play tariffs.<sup>127</sup>
- 4.66 Further, within the SFV market, there is evidence of price discrimination between engaged and unengaged customers. BT offers various ways for customers to save relative to their base prices, such as calling plan coupons.<sup>128</sup> BT also highlighted that it offers a Home Phone Saver tariff, which it launched in 2014 "in response to competitive pressure from the Post Office and other providers".<sup>129</sup> The Home Phone Saver tariff is at least £5.50 lower than standard BT prices and significantly more if

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<sup>126</sup> [https://www.asa.org.uk/News-resources/~media/Files/ASA/Reports/Ofcom%20Fixed%20BB%20Advertising%20of%20prices\\_Futuresight\\_Final%20Report\\_FINAL.ashx](https://www.asa.org.uk/News-resources/~media/Files/ASA/Reports/Ofcom%20Fixed%20BB%20Advertising%20of%20prices_Futuresight_Final%20Report_FINAL.ashx)

<sup>127</sup> This also means that BT has scope to exercise SMP in SFV access through line rental, while competing in dual play by varying the incremental broadband price. As a result, even if there continued superficially to be common pricing of line rental, a finding that BT has SMP in SFV access would not have any implication for its market position in relation to bundles.

<sup>128</sup> BT presentation to Ofcom 30 November 2016, slide 6.

<sup>129</sup> BT presentation to Ofcom 30 November 2016, slide 7.



various opt-in features are included. For example, BT has stated that the Home Phone Saver tariff offers a discount of £11 compared to standard prices.<sup>130</sup> A relatively small proportion of BT's SFV customers take the Home Phone Saver tariff. This implies that relatively few of BT's SFV customers are sufficiently engaged to have sought out a lower price offer which is available (although not prominently advertised). However, by offering such a tariff, BT can respond selectively to customers seeking to switch to an alternative provider without having to reduce standard prices, which would reduce the revenue it earns from less engaged customers.

### Provisional conclusion on price analysis

- 4.67 Our analysis of the evidence on prices suggests that prices are significantly above costs (both the relevant wholesale input prices and other elements of cost as discussed further in Annex 5), and have been diverging further over recent years. BT's prices also appear to be above those of other operators without this materially affecting its position in the market in terms of market share (as set out in paragraphs 4.17-4.19). There is evidence that BT acts as a price leader, with other CPs following its increases in line rental in terms of both timing and magnitude. Price discrimination to offer greater discounts to more engaged customers (for example, through its Home Phone Saver tariff) allows BT to increase prices for (largely unengaged) SFV customers whilst limiting the risk to the revenues it earns from more active customer groups.

### **Profitability**

- 4.68 Annex 5 set out our profitability analysis for BT as well as other CPs. Our analysis shows that BT's profitability (per line) from selling SFV services increased from 2007/08 to 2015/16. Over the period, we estimate that BT's net margins from SFV services increased from approximately £[<] to £[<] per line per year in real terms (in December 2016 prices). This equates to EBIT margins increasing from [<]% to 34-42%. (See Annex 5, paragraph A5.59 and Figure A5.8).
- 4.69 We consider that our views on BT profitability hold for access and calls separately. We have considered the extent to which BT's line rental and calls products drove its fixed voice profitability in paragraphs A5.63-A5.69. As shown in Figure A5.10, we estimate that BT's gross margins per line from line rental have increased, from approximately £[<] per line per year to approximately £[<] per line per year (in real terms, December 2016 prices). If we were to allocate a much greater proportion of BT's retail costs to either line rental or calls, [<].
- 4.70 We consider that the fact BT's profitability per fixed voice line has been high and increasing over time, [<], is consistent with BT facing limited competitive pressure in the provision of these services to SFV customers.
- 4.71 We have some evidence on the profitability of other CPs, although not from all CPs and at an aggregate level. Therefore, we have therefore treated the results of our analysis of the profitability of other CPs with caution. Our analysis suggests that some of these CPs are making reasonably high profits from their fixed voice consumers. Data from [<] indicate that these CPs earn a profit of £[<] to £[<] per year, or [<]% to [<]% EBIT margins.

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<sup>130</sup> BT presentation to Ofcom 17 November 2016, slide 10.

## Countervailing buyer power

- 4.72 We have considered whether consumers possess countervailing buyer power in each of the access and calls markets. Countervailing buyer power is the degree of restraint that a purchaser is able to place on the seller by imposing an effective counter on any attempt by the seller to set its prices above the competitive level. It is more likely when a customer accounts for a large proportion of a supplier's total output, is well informed about the alternative sources of supply and is able to switch at little cost.
- 4.73 However, individual retail SFV customers make up a negligible proportion of BT's revenues and output such that it is difficult to see how BT could be constrained in its behaviour by customers threatening to switch, and individual consumers cannot reasonably sponsor entry by alternative suppliers to challenge BT's position. Nor have we seen evidence of groups of SFV customers operating in way that could exercise effective countervailing buyer power. We therefore do not consider that countervailing buyer power provides an effective restraint on BT's market power.

## CPs' views on customer acquisition

- 4.74 BT claims that the market is competitive. BT argues that it sees a high churn of voice only customers, with churn of [X]% in Q2 2016/17 (above that for fibre or pay TV). BT adds that [X]% of these line ceases are due to competitive losses.<sup>131</sup> As explained earlier (see paragraph 4.18), BT's customer churn largely reflects the declining market (as many consumers exit the SFV market by moving to dual play packages or for other reasons) and a relatively small proportion is due to switching to SFV services from other providers. BT itself notes that upgrade to dual play accounts for three of the four categories of consumer losses BT identified.<sup>132</sup> While some customer churn is likely to include customers moving from a BT SFV service to dual play from another operator, as set out in Section 3 paragraphs 3.30-3.43 we do not consider dual-play exercises a competitive price constraint on SFV services.
- 4.75 [X].<sup>133</sup> We do not have time series data for the provision of SFV service to voice-only customers, however, our data for total SFV services does not show that Post Office is growing its customer base (despite the increase over time in its market share). Between April 2015 and September 2016 the number of SFV lines for BT and Post Office both fell, albeit the percentage decline in BT's base was [X] ([X]% fall for BT and [X] % for Post Office).
- 4.76 In addition, the evidence on market shares (presented in paragraphs 4.17-4. 28) and the price analysis (discussed in paragraphs 4.47-4.67) do not support the existence of strong competition. Despite the declining market, the marketing efforts and lower prices offered by some other CPs, and decline in BT's market share, BT has maintained a high market share of 79% and above over the past four years. Moreover, despite BT claiming it faces competition, it has still been able to raise line rental prices well above inflation year on year (see Figure 4.2 and paragraphs 4.50-451) and increase its SFV profitability.

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<sup>131</sup> BT presentation to Ofcom 30 November 2016, slide 4.

<sup>132</sup> BT notes that its losses from the segment include: customers consolidating voice and broadband with other providers; customers consolidating voice and broadband with BT; customers choosing another provider for voice services; and customers leaving to take voice and broadband elsewhere as their first entry into broadband. (BT presentation to Ofcom 30 November 2016, slide 4).

<sup>133</sup> BT presentation to Ofcom 30 November 2016, slide 4.

- 4.77 We spoke to some CPs about their marketing efforts and the costs of acquiring SFV access customers. Overall, the views expressed by other CPs are consistent with our view on the existence of barriers to customer acquisition, which in turn limit their ability and/or appetite to compete in the market.
- 4.78 First, some CPs – particularly larger ones – expressed no interest in marketing to SFV access customers, saying that the focus of competition, and of marketing budgets, was on multi-play. In particular:
- 4.78.1 [X] no longer offers SFV access services to new customers and mentioned that it has no appetite for re-entering the market. It considers that while margins now look quite high, the low likely numbers of switchers – due to consumer inertia – do not justify the costs/complexity of pursuing the business.<sup>134</sup>
- 4.78.2 [X] said that it does not market to SFV access customers because the market is small and declining, there is limited scope to upsell services such as broadband and TV to SFV customers and it is hard to convince customers to switch away from BT as this customer group shows strong loyalty to the BT brand and is typically older in age profile. [X] added that it prefers to compete for multi-play customers (particularly those purchasing pay TV services), who are higher value customers because they take more services.<sup>135</sup>
- 4.79 Other CPs expressed interest in winning more SFV customers, but noted high acquisition costs, and BT retention activity as barriers to reaching them:
- 4.79.1 Post Office mentioned that it has three acquisition channels for voice-only customers: online (20%), call centre (40%) and in-branch (40%). It described customers as inert and noted that despite regular contact in Post Office branches Post Office struggles to gain much traction. It considered that inertia seems to come from concerns about the switching process even though the potential savings from switching are significant for some customers. However, it said it had successfully reached some of BT's SFV customers by launching various marketing campaigns.<sup>136</sup>
- 4.79.2 Post Office has recently launched an introductory offer to incentivise BT's SFV customers to switch. The offer entails paying a 12-month contract at a price £14.99 a month instead of the full monthly price at £16.99. At the end of the contract, the consumer will pay the full monthly price. Post Office marketing material also shows that they try to alleviate customer's concerns about the switching process. For example, in the marketing material for the new offer, Post Office notes that the end user will keep the same phone line so no engineer will need to visit at home, keep the same phone number that everyone knows and there will be no break in service as the switch takes place.
- 4.79.3 [X] mentioned that active marketing to potential customers of voice-only products is difficult. It considers that identifying and reaching voice-only customers can be challenging, acquisition costs are high and trust is a very

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<sup>134</sup> [X] email to Ofcom, November 2016.

<sup>135</sup> Notes of phone conversation with [X] on 15 November 2016.

<sup>136</sup> Notes of phone conversation with Post Office on 20 October 2016.

important factor for the customer in choosing the supplier. [X] added that voice-only customers are more likely to be vulnerable, and it exercises particular caution in conducting sales to vulnerable consumers, including a policy that stops the sales process if the agent thinks potential customers are not comprehending the discussion.<sup>137</sup>

- 4.79.4 [X] considers telemarketing to be the most cost effective way to reach SFV customers. It identifies two main barriers to gaining market share in voice-only. First, BT's retention strategy, by having a team to convince customers not to switch away from BT, makes it difficult to win customers, particularly older ones who are very loyal to BT. It told us that in some cases BT's SFV customers whom it has contacted will call BT to inform it that they are switching, and be persuaded to stay in the course of the phone conversation. Second, [X] is not listed on some of the price comparison websites as it finds the costs of some sites to be prohibitive - some sites have greatly increased the cost of acquiring voice-only customers (£70-120 per customer).<sup>138</sup>

## **Provisional conclusions on market power**

- 4.80 We provisionally conclude that BT has SMP in SFV access. This is based on the following evidence collectively:
- 4.80.1 Even taking into account the recent decline in its market share, BT had and continues to have a high market share of 79% and above over the last four years for which data is available and a share of at least 60% across all three customer segments (voice-only, split-supplier and split-service customers);
  - 4.80.2 Other CPs face barriers in acquiring new customers and some of them are not interested in marketing to SFV customers. This is mainly due to high acquisition costs (e.g. due to low levels of consumer switching and engagement, BT brand loyalty and BT's ability to launch successful retention policies);
  - 4.80.3 There is evidence that BT acts as a price leader i.e. it sets its prices largely independently of other CPs, while other CPs generally follow BT's price increases;
  - 4.80.4 Our profitability assessment shows that BT's profitability is increasing over time on a per line basis. Our analysis shows that this is true for SFV services (i.e. access and calls combined) as well as for SFV access alone; and
  - 4.80.5 Countervailing buyer power does not provide an effective restraint on BT's market power.

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<sup>137</sup> Notes of phone conversation with [X] on 1 December 2016.

<sup>138</sup> Notes of phone conversation with [X] on 21 November 2016.

## Consultation questions

*Question 4.1: Do you agree with our provisional conclusion that, during the period covered by this market review, BT will have SMP in the standalone fixed voice access market? Please provide reasons and evidence in support of your views.*

## Section 5

# Retail market power assessment: Calls

## Introduction and summary

- 5.1 This Section sets out our market power assessment for the standalone fixed voice (SFV) calls market.<sup>139</sup>
- 5.2 We have provisionally concluded that BT has SMP in fixed calls and that other CPs do not. This view is informed by:
- evidence of BT's high market share;
  - evidence that BT's customers are less engaged and more loyal compared to customers of other CPs; and
  - our assessment of BT's profits from this market.

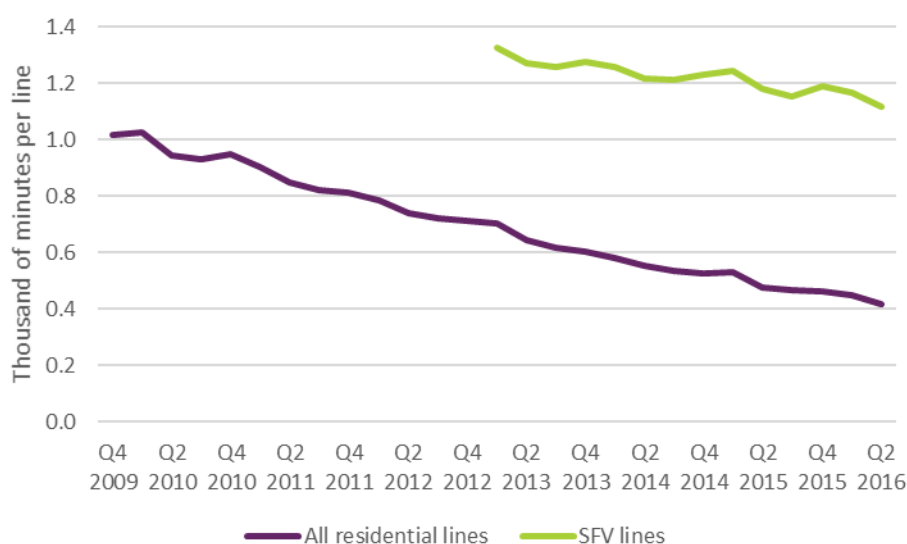
## Market Overview

- 5.3 We begin by setting out an overview of the conditions within the market for SFV calls, particularly as regards declining call volumes.

### Ongoing decline in fixed voice calls

- 5.4 Figure 5.1 shows voice calls per line for both all residential lines and SFV lines.

**Figure 5.1: Call volumes per line per quarter in the UK**



Source: Ofcom/operators and s.135 information requests

<sup>139</sup> As set out in Section 3, the relevant fixed calls market refers to standalone fixed voice calls sold to residential customers in the UK (excluding Hull).

- 5.5 The average volume of fixed line voice calls per line is declining across all residential lines. Calls from all residential lines fell from approximately 3.8 thousand minutes per line in the year up to Q3 2010 to approximately 2.6 thousand minutes per line in the year up to Q4 2013 and down to 1.7 thousand minutes per line in the year up to Q3 2016. This represented declines of 55% between Q3 2010 and Q3 2016 and 33% since Q4 2013 (see Figure A8.5 of Annex 8).
- 5.6 SFV customers make more calls than fixed voice customers generally – 2.3 thousand minutes per line in the year up to Q3 2016, compared to the overall average figure of 1.7. While they are making fewer calls than in the past, the rate of decline is slower than for fixed lines generally – an 9.3% fall since Q4 2013 compared to the overall average decline of 33%.
- 5.7 However, as noted in Section 4 paragraphs 4.4-4.6 and Annex 8, the number of SFV lines has decreased significantly and consequently, total call volumes from SFV lines have been falling faster than total calls from all residential lines – for example (50%<sup>140</sup> vs. 31%<sup>141</sup> between Q2 2013 and Q2 2016).
- 5.8 As we note in Section 3, paragraph 3.92, we have observed an increase in calls originated on mobiles at the same time as this marked decline in the volume of voice calls originated by consumers on fixed lines. The 2016 NMR Consultation shows calls from fixed lines fell approximately 42% between 2009 and 2015, while calls from mobile lines increased 13% in the same period.<sup>142</sup>

## Our SMP assessment

- 5.9 Our approach to the assessment of SMP is set out in Annex 7 and is the same as we have followed for the assessment of SMP in SFV access. We note in this regard that many of the features of the SFV calls market are common with the SFV access market.
- 5.10 We assess SMP in SFV calls using the following criteria:
- Market shares;
  - Barriers to entry and expansion;
  - Pricing; and
  - Profitability.
- 5.11 We set out in Section 4 (paragraphs 4.72-4.73) that countervailing buyer power is not likely to constrain SMP due to the nature of retail customers. This is equally true for calls as for access, and so we do not consider this issue further in this section.

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<sup>140</sup> Total call volumes from SFV lines fell from 3.2 bn minutes in Q2 2013 to 1.6 bn minutes in Q2 2016.

<sup>141</sup> Total call volumes from all residential lines fell from 15.92 bn minutes in Q2 2013 to 10.93 bn minutes in Q2 2016.

<sup>142</sup> See 2016 NMR Consultation, Figure 1.1, [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0016/95011/Narrowband-Market-Review.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0016/95011/Narrowband-Market-Review.pdf).

## Market shares

- 5.12 We have examined the market shares of the main suppliers of standalone voice services over the period 2013-2016<sup>143</sup> (see Figure 5.2), based on shares of call minutes (volume).

### **Figure 5.2: Market shares of SFV call volumes by CPs (in ranges)**

[X]

Source: S135 information request

\* Market shares for 2016 are averaged across January – September.

- 5.13 Figure 5.2 shows that BT has a very high market share [X]%. [X]. The next largest provider has a share of 5-15%. As with the market for SFV access, BT's market share has fallen to some extent over this period, [X].

- 5.14 [X].

- 5.15 As set out in Annex 8,<sup>144</sup> we have also considered revenue market shares by using shares of non-access SFV revenue as a proxy for operators' shares of SFV call revenue.<sup>145</sup>

- 5.16 [X]. [X].

## Provisional conclusion on market shares

- 5.17 BT has a market share of SFV calls [X]. While its volume market share has [X] to some extent in recent years, it [X] and is likely to remain so over the market review period.
- 5.18 We now consider whether barriers to entry or expansion prevent others from challenging this high market share.

## **Barriers to entry and expansion**

- 5.19 As we noted in Section 3, paragraph 3.13-3.20 we analyse SFV access and SFV calls as separate markets because there is scope for a difference in competitive conditions between them due to factors such as the potential to substitute to mobile calls. However, this does not mean that the competitive interaction among providers of SFV services necessarily differs between their provision of access and calls. As calls are typically bought alongside access, if another CP wanted to compete for the call revenues generated by BT's SFV customers, it would have to do so by getting them to switch their landline (i.e. access) away from BT. CPs therefore face the same barriers to entry or expansion in calls as they do in access. As we set out in section, those barriers are largely driven by high customer acquisition costs resulting from:

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<sup>143</sup> Details of which CPs were included and excluded from this analysis is set out in Annex 8.

<sup>144</sup> See paragraphs A8.50-A8.52.

<sup>145</sup> Some CPs, including BT, offer "free" weekend calls within the line rental price. As a result, some line rental revenue is attributable to calls. We do not have a basis for separating access and inclusive calls within line rental prices, so for reasons of practicality we treat line rental as the price of access. However, as noted in Section 3 paragraph 3.24 this does not make a material difference to our analysis of market shares (particularly as a similar effect will apply to BT and other CPs), or to our overall SMP findings.



- 5.19.1 The relatively small size of the residential SFV access market compared to the total number of households in the UK means that, in order to run an efficient marketing campaign, a supplier would need to find a cost-effective way of identifying customers within the SFV access market (see paragraph 4.37 in Section 4). Further, for the reasons set out in Section 4 paragraphs 4.37-4.42 CPs are likely to find it difficult to reach and attract these customers.
- 5.19.2 As set out above, the number of calls per landline is declining over time. This will tend to create an additional disincentive to expansion/customer acquisition, as it means that, other things equal, customers will tend to make fewer calls, further reducing the potential revenues associated with new customers.
- 5.20 As noted in Section 4, we spoke to some CPs about their marketing efforts and the costs of acquiring residential SFV access customers. Overall, the views expressed by other CPs are consistent with our view on the existence of barriers to customer acquisition, which in turn, limit their ability and/or appetite to compete in the market. We set out further detail on CP views in paragraphs Section 4 4.74-4.79. We consider these views are also likely to apply to SFV calls as well as access.

#### Provisional conclusion on barriers to entry and expansion

- 5.21 Our analysis shows that potential competition from new entrants or expansion by existing CPs does not impose a strong constraint on BT. These considerations are consistent with our findings in relation to SFV access (see paragraphs Section 4 paragraphs 4.44-4.46).
- 5.22 In the absence of SMP remedies, we do not expect competition from other CPs to get significantly stronger over this market review period. If anything, it is more likely to be weaker as call volumes decrease as described above.

#### **Price Analysis**

- 5.23 The assessment in this section applies to all fixed voice services and is not limited to SFV calls alone since standalone voice customers currently pay the same call prices (and can purchase the same call plans) as all fixed voice customers.<sup>146</sup> As we have indicated in Section 3 paragraphs 3.82-3.85, we do not, however, consider the market for SFV calls to include calls by purchasers of multi-play access.
- 5.24 Consumers can purchase some types of calls within a call plan, allowing them to make calls to particular numbers (e.g. international calls) at no additional cost beyond the price of the plan (or, in some cases, for a discounted per minute price). Calls outside of a call plan incur a set-up fee per call and a price per minute.
- 5.25 In Annex 8, we set out further data on call prices (see paragraphs A8.80-A8.106).<sup>147</sup> This data covers prices, volumes and revenues for all fixed voice customers (as we

<sup>146</sup> There is an exception to this rule in the case of BT's Home Phone Saver product which offers a SFV specific line rental and call plan package.

<sup>147</sup> The data we analyse in this document differs to that used in the 2016 NMR Consultation. In the NMR, we noted that retail call prices declined somewhat between 2010 and 2015 (see Figure 3.13, available at: [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0016/95011/Narrowband-Market-Review.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0016/95011/Narrowband-Market-Review.pdf)). This is based on a revenue per minute analysis for certain (out of plan) calls applied to a basket of calls. Our analysis uses revenue per minute for out-of-bundle calls, similar to NMR.

cannot conduct analysis on SFV revenues and calls specifically). That analysis shows the following:

- 5.25.1 **Out-of-plan call prices and revenues per minute:**<sup>148</sup> In paragraphs A8.97-A8.99 we set out call prices for a number of CPs, which show that BT's prices are more or less in line with other providers and the market average. However, [§].<sup>149</sup>
- 5.25.2 **Call plan prices:** In paragraphs A8.84-A8.96 in Annex 8 we set out an analysis of selected call plan prices for individual CPs. BT's price increases for these call plans have generally been among the highest of the CPs for which we have data. However, in many cases its prices are still below those of other CPs shown in the charts. There is also no clear pattern about the price changes by different CPs – the size of price changes has varied across CPs, and some CPs have not increased these prices at all. Overall, call plan prices have increased well above inflation, with 11% year-on-year increases for Evenings and Weekends and over 7% for Anytime between 2012 and 2016 (see paragraph A8.104).
- 5.25.3 **Non-access revenue:** As CPs may change the balance of what is offered within and outside call plans, we also analyse overall non-access revenues per minute as a proxy for all call prices in paragraphs A8.106-A8.108. BT had [§] non-access revenue per minute between the financial years 2013/14 and 2014/15, and had [§] in 2015/16. [§].<sup>150</sup> [§].
- 5.25.4 **Decline in volumes:** we noted in paragraphs 5.4-5.8 above that call volumes have been declining significantly in recent years. Call prices may be argued to have increased in response to this trend. However, as set out in Annex 5 Figure A5.10 and paragraph A5.65, [§].
- 5.25.5 **Changes in costs:** We have considered whether changes in prices are justified by changes in wholesale call or retail costs. Regulated wholesale cost of calls is more complicated to examine compared to wholesale access charges.<sup>151</sup> However, the overall trend in regulated wholesale costs has been downwards. As set out in paragraph A5.67, if we were to allocate a much greater proportion of BT's other (retail) costs particularly heavily to

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However, our data also includes 'other calls', such as directory enquiries, premium rate calls, Freephone calls, and all other call types. In addition, we also utilise evidence on retail tariffs available to consumers. The effective prices paid by consumers (captured by revenue per minute) may have reduced over time even in the face of increased retail tariffs if consumers have moved more of their calls into call plans (which generally represent better value).

<sup>148</sup> Out-of-plan revenues potentially represent a substantial proportion of revenues earned from calls. [§] (see Figure A5.5 in Annex 5).

<sup>149</sup> In Annex 8 paragraph A8.97 we also note that the average price of out-of-plan UK geographic calls increased 29% in real terms between 2012 and 2016 (an annual average increase of 6.5%). This is quite similar to the increase in the average price of set-up fees. However, prices of calls to mobiles have been largely steady in real terms.

<sup>150</sup> Figure 5.4 in Annex 5 also suggests that BT's revenue per line for calls (both call packages and out-of-bundle calls) has been [§].

<sup>151</sup> Calls will generally involve a wholesale call origination (WCO) charge and some form of termination fee. For calls to other geographic numbers, this will be the Wholesale Call Termination (WCT) charge. WCO and WCT charges have seen very different trends in recent years, as shown in Figure A8.41. In addition, different types of calls will attract different termination costs which have been declining at different rates.

calls, [X]. Therefore, changes in retail prices do not appear to have been related to changes in [X] costs.

### Provisional conclusion on pricing

- 5.26 It is difficult to draw any firm conclusions from the pricing evidence. Whilst BT's prices for call plans are typically lower than its competitors, its revenues for [X] tend to be higher than its competitors. We note, however, that BT's prices are [X] and the price increases are not obviously linked to changes in [X] costs. Nevertheless, on balance, we have not sought to draw any conclusions as to market power on the basis of the pricing evidence alone.
- 5.27 While call prices are generally the same for SFV customers as for other fixed customers, this does not mean that CPs could not set different call prices between SFV and non-SFV customers in future, as discussed in Section 3 paragraph 3.82-3.85.<sup>152</sup>

### **Profitability**

- 5.28 As discussed in more detail in Annex 5, we estimate that between 2007/08 and 2015/16, BT's net margins from SFV services [X] from approximately £[X] to £[X] per line per year in real terms (in December 2016 prices). This equates to EBIT margins increasing from [X]% to 34%-42%. (See Annex 5, paragraph A5.59 and Figure A5.8).
- 5.29 We considered the extent to which BT's line rental and calls products drove its fixed voice profitability in paragraphs A5.63-A5.69 in Annex 5. As shown in Figure A5.10, we estimate that BT's gross margins per line from calls [X], from approximately £[X] per line per year in 2007/08 to £[X] per line per year in 2015/16 (in real terms, December 2016 prices). If we were to allocate BT's retail costs particularly heavily to either line rental or calls, [X].
- 5.30 As set out in Section 4, paragraph 4.71 and Annex 5, paragraph A5.71, our analysis suggests that SFV customers are also profitable for some other CPs. We do not have sufficient data to estimate the profitability of other CPs with respect to calls separately from access.

### **Other constraints on SFV calls**

- 5.31 We set out in Section 3 paragraph 3.97 that there are other services, particularly mobile, which, while not close enough substitutes to be regarded as part of the same market as SFV calls, could provide an increasing constraint for calls – if not in access – which we take into account in our assessment of market power.
- 5.32 In particular, we noted in paragraph 3.94 that mobile appeared to be a relatively close substitute on a call-by-call basis with respect to some call types by certain groups (but a more limited substitute for others). Mobile call prices had fallen in relative terms and call volumes had increased, and this appeared to be at least a partial driver of the fall in fixed voice volumes. In addition, in the 2016 NMR Consultation, we stated that mobile calls and other services outside the WCO market

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<sup>152</sup> There are examples of such discrimination today – BT's Home Phone Saver product is only available to SFV customers and includes a unique calls offering.

are a greater constraint than at the time of the last NMR. We also noted mobile in particular exerts a relatively stronger constraint for WCO than WFAEL.<sup>153</sup>

- 5.33 However, we note in Section 3 that balancing various factors we considered in the 2016 NMR that mobile calls are not a sufficient indirect constraint on fixed calls to be included in the relevant product market (at the wholesale level). Much of our assessment in the NMR consultation related to fixed calls generally, rather than SFV calls in particular. However, we consider that the considerations supporting our position in NMR also apply in the case of SFV customers, noting that SFV customers are less likely than fixed voice customers generally to have mobile phones, and that in the survey evidence discussed above they appear to be less price-responsive than fixed voice customers generally.
- 5.34 VoIP could also potentially provide an additional constraint on calls from fixed lines. At Section 3 we note it appears that a minority of SFV customers use VoIP and fewer use it frequently. Even consumers who use VoIP frequently mainly use VoIP calls for a limited range of call types (in particular international calls and calls to other VoIP users). In addition, in the 2016 NMR we proposed that, for similar reasons as described here, we do not consider switching to VoIP is a sufficiently strong constraint to prevent SMP in the WCO market in the review period.<sup>154</sup>
- 5.35 Therefore, whilst constraints from mobile and VoIP are relatively stronger for SFV calls than for SFV access, we do not consider that they are likely to provide an effective restraint on BT's market power during the market review period.

## Provisional conclusions on market power

- 5.36 We provisionally conclude that BT has SMP in residential SFV calls. This is based on the following evidence:
- 5.36.1 BT had a high market share of [ $\geq$ ] % or [ $\geq$ ] over the last four years for which data is available;
- 5.36.2 As for SFV access, other CPs face barriers in acquiring new customers and some of them are not interested in marketing to SFV customers. This is mainly due to high acquisition costs (e.g. due to low levels of consumer engagement and BT brand loyalty);
- 5.36.3 The profitability assessment shows that BT's gross margin per line for calls is increasing over time. Our analysis shows that BT's gross and net margins are also increasing for SFV services on a per line basis (i.e. access and calls combined).

## Consultation questions

*Question 5.1: Do you agree with our provisional conclusion that, during the period covered by this market review, BT will have SMP in the SFV calls market? Please provide reasons and evidence in support of your views.*

<sup>153</sup> 2016 NMR, paragraph 6.67.

<sup>154</sup> 2016 NMR, paragraph 6.57.

## Section 6

# Addressing consumer detriment

## Introduction

- 6.1 In Sections 4 and 5 we set out our provisional assessment that BT has SMP in the markets for SFV access and SFV calls. In this section:
- 6.1.1 We set out our view of the consumer detriment which results from BT's SMP;
  - 6.1.2 We explain why we do not consider that wholesale remedies have been effective in addressing this consumer detriment; and
  - 6.1.3 We describe ways in which consumer detriment in these markets might be addressed.

## Our assessment of consumer detriment

- 6.2 We have provisionally concluded that BT has SMP in the markets for SFV access and SFV calls. In our view, the lack of competition in those markets which is a result of BT's SMP, has resulted in two types of consumer detriment: direct effects and indirect effects.

## Direct effects

- 6.3 We have considered the extent to which BT's standalone voice prices are above the competitive level.
- 6.4 Our assessment of BT's profitability, set out in Section 8 and Annex 5, shows that BT is making profits in SFV markets which are [§<] and the profit margins identified using competitive benchmarks. BT's prices are approximately £8-£10 per line per month above the level of its costs and £5-7 per line above a level indicated using competitive benchmarks.
- 6.5 Based on our estimate of around 2.9 million SFV lines in the UK (excluding BT Basic)<sup>155</sup> the overall current<sup>156</sup> consumer detriment is therefore of the order of £150 to £340 million per annum, depending on the choice of benchmark price (see Annex 5 for further details).
- 6.6 As set out in Annex 8, we also consider that in recent years there is evidence that BT has acted as a price leader in the market, in that when it has increased prices other providers have followed with similar price increases. The result is that SFV customers in the market generally pay prices significantly above costs due to BT's SMP.

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<sup>155</sup> Annex 8, paragraph A8.15.

<sup>156</sup> Estimates of future consumer detriment would need to take into account that the base of SFV customers is declining over time and the potential for the detriment per line to change.

## Indirect effects

- 6.7 Competition can deliver a number of consumer benefits such as lower prices, more choice, better quality, and innovation. Competition in the provision of SFV services could, for example, deliver benefits in the form of product differentiation by reference to service features (e.g. reliability of the connection), customer and add-on services. Consumers could also benefit from competition in the provision of different call packages and inclusive call allowances. As a result of the lack of competition in the market, reflected in BT's SMP, consumers are deprived of the benefits that such competition would bring.

## Wholesale regulation

- 6.8 As set out in Section 2, before imposing regulation at the retail level, we are required to demonstrate that we are unable to perform, or to fully perform, our duties through the imposition of wholesale regulation.
- 6.9 The wholesale inputs required for the provision of SFV services, in particular WLR, have been subject to wholesale regulation, on a continuing basis, since Ofcom's last review of the retail fixed line markets in 2009. Wholesale regulation of these services has included an obligation to provide access, as well as different forms of pricing regulation. In our 2016 NMR Consultation we proposed retaining some form of wholesale regulation for these products.
- 6.10 However, as set out in Sections 4 and 5, BT continues to enjoy SMP in SFV markets, despite the presence of wholesale regulation. As also set out in Section 4, increases in retail line rental prices have occurred despite decreasing wholesale prices. Specifically, while the charges for key wholesale inputs to these services have fallen by up to 26% in real terms, retail line rental prices have risen by between 25% and 49% since 2010.
- 6.11 In addition, some of the concerns that we have identified are not addressable through measures at the wholesale level as they relate only to the conditions for competition at the retail level. This is particularly the case with some of the barriers to entry and expansion that we have identified in our SMP analysis, relating to the disengaged nature of the SFV customer base.<sup>157</sup>
- 6.12 In our view, it is therefore clear that wholesale regulation has not been, and will not be, sufficient to address the consumer detriment that we have identified in relation to SFV services. Accordingly, we do not consider that wholesale regulation would enable us to perform our duties, particularly our duty to promote competition, including by ensuring that users derive the maximum benefit in terms of choice, price and quality.

## Retail regulation

- 6.13 As a result of the SMP which we identified in section 4 and 5, BT has been able to raise retail prices to its standalone landline telephone customers despite falling costs. This has directly negatively impacted on current SFV customers who face higher prices than they otherwise would in a competitive market.

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<sup>157</sup> Section 4, paragraphs 4.38 – 4.42.

- 6.14 We are therefore of the view that it is appropriate to take measures to directly address the consumer detriment which has arisen through the imposition of a price cut. We also consider that, in addition to a price cut, it is appropriate to take action to try to increase competition for those consumers. This should result in better consumer outcomes, if it is successful. We are therefore proposing a combination of retail price controls and measures to change consumer behaviour to promote competition.
- 6.15 We set out our assessment of the options and the interrelationship between the remedies in the following Sections 7, 8 and 9. In summary our proposed approach (confirmed in Section 9) takes the following form.

### **Retail price control**

- 6.16 We are proposing to impose a price control on BT covering both line rental and calls as well as ancillary services for standalone landline telephone services.
- 6.17 This control – a price cut on the standard line rental of between £5-7 per month – will immediately reduce the gap between wholesale costs and retail prices we have seen emerge over the last few years. Thereafter BT will only be allowed to increase its charges for line rental and calls in line with inflation.
- 6.18 The price cut will apply to all BT customers using standalone landline telephone contracts (whether or not they buy fixed broadband from BT or other telephone companies outside of a bundle). It does not apply to landline services sold by BT as part of a bundle of services which include broadband or other non-voice services, as we consider competition in this market is delivering good outcomes for consumers.
- 6.19 The effect of the price cut will be to largely reverse the price increases since 2009. We recognise that the price cut may not reduce prices to the level BT might charge in a fully competitive market, however, we consider that it is appropriate to leave some room for competitors, who necessarily have higher customer acquisition costs, to re-enter the market and profitably compete for BT's customers. If we see no prospect of this arising, we may consider it necessary to go further in the level of the price control.

### **Promoting competition**

- 6.20 Competition has the potential to deliver benefits for consumers in terms of price and choice. However, in order for the benefits of competition to emerge, consumers must be sufficiently engaged to make well-informed decisions about switching to get a better deal. For this to happen, we believe that consumers need to have access to helpful, easy to understand information so that they can make more informed choices.
- 6.21 We are therefore proposing to require BT to work with us to trial – and, if appropriate, ultimately deliver – consumer information which will encourage its standalone landline customers to look for better value deals. We propose to trial and implement various ways of providing consumer information which will help customers understand what they are buying and what alternatives they have to get better value for money.
- 6.22 Our aim in imposing these measures is to allow other providers to compete more vigorously in this market and to win customers. If the engagement remedies we are

proposing are effective, we would expect consumers to benefit in terms of price and choice.

## Remaining Sections

- 6.23 In Section 7, we set out our view of the options for promoting competition, including: some details of how measures might be designed to work in the SFV markets, which of these measures are most likely to be effective in the market, and how we would propose to design a potential remedy involving those types of measures.
- 6.24 In Section 8, we set out the potential options for a price control remedy.
- 6.25 While clearly the two categories of remedy are not mutually exclusive, there are potential trade-offs and challenges in progressing with both of them at the same time. In Section 9 we consider these trade-offs, set out the potential range of options for an overall package of remedies, and present our argument for our preferred package of remedies noted above.



## Section 7

# Options to promote competition

## Introduction and summary

- 7.1 This section sets out our assessment of remedies to promote competition. In particular:
- 7.1.1 We discuss the potential role that remedies could play to promote competition, focussing on remedies to increase engagement. We summarise current survey evidence and our intention to carry out further research.
  - 7.1.2 We identify several options for engagement remedies which could promote competition. We discuss two broad categories of engagement remedies. Firstly, information remedies, that provide information to consumers to make it easier for them to engage in the market. Secondly, remedies that lead directly to a change in outcomes for a substantial number of consumers, unless they opt out of them.
  - 7.1.3 We set out the challenges to these engagement remedies being effective and/or appropriate and our initial assessment of each remedy.
  - 7.1.4 Given the uncertainty around effectiveness and optimal design, we discuss the need to trial and test remedies to gather more evidence before making any future decision on whether to impose specific remedies.
  - 7.1.5 In the light of this analysis, we identify that a set of information remedies may be appropriate for further research, development and trialling. We do not propose to take forward more intrusive remedies seeking to directly change outcomes. These carry risks of unintended consequences through potentially overriding consumer choice. They also raise design challenges in ensuring consumer privacy.
  - 7.1.6 We then discuss our initial view of how the trialling process would work, and why we require BT's cooperation in this process.
- 7.2 In Section 9 we consider engagement remedies and price controls together, and set out our proposals on the package of remedies to address the detriment discussed in Section 6. The analysis in Section 9 acknowledges the potential conflict between a price control and the encouragement of competition.

## The potential role of engagement remedies in promoting competition

- 7.3 In Sections 4 and 5, we described the barriers to entry and expansion faced by providers of standalone voice services. One of the key issues we have identified is barriers to the acquisition of new customers, which limit the ability of other communications providers (CPs) to compete effectively and expand in the market (see paragraphs 4.38-4.42).

- 7.4 CPs – particularly non BT CPs – face barriers in convincing SFV customers to switch away from their current supplier. A major factor driving this is the low level of consumer engagement in this market. Our assessment of SMP identified low willingness to switch and low actual switching rates. This is particularly the case for voice-only customers, but is also true for split purchasers. As set out in Annex 8:
- 7.4.1 Our survey evidence<sup>158</sup> indicates that only 3% of SFV customers report having switched in the last year and only 30% report ever switching. This contrasts with 12% of bundle customers who have switched their landline provider in the last 12 months.<sup>159</sup> Survey results also suggest that engagement is lower for BT's customers, as only 16% report ever switching, compared to 64% of non-BT customers. We note that some customers may engage without switching provider, such as by changing their call plan, and this may not be captured in our survey data.
- 7.4.2 In our switching tracker survey, only 9% of SFV customers are classified as “engaged”, as compared with 20% of bundle customers.
- 7.5 Some smaller players in the market offer substantially lower SFV prices than BT, but have struggled to gain market share. Historically, for example, Post Office had lower prices but this did not lead to a significant level of switching, or to BT reducing its headline prices (rather it has increased them, as has Post Office). Many split purchasers could (but do not) make significant savings by bundling their fixed voice and fixed broadband services into a single package with the same (or a different) provider.
- 7.6 Annex 6 sets out our views on barriers to consumer engagement. In summary, using the UK Regulators Network (UKRN)'s<sup>160</sup> framework we have identified several potential key barriers which may hinder consumer engagement for standalone voice customers.
- 7.6.1 **Perceptions of low potential gains** from switching or costs of the switching process may deter consumers from beginning the process of engaging in these markets.
- 7.6.2 Consumers may have concerns about the reliability of alternative providers: remaining with a **trusted provider** is by far the biggest reason given by these customers for not being interested in changing landline provider.<sup>161</sup>
- 7.6.3 Consumers in these markets receive **few triggers** to engage. In particular, there is little marketing of SFV services, and consumers are typically outside a minimum contract period (and so would not be prompted by the end of an initial term).
- 7.6.4 **Accessing information** on competing offers in the market may also be difficult for these consumers, given this lack of marketing. Further, our

<sup>158</sup> Ofcom switching tracker 2016 – see Annex 8, paragraph A8.149.

<sup>159</sup> This difference is statistically significant (at the 95% confidence level). Unless otherwise stated, all direct comparisons of survey evidence between customer groups in this section have differences that are statistically significant.

<sup>160</sup> The UK Regulators Network is a member organisation formed of 13 of the UK's sectoral regulators (<http://www.ukrn.org.uk/>).

<sup>161</sup> Ofcom switching tracker 2016 – see Annex 8, Figure A8.59.

research suggests many of these consumers do not have access to the internet.<sup>162</sup>

- 7.7 We discuss below a range of remedies which could address these barriers to consumer engagement. This would consequently act to promote competition by reducing acquisition costs and so barriers to entry and expansion. We are planning further consumer research to gather more detail on the nature of the lack of consumer engagement, and inform our further consideration of remedies ahead of our statement on this market review.
- 7.8 A relatively small minority of UK households purchase SFV services (around 3 million out of 26 million households).<sup>163</sup> Therefore, in order to run an efficient marketing campaign, a supplier would need to find a cost-effective way of identifying customers within the SFV market. A campaign without targeting would have high costs per customer acquired.
- 7.9 This could potentially be addressed by remedies that make changes to the customer acquisition process, directly reducing these costs. We also discuss these potential remedies below.
- 7.10 There are other factors on the supply side that would not be addressed through engagement remedies, however, and may impact on their effectiveness. The number of SFV lines is in a steady long-term decline (at a rate of around 15% per annum). This would likely include some customers who upgrade to bundled communication services (e.g. dual-play). In addition, some customers cease to have a phone line. As the market declines CPs may have a lower incentive to incur acquisition costs and compete for SFV customers.
- 7.11 Some CPs with strong brands ([&], TalkTalk and Virgin) have told us that they are focused on multi-play offers and so do not devote significant resources to the standalone voice markets. On the other hand, some players with known brands, including Post Office, have told us that they are interested in growing their standalone voice customer bases.

#### Other actions could address barriers to engagement

- 7.12 We also note that there are a number of other actions being taken by Ofcom that could also contribute to addressing barriers to consumer engagement in these markets. A key area of focus in our Strategic Review of Digital Communications (DCR) is consumer empowerment, so that people can understand the array of choices available to them and are able to switch to the best value deal easily. To ensure this, we are taking a variety of actions, including publishing more information on service quality.
- 7.13 In April we will be publishing our first annual service quality report. The report will contain a range of comparative network and customer service quality measures that will aid consumer awareness of different levels of service quality. This would encourage them to choose a provider which best meets their needs and enhance the

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<sup>162</sup> By definition, the 60% of SFV customers who are voice-only do not have internet access at home. See paragraph 4.7.3.

<sup>163</sup> Our estimates of UK households with SFV services is shown in Annex 8. For the number of UK households, see Ofcom, *CMR 2016*.

ability of firms to compete on the basis of their service quality. This may be relevant in relation to consumer preferences for a trusted provider.

## There are a range of potential remedies designed to address low levels of engagement

7.14 We have identified six broad areas that we think could potentially form the basis of a regulatory obligation on BT to improve engagement in this market. These are:

- Provision of information on **savings available** to consumers, to address factors that may prevent consumers from accessing and assessing the information they need to engage in the market.
- Information on the **switching process**, to address perceptions that may be preventing consumers from acting to get the best deal for them.
- Creating a **decision point** at which consumers would be prompted to make an active decision on their landline service.
- Increasing the ease of acting, to **reduce transaction costs** for consumers and increase the likelihood that they will act on information they receive.
- **Automatic switching** within BT tariffs that removes the need for consumers to habitually engage in the market, and ensures they are switched to the anticipated best BT tariff for their circumstances.
- Disclosure of **information on BT's inactive voice-only customers to (potential) competitors or third parties**, to reduce acquisition costs for those seeking to win these customers from BT, and so increase supplier engagement in the market.

7.15 We discuss each of these broad options and some detailed design considerations in turn below. For each we first describe the type of remedy and how it might address barriers to engagement. We then discuss some questions of detailed remedy design. Thereafter we provide our initial views on the potential benefits and the risks (such as failing to achieve the desired objective or unintended consequences). We discuss the potential relative costs of different remedies, but have not at this stage attempted to estimate in detail the costs involved in implementing any of these remedies. We conclude this section by summarising the types of remedy which we consider offer the most potential in terms of proportionate measures to promote competition.

### Information on savings available

#### Description of remedy

7.16 Under this remedy, we would require BT to provide information to its standalone voice customers on potential savings they could make. A simple approach would be to provide information on savings available by changing to a cheaper tariff within BT (and this could include information on BT Basic, including eligibility criteria). A more complex approach would be to provide information on savings available from switching to another provider. This could also include information on dual-play offers.

7.17 This information provided could include a summary of previous usage, to facilitate comparison. As discussed in Annex 6, we do not think an awareness and

understanding of usage is likely to be a hugely important factor for decisions made by many consumers in this market. However, where this information can be provided it may still provide incremental benefits.

- 7.18 Such communications could include references to accredited price comparison websites. We recognise that a proportion of voice-only customers do not use the internet, but price comparison websites may be of use to those who do (including split purchasers). Even for those who do not use the internet, it is possible that family and friends who do have internet access could assist them.
- 7.19 We envisage that this information could take the form of a letter or other communication from BT, or be incorporated into existing communications (such as being part of a consumer's regular bill), or both.

### Remedy design

- 7.20 Content, format and timing are all important to the effectiveness of information. There are a range of aspects that would need to be considered as part of detailed remedy design:
- Personalising the information, such as providing information on the specific savings that a consumer could make given their usual usage (i.e. volume, timing and destination of calls), or using a comparison based on a typical customer. A personalised comparison may be more challenging as it would require BT to make individual assessments for each consumer. If a consumer's usage pattern changes, then this comparison may no longer be relevant.
  - The way a potential saving is quantified (i.e. in absolute or percentage terms) and the time period over which this is presented (i.e. monthly or annual).
  - The way in which potential choices are framed – including whether they are presented as savings that could be made or losses that consumers are incurring through not switching.
  - Whether the basis of comparison is with alternative tariffs from BT or a comparison with the best available tariff in the market. Including whole-of-market comparisons would be a more significant intervention (and may require more effort from BT in assessing and describing potential savings, and ensuring that comparisons reflect currently available tariffs<sup>164</sup>), but is more likely to be effective, as many BT customers may already be on the most suitable tariff that is available to them from BT. Whole-of-market comparisons could also promote competition by giving other CPs an incentive to reduce prices, so as to be identified as the comparator tariff in BT customer communications.
  - Whether the letter is sent from BT or Ofcom (or jointly), and who within the organisation signs the letter. For example, in some cases a letter from an incumbent that includes information about its competitors could have the unintended effect of reinforcing consumers' perceptions of the incumbent as a trusted supplier and potentially dampening switching.

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<sup>164</sup> We envisage this would also require us to agree a methodology for whole-of-market comparisons, to ensure they are carried out on an appropriate basis.

- How information on usage, price comparison websites or BT Basic is explained and framed.

### Initial assessment

- 7.21 **Effectiveness:** The effectiveness of this remedy in promoting competition is likely to be dependent on the existence of material gains from switching provider or tariff. While our analysis suggests that gains from switching at present may be relatively modest for many voice-only customers (of the order £2/month in relation to non-promotional products), improved consumer engagement could potentially give other providers an incentive to offer more competitive tariffs. In the case of split purchasers, there may be potential for a targeted information campaign to highlight to them that they could be paying materially less for an equivalent set of services under a dual-play package.
- 7.22 However, even with the availability of attractive alternative offers, there is a considerable risk that an information remedy of this kind would have limited effectiveness, either by itself or in combination with other engagement remedies we consider below. A recent report by Professor Amelia Fletcher for Which? (“the Which? Report”) comments that:
- “...even where remedies are designed and implemented as well as they can be, the difficulty inherent in trying to change real consumer behaviour means they may still be only partially effective. It may simply be impossible to ensure that consumers fully take in, digest, and act upon the relevant information in a way that significantly improves their decision-making.”<sup>165</sup>
- 7.23 While noting some cases of successful information remedies, the Which? Report sets out a number of examples of information remedies which have been introduced in different markets, but have had a limited impact on consumer decision-making, in relation to: energy tariffs, care homes, unarranged overdraft charges, cash ISAs, credit card fees, and mutual funds.<sup>166</sup>
- 7.24 There is a risk that some types of SFV customers would be particularly difficult to engage through an information remedy. Some older or vulnerable voice-only customers may not be receptive to information about their phone service, or may not be confident in acting on such information. While split purchasers tend to be more connected than voice-only customers, the fact that the remaining split purchasers have not responded to date to widely-advertised dual-play offers suggests that they might not be responsive even to a more targeted information remedy.
- 7.25 **Costs:** Dependent on the nature of the changes to information provided, this is likely to be a relatively low cost remedy to implement, compared to other options discussed below, if it involves information on savings available from changing tariff with BT. BT already regularly communicates with its customer base. This remedy would most likely involve mandating changes to the content of communications sent out by BT. This means it would impose limited additional costs over and above those BT already incurs in communicating with its customers.

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<sup>165</sup> *The Role of Demand-Side Remedies in Driving Effective Competition A Review for Which?* Amelia Fletcher, Centre for Competition Policy, University of East Anglia, 7th November 2016.

<sup>166</sup> *Ibid*, paragraph 2.39.

- 7.26 A remedy requiring BT to make personalised comparisons, or assessments of savings across the whole-of-market, would likely be significantly more complex and costly, as it would require BT to access information on customer usage, and/or the range of tariffs available in the market. This is likely to be further complicated if the comparison involved dual play as well as SFV tariffs, as it would also need to take into account additional factors such as availability at the customer's address and broadband speeds. This would also require the development of an appropriate approach to making these comparisons, to ensure they are made on an objective basis, are accurate, and up to date. We would need to carry out further assessment of these costs and complexities, as this approach may not be feasible and justified given the potential to be higher cost to implement.
- 7.27 **Risks of adverse consequences:** There is a risk that BT providing information on its competitors could unduly increase perceptions of BT as a trusted provider, and hence reduce switching. For example, there is some evidence that improved disclosure required by the OFT in the case of doorstep selling may have acted to increase consumer trust, perhaps unduly. This resulted in a lower proportion of consumers making price comparisons before purchasing.<sup>167</sup> However we consider ways of avoiding this risk – for example by identifying Ofcom, rather than BT, as the source of the communication.
- 7.28 Requiring BT to make whole-of-market comparisons may carry additional risk. For example, there may be a risk that the comparison BT makes is based on tariffs that are withdrawn from the market before the consumer receives the information on the comparison. We would need to take this risk into account in determining whether it would be feasible or justified for a remedy to cover whole of market comparisons.

## Information on the switching process

### Description of remedy

- 7.29 This remedy would seek to address potential barriers to engagement created by perceptions of high costs of switching. 15%\* of landline customers who do not bundle broadband say that “hassle” is a key reason for not being interested in changing provider.<sup>168</sup> Some of the views underlying this could be related to perceptions of the switching process. 22% of BT's voice-only customers say they perceive switching landline provider to be fairly or very difficult. Some consumers may not be confident that the process will be timely and straightforward, or that there may be a risk of loss of service and this may deter them from seeking or acting on information about offers from other providers.
- 7.30 Ofcom has already taken steps to make the switching process easier for customers of fixed telecoms services:
- 7.30.1 Switching voice and/or broadband services between providers within the Openreach or KCOM copper networks can be done through a gaining-provider led (GPL) process. This means that consumers can switch their broadband and/or phone services within these networks simply by agreeing

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<sup>167</sup> Office of Fair Trading (2012), 'Evaluating the impact of the 2004 OFT market study into doorstep selling – Prepared for the Office of Fair Trading by GHK', OFT1413: [http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared\\_offt/reports/Evaluating-OFTs-work/oft1413.pdf](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared_offt/reports/Evaluating-OFTs-work/oft1413.pdf)

<sup>168</sup> \* Caution: base under 100 (87) Ofcom switching tracker 2016 – see Annex 8, Figure A8.59.

terms with their new provider. The gaining provider then manages the switch. This means that consumers only need to contact the CP they want to switch to, unless they are switching between networks (e.g. to or from Virgin's cable network).<sup>169</sup>

7.30.2 In addition, number portability arrangements enable customers (that are not moving home) to change their service provider whilst keeping their existing telephone number.<sup>170</sup>

7.31 Some consumers may not be aware of these features, or the steps they need to take. They may, for example, be concerned that switching would mean changing their phone number or contacting BT, when for many consumers this would not be the case.<sup>171</sup>

7.32 A remedy to address this barrier could require BT to provide information on the switching process to its customers, to address any inaccurate perceptions that they may hold.

### Remedy design

7.33 This remedy would particularly focus on explaining key features of the switching process and number portability.

7.34 We envisage this would be achieved through requiring BT to provide this information through its communications with customers. As with the communications on potential savings described above, there are a range of options around the information included, format and timing. There is some uncertainty around which options would be the most effective way of providing this information to consumers. For example, this may include:

- Determining the most effective pieces of information about the switching process to provide to consumers.
- The way this information is phrased, and the level of detail included.
- The impact of the timing of this information – including whether it is more effective if provided alongside other information (such as information on savings, or notification of price changes).

### Initial assessment

7.35 **Effectiveness:** We do not have detailed information on whether, and to what extent, standalone voice customers specifically see the switching process as being an obstacle to switching provider. In our 2016 Switching Tracker survey, 15%\* of standalone voice customers identified “hassle” as a key reason they were not

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<sup>169</sup> In July 2016, Ofcom published a consultation on proposals to reform the cross-platform switching process, which would make this switching easier and more reliable for consumers (see here: <https://www.ofcom.org.uk/consultations-and-statements/category-1/making-switching-easier>). This would potentially incorporate, for example, the switching of a landline service from the Openreach network to Virgin's cable network, and vice versa.

<sup>170</sup> Consumers that are moving home at the same time as they switch provider may be able to take their number with them if they are staying within the same exchange area.

<sup>171</sup> A current marketing campaign for Post Office notes that customers can retain their existing number and sets out a four-step switching process headlined “Joining us is easy”.



interested in switching their provider.<sup>172</sup> Some of the views underlying this could be related to perceptions of the switching process, though there may be other factors too. However, the question may be of little relevance to those customers who see limited, if any, gains to be had from switching. This remedy is more likely to be effective as a complement to the other remedies we discuss, to ensure that consumers are not deterred from switching where there are gains from doing so.

- 7.36 **Costs:** We anticipate that this remedy would have relatively low implementation costs, in line with the lower cost options discussed under information on savings. The information is likely to be generic across consumers in a given group, meaning there would not be a significant burden on BT in producing the information (as it would not need to be personalised to a given customer). If included as an addition to existing communications, it is likely to be particularly low cost, as it would not require a separate communication to be produced.
- 7.37 **Risks of adverse consequences:** The main potential adverse consequence associated with this remedy is the risk of inadvertently and unduly increasing consumer trust in BT as a provider of SFV services, as discussed in the context of the previous remedy. The provision of this information could reinforce consumers' perceptions of BT as a trusted supplier, willing to provide information on switching away from BT. Conversely, this could potentially dampen switching.

## Creating a new decision point

### Description of remedy

- 7.38 Many of BT's SFV customers have been with BT for an extended period of time (77% for more than 10 years, compared to 10%\* of other CP's customers<sup>173</sup>). These customers are highly likely to be outside a minimum contract period (and so would not be prompted by the end of their initial term to consider their options). Although moving home could act as a trigger for some, most of these customers are not likely to be frequently presented with a decision as to whether they should switch tariff or provider. This remedy would seek to address this barrier to engagement created by a lack of triggers to engage. This barrier may contribute to a lack of consumer engagement and switching, compared with a situation where a customer has to make an active decision to renew a contract or switch.
- 7.39 The European Commission's forced choice remedy in the Microsoft Internet Explorer (IE) case provides evidence that prompting a decision can deliver benefits in terms of increased switching. IE's market share in the EU fell by around 10 percentage points more than in the US over the same time period (2010-2014).<sup>174</sup>
- 7.40 We could introduce a remedy to require BT to actively provide a prompt for consumers to engage. This could provide a spur for consumers to access information, assess whether they are receiving the best deal in voice-only services and make an informed choice as to whether to continue with their current tariff with BT or act to switch tariff or supplier.

<sup>172</sup> \* Caution: Base under 100 (87) – see Annex 8, Figure A8.59.

<sup>173</sup> Ofcom, Switching Tracker, July to August 2016, see Annex 8, Figure A8.54. \*Caution: Base under 100 (59).

<sup>174</sup> See, for example, *The Role of Demand-Side Remedies in Driving Effective Competition A Review for Which?* Amelia Fletcher, Centre for Competition Policy, University of East Anglia, 7th November 2016.

- 7.41 We envisage that this would take place by requiring BT to send a letter or statement to their customers on a regular (likely annual) basis. This would set out their current arrangements and ask whether they want to remain with these arrangements or change them. If customers take no action (i.e. if in effect they ignore the communication), then they will continue to be served by BT as before. In effect, this would create similar conditions to the end of a minimum contract period. BT could be required to provide information on alternatives as part of this notification, and it could include elements of the information on savings and switching set out above.

### Remedy design

- 7.42 The frequency of the decision point and the timing of this are likely to be key considerations. Evidence suggests consumers may be more likely to act at the start of a new month or year.<sup>175</sup> In addition, we anticipate the sender of the communication may have an impact on effectiveness, for example whether it is sent from BT or Ofcom.
- 7.43 In a similar way to the remedies described above, there are a range of aspects where detail on the nature of the information provided, its format and its timing would need to be determined. We envisage this would include:
- The format of communications, including whether this notification is provided via a letter or some other means.
  - What information is included alongside the notification, building on the considerations outlined above for information on savings or switching.

### Initial assessment

- 7.44 **Effectiveness / risk of adverse consequences:** A fundamental limitation of this category of remedy is that if customers are presented with a “decision point” and ignore it, then they will simply continue to be served by BT as before. If this threat of potential switching is low, then BT may not face strong incentives to provide competitive offers to retain customers. As a result, any remedy we would consider in this category would effectively amount to presenting information on savings and the switching process (i.e. the previous two remedies considered) in the form of a decision point. This creates three risks:
- that some consumers may pay no more attention than they would to any other communication;
  - that information overload caused by providing lots of detail in one communication means consumers do not pay attention to the detail which is important to them; or
  - that some consumers may be misled into thinking that they need to take action when that is not the case, potentially causing distress.
- 7.45 **Cost:** We anticipate that the relative cost of implementing this remedy would be moderate. It is likely to be costlier than making changes to existing communications

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<sup>175</sup> See, for example, Dai, H, Milkman, K.L. & Riis, J. (2014), ‘The Fresh Start Effect: Temporal Landmarks Motivate Aspirational Behaviour’ *Management Science*, available at: [https://faculty.wharton.upenn.edu/wp-content/uploads/2014/06/Dai\\_Fresh\\_Start\\_2014\\_Mgmt\\_Sci.pdf](https://faculty.wharton.upenn.edu/wp-content/uploads/2014/06/Dai_Fresh_Start_2014_Mgmt_Sci.pdf)

that would have been sent in absence of remedies. It would require the creation and sending of an additional communication, with associated costs of production and sending. For example, the postage for an additional one million letters could cost in the region of £250k-350k.<sup>176</sup>

## **Increasing the ease of responding**

### Description of remedy

- 7.46 This remedy would look to address the barrier to engagement caused by perceptions of difficulties switching and behavioural biases (such as status quo bias), which may make consumers less likely to act on information. If there are ways to make it easier to act, then this may support an increase in switching where it provides benefits to consumers.
- 7.47 This category of remedy would require BT to provide a mechanism to allow customers to easily respond to information they receive. This could be developed as an addition to the provision of information on savings or additional decision point outlined above. For example, this could include the provision of ‘tear-off’ slips which consumers could sign and return in a pre-paid envelope if they wanted to respond to the information on savings remedy. We envisage this response could take two forms:
- 7.47.1 The first would allow consumers to respond to offered changes in tariff within BT, and request BT make this change to their tariff. In the case of BT Basic, this may take the form of a request for an application form, which would subsequently need to be completed by the consumer.
- 7.47.2 The second would allow consumers to respond to information on savings from switching provider by requesting more information from the alternative provider.<sup>177</sup>
- 7.48 A first step in taking forward this category of remedy would be to carry out further research – particularly qualitative market research to specifically explore barriers to changing tariff or switching provider which SFV customers may currently face.

### Remedy design

- 7.49 The effectiveness of this remedy is likely to depend on the nature of the action required for a consumer to respond, the options provided for consumers to choose from and the framing of this choice.
- 7.50 A response to a potential change of tariff within BT is likely to be straightforward to implement, in that it would only require BT to arrange for consumers to send responses to itself.
- 7.51 Where the response involves requesting more information on a possible switch to another CP, this would be more complicated. It would require a degree of

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<sup>176</sup> Based on Royal Mail business mail calculator, sending 1,000,000 letters second class.

<sup>177</sup> We note some parallels with the “reply card” system that was in place until July 2002. To switch to carrier pre-selection (CPS) when the reply card system was in place customers had to sign and return a confirmation slip to BT. This was alongside the separate process of making arrangements with their prospective CPS provider (such as signing and returning a contract). Industry experience of the reply card found that, in practice, it proved to be an obstacle to switching resulting in low switching levels. After use of the reply card was stopped, CPS orders increased dramatically.

coordination to enable the customer's response to reach the relevant CP, though we envisage this could be achieved by, for example, including an envelope addressed to the relevant other CP identified in the information or comparison provided.

### Initial assessment

- 7.52 **Effectiveness:** A remedy which reduces or removes barriers to responding will, by its nature, only be effective if consumers are willing to change tariff or switch provider in the absence of these barriers. In the present case, it therefore depends on other remedies being effective in increasing consumer engagement (such as enabling consumers to access and assess information on potential savings).
- 7.53 The FCA's work on cash savings looked at a return switching form pre-filled for a switch to the best internal rate, along with a prepaid envelope. This allowed customers to request to change their account with their current provider. In trials, they found this to be successful, increasing switching by nine percentage points.<sup>178</sup> Experience from other cases indicates that the results of making switching easier can vary widely from case to case. This category of remedy may act as a complement to other engagement remedies, by making it easier to respond at the time consumers receive information on savings and switching, helping to overcome status quo bias.
- 7.54 **Costs and risks of adverse consequences:** We would expect these measures would have moderate costs of implementation, such as providing customers with tear-off slips and pre-paid envelopes to select a new BT tariff or request more information from an alternative CP. The cost of postage for reply envelopes could be in the region of £30,000-70,000.<sup>179</sup>
- 7.55 A measure targeted at switching tariff with BT could have the unintended consequence of resulting in consumers inadvertently finding themselves tied into a minimum contract period when they change to a new tariff. This may need to be managed through the remedy design, such as by ensuring any minimum term is clearly communicated to customers.
- 7.56 A broader process allowing consumers to request further information about a potential switch from the prospective gaining CP could incur some additional costs if implemented, as it would require coordination to enable the customer's response to reach the relevant CP.

### **Default tariff**

#### Description of remedy

- 7.57 An alternative approach to address low levels of switching would be to introduce a remedy which directly protects consumers and does not require them to actively participate in the switching process. This could mandate that, as a default, BT move its consumers to its best available tariff given their recent usage. The aim of this remedy would be to address barriers to engagement by reducing the level of engagement needed from consumers. This would ensure that consumers were protected from the detriment of being on the wrong tariff for their usage.

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<sup>178</sup> FCA (2016), 'Attention, Search and Switching: Evidence on Mandated Disclosure from the Savings Market' <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-19.pdf>

<sup>179</sup> Based on a 10-20% response rate to 1,000,000 letters, at Royal Mail Business Reply Plus second class rate of £0.335 per reply sent.

- 7.58 We envisage this remedy could take the form of a provision requiring BT to ensure that each of its SFV customers were moved to the tariff that represented the best value for money for them, given their historical usage. For example, BT currently offers a Home Phone Saver product that would likely be better value for many of BT's voice-only customers. A customer who purchases only standard line rental and unlimited anytime calls from BT could save £5.50/month by switching to Home Phone Saver.
- 7.59 For BT's split-service customers, this category of remedy could take the form of replacing their standalone voice product with an equivalent dual play product bundled with their broadband purchase. For example, a customer purchasing a 17Mb broadband-only product for up to £34/month and separate line rental at £18.99/month would save up to £19/month by switching to an equivalent dual play product. Of course this would only impact on a very small percentage of the market.

### Remedy design

- 7.60 This remedy would require a range of detailed rules to be specified in advance, to ensure consumers were being switched to an appropriate deal. We envisage this would include specifying the criteria for determining historical usage in order to calculate the best tariff for each consumer. For instance, specifying that they should only be moved to a tariff that would have been better for them over a particular length of time (such as each of the previous four quarters). Opt-out arrangements would also need to be specified, including the notice period required before the change would take effect. This would allow consumers to choose not to be switched if they considered that the proposed new tariff was not right for their needs.
- 7.61 The effectiveness of this remedy may depend on the design, format and timing of the notification explaining the default switch to consumers and providing them with the opportunity to opt out. For instance, this could include different ways of explaining the savings that could be made if the consumer allowed the switch to go ahead.

### Initial assessment

- 7.62 **Effectiveness:** This remedy has the advantage of potentially ensuring that consumers are moved to a better tariff from BT if one exists for them, without a need to engage in the market. It provides direct protection for those customers who are not engaged and may be less likely to respond to improved information on savings and switching.
- 7.63 This remedy may be most effective if applied to split-service customers. These customers could be automatically switched from separate, i.e. unbundled, voice and broadband services from BT, to an equivalent dual play bundle from BT if that provided them with savings. We understand several other providers in effect do this already. As they would not experience any change in the service they received, it would be straightforward to design in a way that maximises potential effectiveness in reducing detriment.
- 7.64 Overall, while there is some potential for this remedy to improve consumer outcomes in relation to their BT tariff, this remedy would not promote competition, as it would only lead to switching between BT tariffs, rather than switching to rivals.
- 7.65 **Costs:** We expect that the principal costs of implementing this remedy would be as follows: (a) the operational cost to BT of calculating the optimum tariff for each of its SFV customers, and of switching them to this tariff (i.e. updating its billing systems);

(b) the cost to BT of communicating this change to its customers; and (c) the cost to BT of providing follow-up support to customers who wanted information about the switch, or had failed to opt-out but wanted to revert to their earlier arrangements. We would expect the implementation costs to be somewhat higher than for the information remedies we have discussed above.

7.66 **Risk of unintended consequences:** Automatic switching within BT tariffs may carry several risks of unintended consequences, such as:

- BT altering the range of tariffs it offers, which may affect or remove the cheapest offers in the market. Specifically, BT may choose to change or withdraw the Home Phone Saver tariff, which would eliminate a significant source of current potential savings for voice-only customers.
- Some consumers could change their usage subsequent to the switch, such that the tariff to which they have been moved is no longer the best one for them. If usage is changing over time, this could be an issue unless the automatic switching exercise is repeated periodically.<sup>180</sup>
- BT may not have sufficient information to make this assessment on behalf of consumers. For example, they would not know if the consumer was eligible for BT Basic so this tariff could not be included in this process (although information about BT Basic, including its eligibility criteria, could be provided to BT customers).
- The best available tariff may require consumers to sign up to a minimum contract period, and it may not be appropriate for consumers to be committed to this by default.
- Consumers who feel they have been protected by this remedy might have even less incentive to engage in the market – in particular by considering offers from other providers than BT.
- Some consumers – including some vulnerable consumers – may fail to opt-out if they do not notice the opportunity to do this, and so end up with a different tariff against their preferences without intending to do so.

7.67 Further, it is likely to be challenging to ensure that all consumers are better off if they allow the switch to go ahead. For example, if a consumer's usage pattern was likely to change they may have been better remaining on their previous tariff. Specifically, Home Phone Saver has a higher rate for calls to mobiles, and so a consumer increasing their call volumes to mobiles after being switched could be worse off.

7.68 This risk is closely linked to the importance of usage in determining the best tariff. The more important usage is, the more valuable this remedy is likely to be. For voice-only customers, the key determinant in choosing between call plans is the time of day at which consumers typically make calls (e.g. whether they tend to make calls during

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<sup>180</sup> However, to the extent that usage of landlines is generally decreasing over time, customers could still be better off with a one-off automatic switch than with the status quo. For example, a customer could be switched from an Anytime call plan to an Evenings and Weekends call plan in Year 1. By Year 3 their usage might have declined to the point where a Weekends call plan was most suitable for them, rather than the call plan they are on, but they would still be better off than if they had stayed on the Anytime call plan.

the day on weekdays). It is likely that many consumers may be able to make this assessment relatively easily, which may limit the value of a usage-based automatic change in tariff. In addition, call plans tend to be standardised across providers (most CPs offer three: weekends, evenings and weekends, and anytime).

## **Disclosure of information on BT's inactive voice-only customers**

### Description of remedy

- 7.69 Acquisition costs could be reduced by making it easier for competing firms or third party intermediaries (such as price comparison websites) to identify and contact consumers in this market. This could be achieved by requiring BT to gather information on their standalone voice customers who have not recently switched and create a database of this information, which could then be provided to (potential) competitors or third parties.<sup>181</sup> This would identify these customers, provide contact details and potentially their current tariff and usage pattern. Customers would be able to opt out of inclusion in this process at any time.<sup>182</sup>
- 7.70 This information could be used to make it easier for competing suppliers (or third party intermediaries) to reach these customers, and hence reduce acquisition costs. It would also enable them to provide bespoke offers that reflect an individual customer's circumstances, current tariff and usage patterns.

### Remedy design

- 7.71 It would be important to ensure the database is kept up to date so that it is useful for competing CPs and third parties. The inclusion of detailed usage information would allow competitors to provide personalised offers to consumers. However, this increased complexity may make the database more complex to develop and keep up to date.
- 7.72 It may be necessary to place restrictions on the communications initiated under this remedy (such as their frequency), in order to ensure they do not inadvertently reduce consumer engagement.
- 7.73 The information collected would contain personal information for some of the most vulnerable consumers, and so would be highly sensitive. It would be necessary to ensure sufficiently strong data protection, and restrictions around access to this data. The database could be open to all actual or potential suppliers of standalone voice services, as the telecoms market operates under a general authorisation regime (in contrast to an individual licensing regime as in energy, for example). This may mean the database could be open to a potentially large number of organisations without ex ante approval of this access. This may mean there is a requirement for a screening process before a CP is allowed access, and ongoing monitoring of access. Alternatively, Ofcom could select, through some form of vetting process, a subset of

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<sup>181</sup> Following the CMA's energy market investigation, Ofgem are currently working to implement a similar database for customers in the energy market on standard tariffs. See here:

<https://www.ofgem.gov.uk/consumers/household-gas-and-electricity-guide/how-switch-energy-supplier-and-shop-better-deal/ofgem-energy-customer-database-service>

<sup>182</sup> Consumers who have signed up to the telephone preference service (TPS) should not be contacted by phone for marketing purposes without explicit consent. This may require a separate process to allow these consumers to consent (if they so wished) to inclusion in the database, for the purposes of voice calls.

CPs to have access to the database but this would itself raise issues around constraining competition.

### Initial assessment

- 7.74 **Effectiveness:** The disclosure of information on BT's inactive voice-only customers to competitors would reduce acquisition costs and so could make competing CPs more likely to seek to win these customers from BT. However, its effectiveness would depend firstly on BT customers not choosing to opt out of inclusion in the database in the first instance, and then responding to marketing communications from BT's competitors or third parties. If some of these customers are TPS registered, then CPs should not contact them by telephone without explicit consent. The value of this remedy is also dependent on the importance of usage information in determining appropriate tariff, which we think may be relatively unimportant for many customers in these markets.
- 7.75 **Cost:** Addressing the design issues outlined above may be challenging and costly. For example, ensuring the data was held in a secure format, yet accessible to third parties in a way that enables them to use it effectively. Screening CPs before allowing access would add another level of complexity to this remedy. Implementing this remedy is also likely to be significantly costlier than the other remedies focused on changes to consumer communication. We estimate one-off costs of the order £[X].
- 7.76 **Risk of adverse consequences:** There is a material risk that consumers who would prefer not to be on the database were nevertheless included by default, having failed to opt-out. Consumers on the database may receive more marketing communications than they want to receive about alternative SFV services. Some vulnerable consumers could find this distressing. There is also a risk of confusion for consumers who are already TPS registered; for instance, they may be uncertain which arrangement takes precedence.
- 7.77 Sharing a database of this nature – particularly one including a large proportion of older and potentially vulnerable consumers – with third parties is likely to raise serious concerns about data security. If the information was misused, there is a risk of significant consumer harm (such as from nuisance calls or scams). If we seek to limit access to the database Ofcom would need to develop access criteria for CPs.

## **Scope for engagement remedies to address our SMP concerns**

### **The more intrusive remedies have significant downsides**

- 7.78 Broadly speaking, we can categorise the remedies we have considered above into:
- 7.78.1 Remedies which make it easier for consumers to engage in the market: information on savings, information on the switching process; introduction of a decision point; remedies to facilitate response to this information.
- 7.78.2 Remedies which are likely to lead directly to a change in outcomes for a substantial number of consumers, unless they opt out of them: automatic switching within BT's tariffs, or the creation of a customer database.
- 7.79 While the latter group of remedies may have a more direct effect, they entail a significant risk of adverse consequences. In particular, there is a risk of over-riding consumer choice. This may mean some customers will ignore or fail to notice that



they have an opportunity to opt out of these remedies, and as a result may end up with a change in their landline provision which they did not expect, and/or which may be not suit them if their circumstances are changing. Of these two remedies, this risk may be lowest (though still potentially material) for automatic switching within BT's tariffs, as this remedy does not entail a change of provider (or sharing of customer data with third parties). As this remedy is limited to helping customers get the best available deal from BT, rather than the best deal on the market, and as such does not promote competition and is likely to have a limited effect in addressing our SMP concerns.

- 7.80 Linked to this, some of these remedies require a third party to take responsibility for the outcome for consumers. It may be complex to ensure that the outcome is unambiguously the best one for consumers, and may not be appropriate for the third party to take on this role (e.g., BT selecting which of their tariffs consumers should automatically be switched to), in place of consumer choice.
- 7.81 In addition, as discussed above these remedies present significant design challenges if undesired consequences are to be avoided. We have concerns around consumer privacy in relation to the potential sharing of their information. Also, these remedies could potentially entail repeated intervention (such as repeated automatic switching within BT tariffs) in the light of subsequent market changes.
- 7.82 In the present case, we think the risks associated with these remedies are particularly acute because there are potentially a large number of vulnerable citizens among the consumers concerned – for example around 43% of BT's standalone fixed voice customers are aged 75 or older. At the same time, a standalone fixed voice service typically represents a relatively small proportion of household spend, so the potential savings for an individual moving to a better deal may be relatively limited, albeit that the detriment is significant across the market as a whole.
- 7.83 In summary, whilst these remedies may have the potential to promote competition and reduce detriment, we think the risks of unintended consequences would outweigh these potential benefits. We therefore provisionally conclude that we should not take forward either of the following remedies: automatic switching within BT tariffs, or creation of a customer database and disclosure of this information to CPs or third parties.

### **Making it easier for consumers to engage has potential**

- 7.84 Turning to our first category of remedies – those that provide information that could potentially make it easier for consumers to engage in the market – ultimately these rely on a response by consumers to have the desired outcome of promoting competition and addressing our SMP concerns. On the one hand, this may reduce the risk of adverse consequences as, at worst, consumers can simply ignore them and continue as before. On the other hand, to be effective they rely on consumers not doing this, but rather becoming more engaged in the market. They also rely on at least some suppliers responding to this increased level of customer engagement by actively competing for their business. Finally, fully addressing our competition concerns would require that consumer and supplier engagement must be sustained over time. Trialling these remedies would allow us to gather evidence on their potential impact in promoting competition.
- 7.85 We consider there is a reasonable prospect that an effective increase in consumer engagement would encourage some suppliers to become more engaged in the market. However, there are reasons to believe that achieving and sustaining a

substantial increase in engagement may be challenging. In particular, the fact that in many cases SFV spending – and the potential savings from competition – is likely to be a relatively small proportion of household budgets, may limit the incentive for consumers to become more engaged. In addition, the relatively small (and declining) size of the market and the lack of upselling opportunities may limit supplier engagement even if remedies succeeded in increasing consumer engagement. There are some further risks to the effectiveness of these remedies in increasing consumer engagement:

- 7.85.1 **Price cap:** If we introduce a cap on BT's prices, below current levels, it would mean that other CPs would in most cases have to offer lower prices than they do at present, if they are to attract customers away from BT. We discuss the trade-off between a price cap and measures to promote competition in sections 8 and 9.
- 7.85.2 **Timing:** The effectiveness of many of the engagement remedies we discuss will depend on the attractiveness of alternative offers (relative to BT's prices) which are available on the market at the time that the remedy is tested and/or implemented. Ongoing consumer engagement will require CPs to effectively market and promote their offers. There is a risk that if CPs do not have competitive offers in the market at the right time, consumers will be unresponsive to any engagement remedies based on such offers.
- 7.86 While there is some uncertainty as to the potential effectiveness of these remedies, we consider that there is sufficient merit in this first group of remedies such that, should we conclude promotion of competition is warranted, they are suitable for further development and trialling, namely:
- information on savings;
  - information on the switching process;
  - introduction of a decision point; and
  - remedies to facilitate response to this information.
- 7.87 We see these information remedies as complementary to one another and we would seek to develop them as a package. This trialling would allow us to gather evidence on the effectiveness and optimal design of these remedies.

## Trialling engagement remedies

### We would trial engagement remedies before implementing

- 7.88 The remedies discussed above have the potential to reduce acquisition costs and lower barriers to entry and expansion in the SFV markets. This would act to promote competition and address the detriment identified in Section 6. We identify the remedies that merit further consideration below.
- 7.89 Evidence suggests BT's customers are particularly unengaged, and many have never switched their fixed voice provider. If effective, remedies to promote competition would address BT's SMP by reducing barriers to entry and expansion faced by BT's competitors.

- 7.90 We anticipate carrying out further consumer research on the extent and nature of barriers to engagement, to inform our final decision on which remedies to take forward and their detailed design.
- 7.91 Recent regulatory practice in this area also emphasises the importance of systematically testing, trialling, evaluating and refining engagement remedies. For example, the FCA regularly trials remedies before implementation. The CMA's recommendations in banking and energy also emphasise the importance of trials to gather evidence on the effectiveness of engagement remedies before implementation. The Behavioural Insights Team has also carried out a range of trials across sectors.
- 7.92 In the discussion above, we noted some of the design choices and market features that could determine the effectiveness of the remedies we are considering. Theory, literature and experience from other markets can provide some insights into what measure might or might not be effective, though it is not possible to know which will be most effective in practice in this market. Small changes – for example to the specific information provided or the way in which it is communicated – can make big differences to consumer responses.
- 7.93 Given this uncertainty around the effectiveness and optimal design of these remedies, in our view it would be disproportionate to impose any of these remedies at this stage, without first gathering further evidence. We would propose to require BT to cooperate in testing and implementing engagement remedies. This would allow us to gather evidence on overall effectiveness and test some of the detailed design considerations outlined above. We would propose SMP conditions requiring this cooperation.
- 7.94 In order to design these remedies to be as effective as possible, we would expect to conduct consumer research and a programme of trialling of the remedies that we consider have greatest potential. This would allow us to reach a final view on (a) the specific design features that would maximise the effectiveness of these remedies and (b) whether we can identify a package of remedies which is appropriate and proportionate to implement under SMP conditions.

### Approach to trialling process

- 7.95 Trialling engagement remedies would enable us to identify the most effective engagement remedies, and the optimal design of these remedies.
- 7.96 We envisage five stages to the process:
- 7.96.1 **Diagnosing the issue** to be addressed, potentially including research to identify the specific factor(s) restricting engagement. For example, which are the most critical barriers to engagement. This would also include considering whether the issue is common across all standalone voice customers, or just a subset (such as voice-only or split-purchase customers).
- 7.96.2 **Identifying the remedies** to be trialled, specifying their detailed design, carrying out research and tests (such as focus groups or lab experiments) to refine these options and determining which specific aspects would be varied in trials to provide evidence on optimal design.

- 7.96.3 **Designing and running the trial**, which could be a randomised control trial (RCT) if appropriate, or another method of testing such as quasi-experimental analysis or lab-based testing.
- 7.96.4 **Assessing the results** of these trials, and then implementing the permutations shown to be most effective (if any).
- 7.96.5 **Monitoring and evaluating the implemented measures**, with further testing of refinements and adjustments to remedies where appropriate.
- 7.97 We propose that trialling should be subject to a set of principles to ensure it is effective and avoids unintended consequences. We propose the following principles:
- The remedies trialled should be proportionate to the problem they are seeking to address.
  - The frequency and number of trials should also reflect the detriment identified in the market, accounting for any detriment addressed through other remedies – for example, the application of a price control if one is introduced.
  - The trials should have clearly defined success criteria at the outset, which the results can be measured against.
  - The trials should be transparent, with details published on the process and analysis of the results to allow independent verification.
  - The trials should be ethical – for example they should not deny information to consumers that they would have received in the absence of a trial.
- 7.98 We consider that the overall programme for these trials should be led by Ofcom. This will allow us to take a market-wide view of the trials and their impacts, and ensure that both the process of trialling and any changes subsequently implemented are in the interests of consumers and address the detriment identified in this market review.
- 7.99 We expect that the cost of the initial phase of diagnosing the issue and identifying remedies would fall on Ofcom. This would include further research to inform these initial stages, which we envisage could be carried out at moderate cost. Running any trials themselves would entail some cost which we would require BT to bear, though we anticipate in the case of the remedies we propose to take forward this would be modest (in general less than £100,000 per trial).<sup>183</sup>

#### **Example hypothetical trial process – information on savings**

We set out below a hypothetical example of a trial process, including roles and responsibilities and the type of issues that could be subject to trial:

<sup>183</sup> To give an indication, when implementing the results of RCTs in its review of cash savings, the FCA estimated the overall burden per firm of making several changes the information provided to their entire customer base to be around £100k. We estimate the postage cost of additional communications to be around 30p per letter (so a trial of 10,000 customers would cost around £3,000 in postage).

**Step 1)** Ofcom carries out research into barriers to consumer engagement that indicate that access to information on savings is a key factor limiting engagement among voice-only customers.

**Step 2)** Ofcom determines that this could be remedied through the provision of information on savings as part of BT's bills. Ofcom also carries out initial testing through focus groups or lab tests to narrow down options for trialling. This indicates that consumers respond better to information on annual rather than monthly savings. Ofcom specifies that the trial would test the provision of information on potential annual savings, and would test whether this information should be presented in absolute or percentage terms, and whether it should be provided as a generic or personalised statement.

**Step 3)** Ofcom determines that these four options should be tested through an RCT, with a random sample of 20,000 of BT's voice-only customers. The sample would be split into a control group and 4 treatment groups with the permutations specified above (that is: generic, absolute terms; personalised, absolute terms; generic, percentage terms; personalised, percentage terms).

**Step 4)** The trial is run, with BT making the specified changes to the next bill for these customers, and then monitoring their behaviour in the following three months. This would include collecting information on whether customers in the control and treatment groups switched provider or changed tariff. Ofcom evaluates the results of the trial, and determines whether any of the treatments generated statistically significant effects, and if so which generated the largest effect. Ofcom then directs implementation of this remedy across BT's voice-only customer base.

**Step 5)** BT is required to continue to gather information on the impact of the implemented remedy, by monitoring switching rates, and reporting on this to Ofcom. Ofcom would evaluate this information and determine if the remedy was effective as indicated by the trial. If necessary, Ofcom would propose changes to the remedy, and kick-off a new round of trials to examine these.

- 7.100 In summary, should we decide to act to promote competition, we would propose BT be required to provide information to Ofcom to inform the design of any trial, as well as details on the results of a trial. This is because BT holds information that we could not easily obtain ourselves, and has the customer relationship that would allow them to effectively measure the impact (such as recording the number of customers from each group who switch tariff or supplier in a given time frame).
- 7.101 We would also propose that BT would be required to carry out the trial in line with the parameters set out by Ofcom. This is because BT is best placed to carry out these trials efficiently as it has the existing systems and processes in place to communicate with its customer base. For Ofcom to carry out the trial would require a degree of replication of these systems, and so significant additional overall cost. In addition, much of the remedies may involve changes to existing BT communications, which by definition would need to be made by BT.
- 7.102 We anticipate that these trials would be of a relatively large scale. This is because changes in behaviour may be relatively small yet still have a meaningful impact on consumer detriment. A large sample is therefore needed to ensure appropriately narrow confidence intervals and provide robust evidence on the effectiveness of potential remedies. The sample size will also depend on the number of permutations

being tested. As a guide for scale, we anticipate a trial may involve around 10,000 BT customers.

- 7.103 We recognise that trialling engagement remedies will mean it will take time before those remedies identified as effective can be fully implemented across BT's standalone voice customer base. We anticipate that this process of development, trialling and implementation could take up to two years before any engagement remedies are fully implemented.<sup>184</sup> Due to this time needed for development and trialling before full implementation, these engagement remedies will not be able to immediately address the detriment we have identified.
- 7.104 If a particular remedy is shown to be effective in the trialling phase, we would direct BT to implement the remedy in respect of all SFV customers.
- 7.105 We consider the appropriateness of setting regulation to impose these remedies in Section 9 alongside our consideration of our options for price controls.

## Consultation questions

*Question 7.1: Do you agree with the need to trial and test engagement remedies before implementation? Please explain your reasons for this.*

*Question 7.2: Do you agree that remedies focussed on improving consumer communications to increase engagement listed below offer a reasonable prospect of success in encouraging competition?*

- *information on savings;*
- *information on the switching process;*
- *introduction of a decision point; and*
- *remedies to facilitate response to this information.*

*Please explain your reasons.*

*Question 7.3: Do you agree with our conclusions that the other remedial options we have considered, namely the establishment of a customer database for marketing purposes and automatic switching within BT's tariffs, raise significant implementation risks and therefore do not warrant further consideration? If you do not agree or consider there are other options we should have considered, please provide your reasons.*

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<sup>184</sup> On the basis of the process outlined in paragraph 7.96 above, we envisage it would take 6-12 months to diagnose the issue, identify remedies and carry out any initial testing of these (such as focus groups or lab tests). The RCT would then be in the field for at least three months, and analysis of results and direction to implement successful remedy would take a further three months. Finally, allowing time for the changes to be implemented could take up to a further six months.

## Section 8

# Options for a price control remedy

## Introduction

- 8.1 We set out in Section 6, the direct consumer harm that we believe is occurring due to pricing of standalone fixed voice (SFV) services above the competitive level and that a possible remedy to deal with this harm was the imposition of a price control obligation on SFV services provided by BT. In this section we explain:
- i) How we have determined the options for the appropriate level of a price control; and
  - ii) If a price control is imposed how we would plan to implement a price control in terms of duration, which products are price controlled and over what period we would reduce prices.

## Framework for assessing the appropriate level of prices

- 8.2 In developing proposals for the appropriate level of prices for an SFV control, we have considered the following factors:
- **Protecting consumers from prices above costs:** as set out in Section 6, our analysis suggests that BT's prices of SFV services are above what we would expect to see in a competitive market. Given past price increases and BT's current level of profitability, customers of SFV services are paying considerably more than they should be.
  - **Promoting competition in the provision of SFV services:** in Section 7 we discuss remedies to support increased consumer engagement and encouraging competitive entry and expansion. These remedies will not be effective in promoting competition if we reduce the price of SFV services below the level at which it is profitable for other CPs to acquire SFV customers. When dealing with SFV customers, these acquisition costs may be quite substantial, although such costs should be reduced if engagement remedies prove to be effective.
- 8.3 We therefore face a trade-off between controlling prices in a way that protects consumers and ensuring that we do not reduce them by so much that we weaken the scope for growth in competition (taking into account the impact of any engagement remedies discussed in Section 7). We can strike this trade-off in various ways with a range of options on a price control.

## Options for setting prices

- 8.4 When setting prices via a price control, we first need to consider whether the purpose of the price control is to prevent SFV customers being made worse off than currently (i.e. by stopping prices rising above their current levels) while any engagement remedies take effect, or whether we want to actively reduce the prices paid by SFV customers.

## A safeguard cap

- 8.5 When we use a safeguard cap, we set a price control that prevents prices increasing above their current levels (in either nominal or real terms, allowing for increases up to the rate of inflation). We generally use a safeguard cap when we believe that competition is growing and we expect that as competition develops competitive pressures will cause prices to decrease without undue delay. The safeguard cap ensures that consumers are made no worse off by further price increases in the time it takes for competition to develop.
- 8.6 If competition does not develop sufficiently quickly, a safeguard cap may not be appropriate because it would leave consumers paying high prices for longer than necessary. We would therefore only wish to use a safeguard cap if we believed that effective competition would develop within a reasonable time after the start of the price control.

## A price reduction

- 8.7 In developing our price reduction options we have sought to assess two price points:
- The price reduction we could impose on BT if we were not concerned about allowing competition to develop because we believed it was not viable (i.e. a cost based charge derived from BT's costs). We refer to this option as the **"maximum price reduction"**.
  - The price reduction we could impose on BT in order to protect consumers from high prices whilst still allowing effective competition to develop for SFV customers. We refer to this option as the **"price reduction consistent with promoting competition"**.
- 8.8 We set out our conclusion on the prospects for competition to develop and which of the price control options we propose to use in Section 9.

## **Options for the size of a reduction in the price of SFV services**

### **BT's cost of providing retail services**

- 8.9 We have collected information from BT on its costs of providing retail services. In assessing the level of BT's costs, we did not consider it appropriate to produce detailed cost modelling. Cost models are most appropriate where there are clearly identifiable relationships between services and the costs to provide those services. Some costs associated with the provision of retail services are easily identifiable (e.g. the price of wholesale line rental), however, where we have a retail provider providing multiple products, allocating retailing costs between products is not straightforward. We have therefore taken a relatively high level approach to allocating retail costs (as described below and in paragraphs A5.40 to A5.42 rather than attempting to model costs explicitly.
- 8.10 We do not believe there is clear evidence that service costs per line will change significantly over the price control period. [X]. [X]. We have therefore not



undertaken any cost forecasting when determining BT's level of future profitability.<sup>185</sup> We discuss how we might allow prices to change over the price control period below.

- 8.11 In addition to determining an appropriate cost level, we also need to consider how to determine an appropriate level of profitability for BT retail services. Our starting point is to use a measure of BT's weighted average cost of capital (WACC) as an appropriate level of profitability and compare this to BT's ROCE for SFV services. This is our preferred approach when setting charge controls on wholesale services. As we set out in Annex 5, using a ROCE approach has some drawbacks when dealing with retail services. We would expect retail operators to have low capital employed which is partly due to a high level of intangible assets.
- 8.12 We may not wish to include some of these intangible assets, such as brand value, because they may (at least in part) reflect BT's market power. However, we would want to capture the value of other intangible assets, such as the value of staff training. As discussed in Annex 5, we would only want to include intangible assets to the extent that they would form part of an operator's asset base if it operated in a competitive environment.
- 8.13 We have also considered using BT's return on sales (ROS)<sup>186</sup> as a measure of BT's profitability. As discussed in detail in Annex 5, we consider ROS as preferable in this case. Although ROS is not as well based in economic theory as ROCE, we are able to estimate it more accurately and it does provide us with an acceptable proxy for profitability. It is also a measure that is widely used by regulatory bodies controlling retail prices and is well understood by industry.
- 8.14 Although we are able to measure BT's ROS, we do not have an established method for calculating a cost-based level of ROS. We have looked at benchmarks used across other industries and believe that a ROS of between 5% and 10% is broadly consistent with a cost-based measure of profitability in a fully competitive market (see Section A5.86).
- 8.15 In order to calculate BT's level of profitability, we requested data from BT Consumer on costs and revenues for its fixed voice consumers. BT was able to provide us with the direct wholesale cost of providing voice services, but it was not able to split the majority of retail costs between different services. Where BT was not able to identify to which products retail costs should be allocated, we allocated them between fixed voice and fixed broadband services based on the number of lines in each financial year, i.e. we assumed the cost was the same for each fixed voice and for each fixed broadband line. We consider this to be a conservative assumption because we did not allocate any of these costs to BT Mobile, BT Sport or BT TV.
- 8.16 We also considered whether we should calculate costs and revenues for SFV customers separately from other voice customers. Our analysis (as shown in paragraphs A5.43 to A5.52) suggests that the net cost and revenue difference between SFV customers and other voice customers is not material for our

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<sup>185</sup> As discussed in Annex 5, we are aware that there may be price and cost changes in the 2016/17 and 2017/18 financial years (e.g. the cost of nuisance call blocking) and we will look to capture these changes once further data is available. However, we do not believe that any of these changes would be sufficiently large to change our view on BT's profitability.

<sup>186</sup> Also referred to as the EBIT (earnings before interest and tax) margin.

purposes.<sup>187</sup> We have therefore calculated the profitability per line BT achieves on voice across all consumers and assumed this is the same for SFV customers.

- 8.17 BT currently earns revenue of approximately £[<] per month (ex VAT) from SFV subscribers on average. Our estimates of BT's costs suggest it achieved profitability (ROS) for SFV services in 2015/16 of c.34-42%, which equates to profit of about £8-10 per line per month (ex VAT). Our analysis suggests that a ROS of no more than 10% is consistent with a cost based estimate of profitability for a provider of retail voice services, which equates to profit of between £[<] and £[<] per month. We could therefore reduce prices for SFV services by around £[<] per month (ex VAT) in order to reduce BT's profitability on these consumers to a cost based level, which equates to a decrease in prices that consumers experience of between £8-10 per month (inc VAT).
- 8.18 However, as discussed below, an adjustment of this size would be highly likely to make it uneconomic for other CPs to compete in offering SFV services and acquiring customers. Other CPs incur substantial acquisition costs when acquiring customers, which BT does not incur when serving its existing SFV subscriber base. These costs make other CPs less profitable when compared to BT. Even if the engagement remedies we discuss in Section 7 are effective, some acquisition costs will remain meaning it is unlikely that other CPs would be able to profitably supply SFV customers if prices were set on the basis of BT's costs. We would therefore only use an £8-10 reduction in prices if we were not also imposing engagement remedies. We discuss below the level of price reduction that is still consistent with competition emerging.

### **A competitive benchmark for SFV retail prices**

- 8.19 In order to understand how much we could reduce prices by and still expect competition to emerge, we have looked a number of different measures in order to estimate a competitive benchmark. Analysis of these options is set out in more detail in paragraphs A5.70 to A5.86.

#### **BT's historic levels of profitability for SFV voice services:**

- 8.20 In 2009 we removed retail regulation on the basis that the retail market was competitive. BT's level of retail profitability at this time was at a level at which we believed regulation was no longer necessary, given the market circumstances. At that time BT was struggling to maintain its market share and, despite the removal of retail price controls in 2006 did not appear to have the commercial freedom to raise retail prices. Accordingly, the level of profitability that BT achieved on retail services at that time provides us with a starting point for the level of profitability that we believe is consistent with a market that is sufficiently competitive not to require regulation.
- 8.21 In 2009, we assessed BT's profitability using ROS and have used the same approach for this assessment. Our assessment of ROS in 2009 suggests a margin for BT of c.20% is consistent with emerging competition.<sup>188</sup> If a similar margin was applied today, BT's monthly line rental would need to be reduced by approximately £[<] (ex. VAT).

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<sup>187</sup> We estimate that there is £[<] more revenue for SFV customers and £[<] more cost. However, there is a high degree of uncertainty associated with these estimates.

<sup>188</sup> See Figure 5.4, [https://www.ofcom.org.uk/data/assets/pdf\\_file/0023/51836/statement.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0023/51836/statement.pdf)

### Current levels of profitability in the dual play market:

- 8.22 Although there is limited competition in the SFV market there is more active competition in other retail services. For example, dual-play bundles include voice services but also broadband services. By assessing the level of profitability in dual-play services with active competition, we can obtain a benchmark for the level of profitability required to encourage competitive entry.
- 8.23 Using a similar approach as we used to calculate the profitability of SFV customers, we have assessed current levels of profitability in dual play for BT (outlined in paragraphs A5.79 to A5.81. We have calculated ROS margins of c. [X<] % for BT's combined net margin for fixed voice and broadband service.<sup>189</sup>

### Profitability of other communication providers

- 8.24 Other CPs are likely to have a different cost base to BT and may not benefit from the same economies of scale. As with BT, we have sought to calculate the level of profitability achieved by other CPs offering retail voice products.<sup>190</sup> Our analysis of other CPs' data suggests they are achieving ROS margins of c.[X<] % for retail voice services. This may not be surprising because, as we discuss in Section 4, we have evidence to suggest BT acts as a price leader with other CPs following its price increases. However, while these ROS margins appear to be similar to those for BT, other CPs had lower revenues and lower profits in absolute terms. BT's absolute profit in £ per customer was approximately [X<] % higher than the next most profitable CP.
- 8.25 This level of profitability for other CPs is still high, suggesting other CPs could still potentially be profitable if we reduced SFV prices closer to BT's costs. However, we are concerned about the robustness of our estimates for other CPs' profitability. We were not able to obtain data for all other CPs and those CPs that were able to provide us with data were only able to provide them at an aggregate level (i.e. for all fixed voice customers including those that purchase broadband). We have therefore treated the results of our analysis of the profitability of other CPs with caution.

### Profitability of a marginal subscriber

- 8.26 In the context of promoting competition, basing our assessment of profitability on benchmarks from other markets and on BT and other CPs' historic profitability has the drawback of being based on the average costs and profitability of subscribers. In deciding on whether to try to acquire an additional subscriber, a rational CP will consider whether the discounted revenue it can earn from serving the subscriber is greater than the discounted marginal cost of serving the subscriber. Excluding the cost of acquiring the subscriber, the marginal cost is likely to be considerably lower than the average cost of serving the subscriber that we are measuring with our benchmarks. The cost of acquisition is therefore a key input in determining whether a marginal subscriber will be profitable.
- 8.27 Unlike the benchmarks we have calculated, cost information on a marginal subscriber is not readily available from accounting data. We have built a simple discounted cash flow model in order to try and assess the profitability of the marginal

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<sup>189</sup> This includes an allocation for BT Sport where this is provided free with BT broadband.

<sup>190</sup> Given the available data, we were not able to calculate the other CPs' profitability of offering SFV products.

subscriber faced by a notional CP. This model is described in detail in paragraphs A5.72 to A5.78. If this model calculates that a marginal subscriber is still profitable (i.e. the discounted revenues are greater than discounted costs) when a price reduction is introduced, then this would suggest that it is still possible for competition to develop.

- 8.28 We used this model to consider how profitable it will be to acquire marginal consumers under different scenarios depending on how successful our demand-side remedies are at reducing acquisition costs. In each of these cases we assume that our notional CP sets prices at a 10% discount to BT's prices. Our modelling suggests that even if we only achieve a modest (25%) reduction in acquisition costs it would still be profitable for CPs to acquire new standalone voice subscribers after a reduction in line rental prices of up to £7 (inc VAT) per month, which equates to a 37% discount on BT's prices.

### BT's Home Phone Saver

- 8.29 As discussed in Section 4, BT uses its Home Phone Saver tariff as a retention tool where it may lose its customers to competitors. As such, this provides a market indication of the price cut BT is willing to offer commercially where it perceives the threat of competition. The Home Phone Saver tariff is at least £5.50 lower than standard BT prices for a customer taking Anytime calls (and significantly more if various opt-in features are included – see Annex 8 for details).<sup>191</sup>

### **Conclusions on the options for the size of the price reduction**

- 8.30 If we consider that a reduction in prices is appropriate in order to protect consumers from prices that are above the competitive level, based on our assessment we believe that the maximum price reduction that we could introduce would mean a reduction in line rental of approximately £8-10 inc VAT per month. This size of reduction would be consistent with reducing prices to our estimate of BT's costs. However, such a reduction would be likely to seriously reduce the chance of competition emerging. Our competitive benchmarks and DCF analysis suggest a range of between £5 and £7 inc VAT a month would still allow profitability at a level that would be consistent with competition developing. The discount offered by BT on its Home Phone Saver product is consistent with this range.

## **Design of the price control**

### **Duration of price control**

- 8.31 We have considered what period of price control would allow certainty for consumers and CPs. The periodic re-setting of price controls allows the regulator to ensure that allocative efficiency objectives are met by setting the new control based on an up-to-date view of costs and revenues. In this case, we propose to use a three-year price control period that aligns with the market review period. This length of price control would give consumers and CPs certainty over BT's charges over the medium term.

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<sup>191</sup> Home Phone Saver Plus incorporates a number of additional inclusive services not automatically included with the standard line rental. These are relevant to the benefit of Home Phone Saver to customers if they are valued or would have otherwise been purchased with the standard tariff.

## **Which customers are going to be affected by the price control?**

- 8.32 As discussed in Section 3, we have identified two categories of purchasers of SFV services:
- Voice-only customers who do not purchase fixed broadband from any supplier; and
  - Split-purchase customers who purchase both fixed telephony and broadband but outside a bundle.
- 8.33 Both sets of consumers purchase the same SFV products and therefore, as we noted in Section 3, they both face the same detriment from the prices of SFV services being above the competitive level. Our provisional conclusion in Section 3 is that both of these sets of consumers are included in the same SFV markets. These provide reasons to include both sets of consumers in any price control.
- 8.34 Nevertheless, we have also considered whether there is a reason to exclude split purchasers from any price control. One possible reason is the potential for engagement remedies to be more effective in promoting competition for split purchasers than for voice-only consumers. Compared to voice-only customers, split purchasers have the added benefit of using the internet to compare and switch between products and CPs. In addition, there are many CPs offering competitive dual-play packages which split purchasers could adopt. However, even if, assisted by these circumstances, engagement remedies proved to be effective, in the absence of a price control, consumers who remain split purchasers are likely to continue to suffer detriment from BT's prices for SFV services being above cost in the significant period of time before the implementation of such remedies. Therefore, we propose that both sets of consumers purchasing SFV services would be included in a price control.
- 8.35 All other fixed voice services sit outside our market definition, such as those included in dual-play or other multi-play bundles, and will therefore not have a price control applied to them.
- 8.36 We have considered the risk that BT could look to recover lost revenue on SFV services by increasing prices in other markets (e.g. bundle prices for dual-play subscribers). However, we have not identified a clear causal mechanism to connect a reduction in prices in BT's SFV services with higher prices in other markets in which BT operates.<sup>192</sup> In particular, we believe that there is sufficient competition in these other markets to place a constraint on BT and stop it raising its prices in response to a price control for SFV services.

## **How quickly should we reduce prices?**

- 8.37 In considering how we would go about price controlling SFV services we have considered two options:

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<sup>192</sup> This is in contrast to some other situations, such as the causal mechanism that in principle connects reductions in mobile termination charges to higher prices offered by mobile operators to acquire mobile subscribers. This mechanism – often called the “waterbed effect” – is that a reduction in termination charges reduces the profitability to a mobile operator to acquire a new subscriber, because less profit is earned on incoming calls to that subscriber. In this case, however, it is not clear that the profitability of dual play or other services are reduced by a price cut for the services in the SFV markets.

- 8.37.1 **One-off reduction:** reduce prices using a one-off adjustment and hold them constant in real terms thereafter.
- 8.37.2 **Reduce prices using a glide path:** glide paths involve setting a control so that there is a gradual convergence of prices from the current level to the target level by the end of the control period.
- 8.38 When setting price controls, particularly where the control replaces existing controls, we have a strong preference for glide paths, rather than one-off adjustments. However, we do not always use glide paths and in some circumstances we have considered it more appropriate to use one-off adjustments.<sup>193</sup> For instance, we have considered making one-off adjustments where there is a risk to competition from distorted pricing signals, or where prices are significantly above or below cost for reasons other than efficiency or volume growth.
- 8.39 When moving between control periods a glide path approach provides greater incentives for cost efficiency improvement as it allows the firm to retain the benefits of cost reductions made under the previous price control. By contrast, one-off adjustments to charges reduce the effective regulatory lag, and hence the incentives to reduce costs.
- 8.40 Using a glide path also has the benefit of avoiding discontinuities in charges over time and leads to a more stable and predictable background against which investment and other decisions may be taken by both suppliers and consumers.
- 8.41 The drawback of using a glide path is that it allows prices to be above the target level for an extended period of time. In this case, that will mean SFV customers paying more than the target level for the duration of the glide path.
- 8.42 In this case, there is no existing price control and we therefore do not have the usual concerns regarding removing the incentive to reduce costs. Additionally, our analysis shown in Annex 5 suggests that the majority of the increase in BT's profitability over time has been caused by increases in the prices of line rental and calls rather than by cost reduction measures.
- 8.43 We estimate that using a glide path rather than a one-off adjustment would lead to BT's SFV customers paying around £60-80m more over the three-year price control period. If our engagement remedies led to competition emerging quickly then the impact of using a glide path would be reduced as competitive pressure pushed down prices. However, as discussed in Section 7, we expect that the process of developing, trialling and implementing engagement remedies could take up to two years, which would limit the time before the end of the price control period for them to have a material effect on competition.
- 8.44 Due to the potential for consumer harm during the price control period, we are proposing to impose a one-off reduction in prices. We recognise that some transition period is appropriate to allow BT sufficient time to implement price changes. We are therefore proposing that the one-off reduction to line rental prices occurs one month after the start of the price control period.

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<sup>193</sup> For instance, we made one-off adjustments to starting charges for Ethernet and TI services in the 2016 Leased Lines Charge Control (see Business Connectivity Market Review – Volume II, Section 7.4) [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0015/72312/bcmr-final-statement-volume-two.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0015/72312/bcmr-final-statement-volume-two.pdf)

## How should we price control SFV products?

- 8.45 As discussed in Section 4, when assessing pricing and profitability for SFV retail services, we have looked at line rental and call costs. When assessing options for which services to price control we have considered a number of trade-offs:
- 8.45.1 **Simplicity:** it should be clear to consumers what they can expect from a price control on retail services. Our price control should provide certainty to SFV customers in relation to what they will pay over the period of the price control.
- 8.45.2 **Flexibility:** over time, the products that consumers purchase change. For instance, we may expect the number of calls that subscribers make to change, or subscribers may start to purchase additional add-on services. We would want to price control services in such a way that BT can respond to market developments.
- 8.45.3 **Effectiveness:** our price control should prevent consumers being overcharged for SFV services. BT should not be able to rebalance its pricing structure in such a way that consumers are overcharged.

### A maximum cap or an average basket cap

- 8.46 In determining proposals for controlling prices we have considered:
- **Line rental charges only:** a cap on the maximum charge for line rental and pricing freedom for call charges and ancillary services; or
  - **A basket of line rental charges, call charges and ancillary services**<sup>194</sup>: a cap on the average revenue earned by BT across standalone line rental, calls services and ancillary services.
- 8.47 Line rental charges make up the majority of the cost for SFV customers.<sup>195</sup> Only price controlling line rental provides a simpler price control because we would be able to set a maximum cap on charges. A maximum price cap control provides certainty to consumers over their line rental prices and transparency in the compliance process.
- 8.48 However, there is a risk that if we do not include the price of calls and ancillary services in our price control, then BT would respond to a reduction in line rental charges by increasing the price of calls, call packages or ancillaries to SFV customers.
- 8.49 We believe that a basket control is the appropriate way to ensure our price control is effective. However, we believe there is benefit for consumers having certainty over what the new price control will mean for them. A one-off reduction to line rental also means that all SFV customers benefit by the same amount per line. We are therefore proposing to apply the first year one-off reduction to line rental charges only. We propose that all other call and ancillary products should be included in a basket for the first year.

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<sup>194</sup> Ancillary services are optional services that are provided alongside line rental. A full list of ancillary services can be found at the end of this section.

<sup>195</sup> From 2007/08 to 2015/16, line rental costs made up between 50% and 60% of the total cost of SFV customers' bills.

- 8.50 In the second and third year of the price control we propose that all services should be included in a single basket. However, for the reasons set out above, we would be concerned if the one-off reduction to line rental was undone by significant increase in line rental prices as prices were rebalanced. We are therefore proposing to place a sub-cap on line rental services to prevent unduly large increases in the line rental prices.
- 8.51 The basket control limits the maximum weighted average increase in prices in any given year. When determining the weighting of each service in the basket, we propose to use a prior year weighting approach. This approach sets basket weights equal to the proportions of basket revenue accruing to the relevant services in the year prior to the one in which the price change occurs. By using prior year weights, we allow BT to plan its price changes in a given year with confidence that it can assess whether it will meet the overall basket control.

### Indexation of the price control baskets

- 8.52 In addition to reducing SFV prices in year 1 of the price control, we will need to decide how prices should be allowed to change over time. Over time, costs may increase due to general inflation, or they may decrease as operators find efficiency savings in the way they provide services. We have not forecasted costs and revenues over the price control period and so do not have new cost estimates to adjust to in each year of the price control. However, as discussed in Annex 5, we do not expect a significant deterioration in BT's profitability during the price control period. Therefore, we believe broadly flat prices across the basket over the price control period would be appropriate.
- 8.53 In determining the level of indexation we have considered:
- **A flat nominal cap:** average basket prices remain the same over the price control period; or
  - **A flat real cap:** average basket prices are allowed to increase each year by the consumer price index (CPI).
- 8.54 We recognise that there is a risk to operators from general economy-wide inflation and therefore we believe it is appropriate to allow BT to respond to this inflation by increasing its prices where we have determined a specific level of profitability. If we did not allow BT to increase prices in line with inflation, there is a risk that prices, and the associated level of profitability, could fall below the level on which we based our assessment.
- 8.55 If we decided to propose the use of a safeguard cap, then we believe a flat nominal price cap is more appropriate. We would not have the same concern regarding profitability falling below a particular level given that our expectation would be that prices would fall as competition emerged. We are therefore not targeting a particular level of profitability for BT or other CPs and if we allowed prices to increase with inflation, we would unnecessarily allow additional consumer detriment while competition is developing.
- 8.56 The CPI is a widely recognised measure of inflation and forms the headline figure for multiple government agencies. It is also the measure that the Bank of England uses as its target for economy-wide inflation and is recognised as an official statistic by the



UKSA.<sup>196</sup> We therefore believe it appropriate to allow the average price of the basket of SFV services to increase by the CPI each year.

- 8.57 We are proposing to place a sub-cap on line rental in the price control basket in order to stop line rental prices increasing significantly over time. However, this does not mean that we wish to remove all flexibility for BT to increase line rental prices. Indeed, there may be good reasons for us to give extra flexibility for BT to increase line rental prices if we believed that changes in the market meant lower levels of profitability for BT than we considered when setting the controls. For instance, over time call volumes have been decreasing and we expect them to decrease further in the future. In Section 3, we recognise that the pricing constraint on SFV calls may be greater than for SFV access. BT may wish to decrease call prices in the future in response to this competitive pressure. If we do not allow sufficient flexibility on the line rental price in the price control basket, BT would not be able to reduce call prices without undershooting the price control target.
- 8.58 In order to take account of this, we have considered either aligning the line rental sub-cap with the price control basket and allowing it to increase by the CPI over time, or allowing it to increase by more than CPI.
- 8.59 We have considered the extent to which BT may wish to reduce call prices during the price control period. As discussed in Section A5.63 to A5.69, we have examined the proportion of total SFV revenue that are made up of SFV call revenue and how SFV revenue has changed over time. We believe allowing BT the ability to increase prices in the line rental sub-basket by up to CPI+2.5% would be sufficient pricing flexibility to allow for any change in market circumstances. We estimate that this would allow BT to reduce call prices by approximately 7% per year in nominal terms and still set price at the price control cap.
- 8.60 If BT chose to increase prices in the line rental sub-basket by the full permitted amount of CPI+2.5%, it would need to reduce call prices in real terms to comply with the cap on the overall basket of CPI. A sub-cap of CPI+2.5% on line rental would not therefore allow BT to recover additional revenue and should ensure that price rises for consumers do not exceed CPI when other services are taken into account.
- 8.61 For the first year of the price control, we propose to assess whether BT has set prices that comply with the control by comparing them to prices in place on the 2 April 2017, rather than the prices in place for the period immediately preceding the start of the price control. We propose to do this in order to avoid giving BT the opportunity to game the price control by upwardly adjusting its prices in the period between the publication of this consultation and the start of any price control.

#### Which version of line rental should we price control?

- 8.62 As discussed in Section 3, we have included all SFV access products in the market definition excluding BT Basic. These products are Standard Line Rental, Standard Line Rental Saver, Home Phone Saver and Line Rental Plus.<sup>197</sup> We propose to include the Standard Line Rental and Standard Line Rental Saver in the price control.

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<sup>196</sup> The United Kingdom Statistics Authority is the body class with assigning statistics their classifications.

<sup>197</sup> These line rental products are discussed in more detail in section A5.37.

- 8.63 Although we have included Home Phone Saver and Line Rental Saver in our market definition, both products have quite different pricing structure and level of profitability to Standard Line Rental standalone voice products. As discussed above, the discounts reflected in Home Phone Saver are already at a level similar to or larger than those available to customers on the standard tariff if we reduce standard line rental by £5-£7.<sup>198</sup> We therefore believe that Home Phone Saver is priced in a way that is broadly consistent with the prices in the price control option designed to be consistent with competition developing. The Line Rental Plus package is also sold at a discount that is similar to the reduction in line rental that we are proposing. We would therefore propose not to include Home Phone Saver or Line Rental Plus in the price control for the price reduction consistent with promoting competition option.
- 8.64 However, under our maximum price reduction option (i.e. a reduction in the price of standard line rental of £8-10), Home Phone Saver would require a reduction in prices to be consistent with the price of standard SFV services. We would therefore propose to include Home Phone Saver in the price control. However, due to the discount offered by BT on the Home Phone Saver product, reducing its price by £8-10 may force BT to sell it at or below cost. A price reduction that reduces the level of profitability on Home Phone Saver to the benchmark level of profitability on standard line rental (i.e. a ROS margin of around 10%) would lead to a one-off reduction of £[>] (inc VAT) in the price of the Home Phone Saver product.<sup>199</sup>
- 8.65 The Standard Line Rental Saver product provides a 10% discount on the Standard Line Rental price for those consumers willing to pay their line rental for a year in advance. We believe that this product should benefit from a one-off reduction in line rental prices. We therefore propose to set the Standard Line Rental Saver product price at a 10% discount to the price we set for Standard Line Rental in the first year of the price control. For those customers who have paid for Line Rental Saver for the period of up to 12 months in advance of the start of the price control, we propose that they receive a discount on the remainder of their contract equal to the number of complete months left on their contract multiplied by the monthly reduction in the Standard Line Rental Saver price.
- 8.66 We believe that in subsequent years, Standard Line Rental will constrain the price of Standard Line Rental Saver. We therefore do not believe it is necessary to continue including Standard Line Rental Saver in years 2 and 3 of the price control and propose to exclude it.

#### Which ancillary products should we include in the price control?

- 8.67 BT currently offers a number of different ancillaries alongside line rental and as part of its call packages. Some of these ancillary services simply enhance the caller experience, such as a voice mail service and the equivalent of this service can be obtained through alternative competitive means. Other services are, like the Line Rental Saver, sold as a discount on a core service and will by necessity be controlled by a constraint on the core service. We, therefore, do not consider that we need to price control these “services”.

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<sup>198</sup> When ancillary services are also taken into account, Home Phone Saver 2019 offers a £5.50 to £13.05 per month reduction on similar package of standard SFV products (see paragraph A.114-A.116 Figure A8.38).

<sup>199</sup> See Annex 5.

- 8.68 However, there are a number of ancillary services that form an essential part of customers' SFV services. For example, we consider those ancillaries that have a consumer protection function (such as anonymous call reject and choose to refuse) form an essential part of fixed voice services. With this in mind, we would be concerned of a risk that BT could inflate the prices of this type of services to recover revenues lost from any one off adjustment and price cap within a basket. We therefore propose to include these essential ancillary service in the price control basket.
- 8.69 Below we set out a full list of BT ancillary services that we consider to be essential. We have identified the following services as those we propose include in any price control basket because they form an essential part of consumers' SFV services.

Line Rental, which includes:

Service	Description
<b>Standard Line Rental or Line Rental</b>	Price paid per month for line
<b>BT Smart Talk</b>	Smartphone app which allows calls on mobile at BT call plan rates.
<b>BT Call Protect</b>	Sends user defined calls to a junk voicemail.
<b>Permanent withhold number</b>	Number not available or displayed when calling.
<b>Bar Three Way Calling</b>	Prevents anyone using Three Way Calling from customer's phone.
<b>Block Ring Back</b>	Prevents callers booking a Ring Back to the customer's line.
<b>1471</b>	Provides the last number that called.
<b>1470</b>	Display number on a per call basis

Ancillary services we consider to be essential, include:

Service	Description
<b>Unlimited Anytime Calls (not including Line Rental)</b>	Calls made at any time of day.
<b>Calls to BT Mobile Consumer numbers</b>	Calls to all BT Mobile consumers at any time of day.
<b>Calls to all other UK Mobile numbers</b>	Calls to all other UK Mobile numbers, including non-BT Mobile Consumer numbers at any time of day.
<b>Calls to UK National and local numbers</b>	
<b>Calls to 0845 &amp; 0870 Numbers</b>	Calls to numbers with these prefixes at any time of day
<b>Calls to Service Numbers 090, 118 and other 084 &amp; 087</b>	Calls to numbers with these prefixes at any time of day
<b>Calls to International numbers</b>	Calls to numbers
<b>Friends &amp; Family International</b>	
<b>International Freedom</b>	
<b>Calls to 070/076/055/056 number ranges</b>	Calls to numbers with these prefixes at any time of day.
<b>Choose to Refuse</b>	Block up to ten telephone numbers.
<b>Anonymous Call Reject</b>	Stop calls from people who have withheld their number.

<b>BT Privacy at Home</b>	Registers customer for the Telephone Preference Service to stop unwanted sales calls.
<b>BT Privacy with Caller Display</b>	As above together with showing number of person calling (requires compatible phone)
<b>Call Barring</b>	Allows customer to stop certain types of calls being made from the phone line.
<b>Call Diversion</b>	Divert incoming calls to another phone number.
<b>Call Waiting</b>	While on a call a beep sounds when another call is incoming.

## Monitoring compliance with the price control

- 8.70 In order to carry out our duties it is important that financial information is available on the services and markets that we regulate. The availability of this information helps us understand the volumes, revenues, costs and returns of services and markets, which allows us to monitor the impact and effectiveness of, and (for certain remedies) compliance with, the remedies imposed as part of a market review. We propose that BT is required to supply information in order for us to monitor its compliance with the control. BT would be required to provide this information annually to Ofcom, three months after the end of the price control year.<sup>200</sup>
- 8.71 In the 2014 Regulatory Financial Reporting Statement we said that “BT must produce non-confidential compliance schedules for each regulated market. These non-confidential compliance statements must be published on BT’s website in the same location as the Published Regulatory Financial Statements and at the same time as the confidential compliance statements are provided to Ofcom”.<sup>201</sup> Publication of compliance statements helps provide assurance about BT’s compliance with price controls. We therefore propose to require BT to publish non-confidential compliance schedules for the retail voice only price controlled services on its website alongside the public version of the RFS.

## Consultation questions

*Question 8.1: Do you agree with our approach to determining the options for the level of price controls for Standalone Fixed Voice services? If not, please give your reasons.*

*Question 8.2: Do you agree with our proposed basket structure if implementing a price control for Standalone Fixed Voice services? In particular, do you agree with the need for a separate sub-cap on the Line Rental within the basket? If not, please give your reasons.*

*Question 8.3: Do you agree that it would be appropriate to allow the prices in a price control basket to rise by up to consumer price index (CPI)? If not, please give your reasons.*

*Question 8.4: Do you agree that we should exclude Home Phone Saver and Line Rental Plus from the price control? If not, please give your reasons.*

<sup>200</sup> This requirement is set out in Condition 2.7 of Annex 9.

<sup>201</sup> See 2014 Regulatory Financial Reporting Statement (Section 4.49).

[https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0025/78460/financial-reporting-statement-may14.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0025/78460/financial-reporting-statement-may14.pdf)

*Question 8.5: Do you agree that it is appropriate for the Line Rental sub-cap to have greater price flexibility than the overall price cap to allow BT to rebalance pricing between the line rental and call prices? If not, please give your reasons.*

*Question 8.6: Do you agree with the services we are proposing to include in a price control remedy basket for Standalone Fixed Voice services? If not, please set out your alternative proposals and please give your reasons.*

## Section 9

# Our proposals

## Introduction and summary

- 9.1 In this section, we set out our package of proposed remedies to address consumer detriment arising from BT's SMP in SFV access and calls. As discussed in Section 6, we consider that we cannot rely on wholesale remedies to address competition concerns associated with BT's SMP, and that we need to respond directly with regulation of BT's retail activity. We also set out our consideration of the relevant legal tests that we need to satisfy in imposing regulation.
- 9.2 We are proposing a package of remedies consisting of measures to promote competition by encouraging greater engagement in the market, and a price control on BT to address the consumer detriment we have identified.
- 9.3 Specifically, we propose to set a three-year retail price control on BT's standalone fixed voice services of the following form:
- 9.3.1 An initial one-off price reduction of the line rental by between £5 and £7 per month and controls on line rental in years 2 and 3 of between CPI-0 and CPI+2.5%;
- 9.3.2 A CPI-0 basket control on all other core<sup>202</sup> existent standalone fixed voice services available to residential customers' charges in each year
- (the basket will also include the line rental in years 2 and 3 though subject to a sub-cap to avoid significant rebalancing between call charges and the line rental, which might harm consumers who make fewer calls).
- 9.4 We propose that the price control will apply to all BT customers who purchase the relevant standalone voice services. This includes all the customer segments of voice-only, split-supplier and split-service customers (i.e. whether or not they purchase fixed broadband from BT or third parties outside a bundle). It will not apply to voice services sold by BT as part of a bundle of services which include broadband.
- 9.5 In order to encourage greater engagement in the market, we also propose to impose an obligation on BT to:
- 9.5.1 cooperate with Ofcom in the testing or trialling of different measures to provide information to its customers; and
- 9.5.2 if justified in the light of that evidence, to implement measures in the manner and form as Ofcom may direct.
- 9.6 The level of the one-off adjustment in the price control has been chosen so as to be consistent with promoting competition to BT in this market. In particular, we have set a price which we consider reduces, to a significant extent, direct consumer detriment

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<sup>202</sup> We propose to exclude BT's Home Phone Saver from the price control as this is already significantly discounted. BT Basic does not form part of our relevant market definition and is therefore also excluded from the price control.

in the form of high prices, while also allowing BT's competitors to win new customers from BT and make an adequate return from serving those customers, taking into account the potential reduction in acquisition arising from measures to encourage greater customer engagement.

## Introduction to assessment of options

- 9.7 As set out in Section 6, we consider that SFV customers suffer detriment arising from BT's SMP, and we distinguish between (a) direct detriment due to prevailing market prices being above the competitive level; and (b) indirect detriment arising from a lack of competition in the market. We have presented estimates that the price-related detriment is at least £150 million and up to £340 million per year, while we have not quantified the indirect detriment.
- 9.8 A suitably designed cost-based price control could largely address the direct price detriment we have identified. However, a cost-based price control would not promote competition.
- 9.9 As we remain of the view that in the medium-term competition offers the potential to deliver benefits for consumers in terms of price, choice and available services, we therefore need to consider whether there is scope for measures to promote competition to be effective in this market. If so, we also need to consider the interaction between such measures and a price control. The right balance of reliance on competition promotion remedies and a price control depends, in part, on our expectation of the effectiveness and timeliness of measures to promote competition.

## Remedies Options

- 9.10 We have considered the following combination of remedies to address the concerns identified in this document:
- Option 1: Measures to promote competition alone (i.e. no price control).
  - Option 2: Measures to promote competition, plus a safeguard cap on BT's prices at current levels.
  - Option 3: Maximum price reduction on BT line rental (£10), followed by a price freeze (with no measures to promote competition).
  - Option 4 (Preferred Option): Measures to promote competition, plus a price reduction on BT line rental consistent with promoting competition (£5 to £7), followed by a price freeze in real terms.

### Option 1: measures to promote competition alone

- 9.11 Under this option, we would impose an obligation on BT which would allow us to impose measures to promote competition, but we would not impose a price control.
- 9.12 In Section 7, we concluded that the most appropriate potential remedies to promote competition are those which make it easier for consumers to engage in the market, namely:
- 9.12.1 Communications to BT customers aimed at providing them with useful and suitably tailored information about alternative services available in the market which might be more suitable and better value for them;

- 9.12.2 Communications to BT customers making them aware of the process for switching SFV provider, and particularly reassuring them about aspects of the process,<sup>203</sup> such as the ability to switch between providers without contacting BT, the ability to retain their existing phone number (if not moving home), and that they will not need new equipment or face a significant interruption to their service;
  - 9.12.3 Introduction of a decision point, by requiring BT to provide a prompt for consumers to consider switching their SFV provider or the tariff they use from their existing one;
  - 9.12.4 Remedies to increase the ease of responding to a potential change in tariff or switch, such as the provision of tear-off slips which consumers could sign and return in a pre-paid envelope to either BT or another provider if they wanted to change BT tariff or engage with another supplier.
- 9.13 The advantage of this option is that it would ensure that BT's competitors have the greatest possible incentive to compete for SFV customers, both in terms of prevailing prices and hence returns associated with winning customers, and also in terms of signalling to BT's competitors that we did not intend to intervene in the market by cutting prices.
- 9.14 If measures to promote competition were successful, we would expect these to lead to a reduction in prices over time to competitive levels (this would be one of the key success criteria). In the extreme case – where acquisition costs are materially lowered and providers start to compete aggressively to win and retain customers – this could in principle lead to lower prices than we are considering in the context of price controls.
- 9.15 However, such a package of remedies would do nothing to protect consumers from price increases in the short term and we recognise that success in promoting competition may be challenging due to:
- 9.15.1 the age of SFV customers, lower-than-average rate of online adoption, and relatively limited share of household budget accounted for by SFV services;
  - 9.15.2 the fact that brand loyalty to BT is strong;
  - 9.15.3 some CPs have already stopped competing in the market, while declining customer numbers and limited opportunities to upsell mean this segment is unlikely to be a priority for most CPs; and
  - 9.15.4 the limited evidence in other markets of the effectiveness of such remedies
- 9.16 Even in the best-case scenario, it would likely take some time for us to trial, evaluate and implement a package of measures to promote competition, and for greater competition to develop in the standalone fixed voice markets.
- 9.17 For example, if measures to promote competition took two years to start to have an effect, then we estimate that the consumer detriment would be about £200 million to £425 million at current prices<sup>204</sup> (and we note that the delay before the market

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<sup>203</sup> If switching within the Openreach copper network.

<sup>204</sup> See Section 6 where we discuss consumer detriment.



became effectively competitive could be materially longer). This estimate takes into account that the base of standalone voice customers is declining over time. In addition, providers are continuing to raise prices, so in the absence of any price cap it is likely that consumer detriment per line would increase in the coming years.

- 9.18 Finally, as discussed Section 7, we also consider that there are material risks that such a package of remedies would not ultimately be effective in promoting effective competition.

### **Option 2: measures to promote competition, and a safeguard cap**

- 9.19 Option 2 differs from Option 1 in the inclusion of a safeguard cap, which would remove the risk of detriment increasing further in the coming years. A safeguard cap would be based on prices as at a fixed date. However, this would not address the existing high level of detriment in the market, which measures to promote competition may not address in a timely fashion, if they do so at all. So, for the reasons set out under Option 1, we do not consider this option is appropriate.

### **Option 3: maximum price reduction on BT line rental, followed by a price freeze**

- 9.20 A £8-10 price cut on BT's line rental, followed by a price freeze, would remove all current price related consumer detriment we have identified arising from high prices in the provision of SFV services.
- 9.21 We expect that if we imposed such a price cut, other CPs would face pressure to reduce their prices to new and/or existing SFV customers since BT is a price leader and customers could switch to BT at the price-controlled level (or potentially to another provider).<sup>205</sup>
- 9.22 However, we expect that in this case these other CPs would not have an adequate incentive to compete for new customers, as prevailing prices (based on the price control on BT) would not allow them a sufficient return to cover new customer acquisition costs. This might also mean some providers might even withdraw from existing supply. For this reason, if we imposed a price control at this level we would not impose an obligation on BT in relation to measures to promote competition, as we would not expect any such measures to have a reasonable chance of success.
- 9.23 However, given the benefits we consider competition offers, we do not consider this to be a desirable outcome if there is a reasonable prospect of improving competition in this market.

### **Option 4 (Preferred Option): measures to promote competition, and a price reduction on BT line rental consistent with promoting competition, followed by a price freeze**

- 9.24 While there are challenges to introducing successful measures to promote competition in this market, there is also a case for exploring whether such measures can be successful, in particular given the presence of competitors who are interested in acquiring – or actively seeking to acquire – more SFV customers.

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<sup>205</sup> Whilst current rates of switching are low, the evidence suggests that rates of switching are materially higher for SFV customers of other CPs than for BT's customers (see Annex 8).

- 9.25 If we are to explore the scope for such measures to succeed, in our view this needs to be balanced against the need to protect consumers from detriment. A price cut of £5 to £7 in the monthly line rental would substantially reduce consumer detriment in this market.<sup>206</sup> The choice of price cut within this range would depend on our judgement about the most appropriate balance between promoting competition and protecting consumers, as well as any refinement in our analysis of competitive benchmarks and profitability (discussed in Section 8 and Annex 5) following responses to this document.
- 9.26 We have derived the size of this range for the price cut on the basis that it is consistent with promoting competition. However, we recognise that there is still a risk that other CPs would be deterred from engaging in the market, by the reduction in margins and potentially the prospect of future price regulation.
- 9.27 We also note the potential interaction with our proposed change in regulation of a key wholesale input in the 2016 NMR Consultation, to change from a charge control for WLR to a fair and reasonable charges obligation (providing BT with greater flexibility in setting WLR charges).<sup>207</sup> We are proposing this change to wholesale regulation on the basis of our assessment that BT's market power in wholesale lines is likely to be lower than it was when we last reviewed the market, as a result of growing alternatives to traditional fixed voice services, particularly increased competition from infrastructure based competitors. Nevertheless, this proposed change is clearly a material consideration for existing and potential suppliers of retail SFV services.
- 9.28 While, as we have argued, BT has SMP in the standalone fixed voice markets there are some willing competitors with the potential to become stronger rivals to BT.
- 9.29 As discussed in Section 6, we consider that there are benefits to competition in service provision that go beyond simply the service price. Telephony services are not a simple commodity product and absent competition there is a risk of a slow decline in diversity of service options and even quality.
- 9.30 On balance we do not at this stage favour giving up on the prospect of promoting competition and we consider that we should trial and test the measures discussed above to improve customer engagement alongside price controls including a significant price cut of £5-7 per month to mitigate consumer detriment. In the event that we consider in future that our initiatives do not lead to a material improvement in competition, and we conclude that they were not likely to do so, then we would expect to reconsider this position.

## Proposed retail regulation

### Promoting competition

- 9.31 The detailed justification for our proposal to set information remedies to encourage competition is set in Section 7. In summary, the proposals are:

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<sup>206</sup> Beyond the reduction arising from the declining base of standalone voice customers.

<sup>207</sup> This proposed change in regulation of WLR is less relevant to the other options. For Options 1 and 2, the price of WLR is unlikely to be a major constraint on growth in competition. For Option 3, promotion of competition is not important.

- An obligation on BT to act in accordance with Ofcom's directions requiring it to produce, provide or distribute information, or make specific communications to, its customers ("Communications Requirements");
- Our directions may include the content, format and frequency of the information to be provided;
- They may also specify the identity of the sender, the group of customers that will receive the communications or require the provision of information about BT's prices and the prices of other communications provider. Ofcom's directions may also require BT to provide response cards, tear off slips and addressed envelopes to its customers; and
- An obligation on BT to cooperate in the development and design of Communications Requirements and to provide information to Ofcom.

## **Price control**

9.32 The detailed justification for the structure of the price control is set out in Section 8. Given our preference for Option 4, our proposed price control will take the form of:

- a basket control on all core SFV services, based on BT prices as at 2 April 2017, allowing BT to increase price by up to CPI in each year of the control;
- a one-off adjustment to the line rental of between £5-£7 per month, subject to our final assessment, taking into account responses to this consultation, of the balance between promoting competition and protecting consumers. The adjusted line rental price will remain in place for the remainder of year one;
- a sub-cap on the line rental in years two and three of the control of between CPI and CPI+2.5%, subject to our final assessment, taking into account responses to this consultation, on the appropriateness of allowing BT some freedom to rebalance prices as between the line rental and calls in the face of continuing declines in retail calls;
- a requirement on BT to reduce the price of its line rental advance payment product – Line Rental Saver – by a proportionate amount to the reduction in the line rental and refund existing purchasers of this product for any period of the pre-payment that overlaps with the price control period;
- an annual compliance report to confirm adherence to the price control; and
- BT will have to adhere to a fixed date for the commencement of the price control but have at least one month after the statement date to implement the new controls.

## **Regulatory reporting**

9.33 As set out in Section 2, section 91(6) provides that, when imposing regulatory controls on tariffs, Ofcom shall also set the necessary and appropriate obligations relating to the use of accounting systems. We are considering whether such obligations are required for this market and if we consider they are we will consult separately.

## Legal tests

- 9.34 Section 91 authorises the imposition of SMP conditions in relation to the provision of retail services. For the reasons set out below we are satisfied that the conditions we are proposing to impose on BT meet the various tests set out in the Act.
- 9.35 In making our proposals, we have considered, in particular, our duties under section 3 of the Act. We consider that by addressing the direct and indirect consumer detriment that we have identified, our proposed regulations will further the interests of citizens in relation to communications markets and further the interests of consumers in relevant markets, including by promoting competition. We have also had particular regard to our duty under section 3(4)(i) and the needs of the elderly who form a large part of the relevant retail markets.
- 9.36 In making our assessment, we have also taken into account the Community requirements set out in Section 4 of the Act and Article 8 of the Framework Directive. We consider that our proposals will promote competition in relation to the provision of electronic communications services by ensuring that users derive maximum benefit in terms of choice, price and quality.
- 9.37 In addition, we have considered whether our proposals satisfy the test set out in section 47 of the Act, namely that SMP obligations must be:
- 9.37.1 objectively justifiable in relation to the networks, services, facilities to which they relate;
  - 9.37.2 not such as to discriminate unduly against particular persons or against a particular description of persons;
  - 9.37.3 proportionate to what the conditions are intended to achieve; and
  - 9.37.4 transparent in relation to what is intended to be achieved.

## Communication Requirement

- 9.38 Condition 1 is specifically aimed at promoting competition by reducing the acquisition costs to communications providers through greater engagement of consumers in this market. We consider this remedy is:
- objectively justifiable in light of the market failure we have identified and our provisional conclusion that there is still potential for competition in the SFV market that can deliver good outcomes for consumers. Our proposed measure is also appropriate in light of our provisional conclusion that wholesale remedies are not sufficient to address the identified harm;
  - not unduly discriminatory, in that it will only apply to BT, which we have identified as the only CP having SMP in the relevant markets;
  - transparent in that it is clear what it is seeking to achieve – the promotion of competition through greater consumer engagement – and in setting out what BT is or may be required to do in future; and
  - proportionate, in that we have identified a market failure and the condition is targeted specifically to the area for which regulation is required. Our proposed condition is the least onerous means of achieving the objective we have

identified in that it allows for the trialling of the least onerous engagement remedies.<sup>208</sup>

## Price control for exchange line services

- 9.39 Condition 2 has been proposed in order to reduce the consumer detriment we have identified in this market through regulation of the maximum price the dominant provider can provide to SFV customers. We consider this remedy is:
- objectively justifiable, in light of the direct consumer detriment we have identified and the inadequacy of wholesale regulation in addressing that harm identified in section 6;
  - not unduly discriminatory, in that it will only apply to BT, which we have identified as the only CP having SMP in the relevant markets. Our proposed remedy will also affect all BT customers that purchase SFV in the relevant markets;
  - transparent in that it is clear what it is intended to achieve and in setting out the controls that we are proposing to implement on BT's prices; and
  - proportionate, in that it seeks to strike the right balance between promoting competition and protecting consumers from harm and is the least onerous means of achieving that balance.
- 9.40 Lastly, we have considered, as required by section 91(2), whether wholesale regulation alone would have allowed us to perform our duties under section 4 of the Act. For the reasons set out in this section, we are satisfied that wholesale remedies have not been, and are not likely to be, sufficient in achieving those aims. Accordingly, we consider the legal tests set out in the Act are satisfied.

## Consultation questions

*Question 9.1: Do you agree with our proposed set of remedies for the Standalone Fixed Voice services markets, that is a price control, with a one-off adjustment set with reference to the costs of BT competitors in this market, and an obligation on BT to work with us to explore and ultimately implement information options to promote competition? If not please set out your reasons.*

*Question 9.2: Do you agree that BT should have at least one month after the date of the statement to implement the new price structure? If not, please set out your reasons.*

*Question 9.3: Do you have any additional comments on our analysis or conclusions in this consultation?*

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<sup>208</sup> We note that any direction made by Ofcom in relation to BT's compliance with the proposed condition will be subject to separate consultation.