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Ofcom's Directory Enquiries Review

CEG Expert Report

Non-Confidential Version

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Executive Summary

1. Ofcom's *Directory Enquiries (118) Review* consultation ('the Consultation') published on 13 June 2018 proposes that the market for directory enquiry ('DQ') services be subject to a price cap. In this report, I review Ofcom's analysis and the market evidence to assess whether there is evidence of substantial consumer harm to warrant a market-wide price cap or whether any consumer harm could be better addressed through more targeted measures.

2. The current market is delivering significant benefits to both residential and business customers. As found by Ofcom, DQ services are particularly valued for speed and convenience. Ofcom states that DQ services enable customers to make important calls including where there are limited alternative ways to find the numbers. The vast majority of users are satisfied with the service. The introduction of competition to the UK market in 2002 has led to significant benefits to consumers including the introduction of a greater variety of service features and a marked increase in quality of service.

3. The presence of The Number UK (TNUK) in the markets for the provision of DQ services – i.e. in both the retail and the wholesale markets – has been critical to the development of competition that had driven those benefits. TNUK has grown to be the largest competitor to BT in the retail market and has led improvements in quality in the market as well as introducing new service features. In addition, TNUK has, by its activities in the wholesale market, made it possible for a variety of other operators to have a presence in the retail market, taking advantage of TNUK's willingness to supply competitors with a 'white label' service at wholesale prices which enable them to compete with both BT and TNUK in the retail market.

4. Critical to customers' use of DQ services is the ability to remember the number for a service when they need it, even when they use the service infrequently. TNUK has achieved high number memorability through substantial investment in marketing since entering the UK. As an entrant, TNUK incurred significant risks in marketing and customer service investments to build a customer base in competition with BT. BT was the incumbent monopoly provider of DQ services and enjoyed large advantages including strong brand recognition and the ability to promote its services through the Phone Book and regular communications with its large telecoms customer base. TNUK had no such advantages. TNUK having made this investment and delivered the benefits to customers that flow from it is now facing the prospect of Ofcom overturning the pro-competitive regulatory framework and instead imposing a cap [✂].

5. The basis on which price regulation is being proposed is highly unusual. Ofcom has not found that any player has Significant Market Power. Ofcom's main reason for price regulation appears to be so-called 'bill shock'. Ofcom is using

that emotive term to refer to any situation where the consumer's guess as to what the call would cost is lower than the actual cost he or she incurred. Ofcom's basis for considering that a price cap is needed to protect consumers from 'bill shock' is the finding that 39% of DQ users underestimated the price of DQ calls when asked in a survey. It is not clear, however, why it should be considered a matter of concern that a substantial proportion of users of DQ services have an inaccurate recollection, or make an inaccurate guess, of the cost. Consumers would be expected to have only limited recollection of the price of any product that most buy only once or twice a year. Notably only 10% of DQ users (0.2% of the population) mentioned DQ calls when asked if they had spent more than they expected to for any telecom services in the last 12 months.

6. Moreover, consumer harm from bill shock should be measured by the extent to which customers have made calls that they would not have made had they known the price. Evidence suggests that many DQ users who have experienced 'bill shock' under Ofcom's definition would have made those calls anyway. Kantar found that of the users who had a call that cost more than expected, 53% were nonetheless satisfied with the experience, 32% were dissatisfied and the remainder neither satisfied nor dissatisfied.[1] While the services come at a price, they benefit customers in terms of the speed and convenience offered by calling a known DQ service including in situations where the caller is in a hurry, occupied with another activity (e.g. driving), or for some other reason values speed and convenience more than the time or effort involved in looking up a phone number by an alternative method. Customers who would have made the call anyway have not been made financially worse off from not being able to guess accurately the price. Further, for the remaining customers, the extent of the harm is the difference between the price paid and how much they would have been willing to pay. This is likely to be around half of the £5.44 figure estimated by Ofcom with reference to the average amount DQ users experiencing 'bill shock' spent in excess of expectations. Ofcom's analysis thus substantially over-estimates both the number of customers harmed by 'bill shock' and the extent to which each has been made worse off.

7. In relation to affordability issues particularly for low income customers, while Ofcom's research found that 8% of DQ users were 'financially impacted' by calling DQ services, it is not clear how material is the harm suffered. For households with finite incomes and the roughly half of UK households with financial (non-mortgage) debt, spending on *any* product could be said to require less spending on other products and to contribute to their borrowing money. Only 1% of DQ users reported a clear affordability issue, i.e. not being able to pay their telephone bill. In terms of consumers not using DQ services, Ofcom's

[1] Kantar Media, *Directory Enquiry Services Research Report*, 2018 ('the Kantar Report'), p.30.

evidence shows that only between 0.02% and 0.2% of consumers stated that they had a problem from not using DQ services for affordability reasons.

8. For all these reasons, the evidence base for Ofcom's provisional conclusions in the Consultation regarding the need for further regulatory intervention in relation to DQ services is dubious. In particular, the Consultation's assessment of the alleged extent of consumer harm, which is the asserted basis for the proportionality of the proposed price cap, appears to be seriously flawed.

9. Moreover, even if the assessment of consumer harm were robust, the Consultation fails to properly assess the proposed price cap's likely and potential detrimental effects on BT's competitors, on competition, and on consumers and other users of DQ services. While the proposed price cap is designed to address issues for a small minority of consumers, it risks significant harm to DQ users generally. In this report, I identify the risks of the price cap including:

   - [✂];
   - reduced quality of service for all DQ users by reducing returns to investment in quality and through weakening remaining competition; and
   - reducing competition and potentially increasing prices of some cheaper services to the focal point created by the price cap.

10. The design of the proposed price cap is also peculiar. The reasons offered for the level of the cap are that it would accommodate BT, it aligns with average consumer expectations (without consideration to whether those expectations are reasonable) and it aligns with 2013 prices (although Ofcom's understanding of 2013 prices is mistaken and nor has Ofcom considered how unit costs have changed since 2013). There is no consideration of a methodology to allow for efficient cost recovery which would normally form the basis of price regulation. The proposed 4 month implementation period risks imposing substantial costs on investors, the businesses and their employees given that such a large price reduction can be expected to require [✂].

11. The proposed price cap could only reduce the degree of (and not eliminate) 'bill shock', affordability issues or fraud. 'Bill shock' could be eliminated only through customers knowing actual prices – Ofcom could target this issue directly through helping to publicise prices. There are a number of means by which this could be done. For example:

    - Price comparison tables, if given appropriate publicity, could assist consumers generally to know the prices of the DQ services they use. Such comparison tables could also assist price-sensitive consumers to choose to remember, or make a note of, a DQ service number that is set at a relatively low price, potentially below the level of Ofcom's proposed cap.

- Another possible regulatory approach would be the introduction of pre-call announcements (PCAs) that inform customers of a voice-based number checker facility so they can check actual charges if they wish.
- Affordability issues could also be better addressed through Ofcom helping to publicise the services that are today priced below its proposed cap level. Ofcom could also consider consulting on specific safeguard measures that could be better suited to protecting lower income consumers against unexpected high charges: for example, a requirement for all DQ providers to offer the kind of 'no quibble' compensation arrangements that providers such as TNUK already offer.
- The PSA already has powers to target the few rogue providers responsible for fraud and is proposing enhanced measures. Whilst Ofcom's proposed price cap could have some effect in reducing the profits that can be made from fraud, unscrupulous operators are still likely to view fraud as a profitable activity unless deterred by pro-active effective anti-fraud enforcement measures.

12. Instead of considering what approaches would be most effective for meeting its concerns, Ofcom has used BT's new price for its 118500 service to make a quick proposal for price regulation without regard to the range of costs that it would create for DQ users generally. In making its price cap proposal, the Consultation appears to have taken a hasty approach in dismissing other available remedies that could more effectively address Ofcom's specific concerns and do so at lower cost to customers generally.

1 The current market provides significant benefits to customers

13. DQ services bring significant benefits to both residential and business customers. Many users call DQ services because of factors relating to speed, convenience and accuracy, even when they have alternatives available. Kantar[2] found that of DQ users who had alternatives available, 58% used DQ services for one of the following reasons: to get the number/be connected quickly; the service's convenience; ease of use; and to make sure they had the correct number.[3] 42% of users believed a DQ service was the only way they could get the number - although with DQ call volumes continuing to fall rapidly and 98% of the population already not using these services, these users may have simply been indicating that alternatives for them were significantly less convenient.

14. The vast majority of users are satisfied with the service: "Our consumer research found that seven in ten DQ users said that they were satisfied with their last experience of calling a DQ service".[4] Only 15% of respondents indicated that they were dissatisfied.[5]

15. The in-depth interviews presented in the Kantar Report indicate that the users who are satisfied with the service recognise that it is a good service that comes at a price: "*Very satisfied, they always get the numbers and can provide an address if I need it. It's a necessary evil, its expensive, but it's good, the people are quite helpful and pleasant*"; "*She claims she will continue as she normally does, and will continue to be mindful of the potential charges*"; and "*They gave us a service and that's their charge. They give you the number really quickly. The service they give you is good…it's just very expensive*" (Kantar Report, p.67, 70, 74). 30% of users choose to use the call connect service rather than hanging up and re-dialling the specified number.[6] Consumers are told the cost of using the call connect service before they are put through to the number. This illustrates the value placed on speed and convenience by DQ users.

16. In being a service that is used infrequently but that is valued for speed and convenience, DQ services are similar to other convenience services which also charge a premium such as taxis and corner stores over alternatives. For such purchases, price may be a less important factor for many customers. A peculiar

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2 I understand that TNUK is submitting a separate report to Ofcom, from an expert in consumer survey studies, which raises concerns about the study carried out by Kantar and on which Ofcom is relying. The technical design of consumer surveys are not within my own areas of professional expertise and I therefore will not seek to comment on those matters.

3 The Kantar Report, p.35.

4 The Consultation, para. 3.24.

5 The Kantar Report, page 30.

6 The Consultation, para. 3.20.

feature of DQ services is that speed of use also requires that customers can readily remember the number to call. Since entering the UK, TNUK has incurred substantial marketing expenditure to build customer awareness and recollection of its main 118 118 number. TNUK has spent £[✂] on brand advertising, wages and fixed/operational expenses since entering the UK.[7] UK consumers benefit from this expenditure in being able to quickly remember and reach a DQ service. In the absence of marketing expenditure to build number recollection, consumers would not know which number to call for DQ services despite 82% of DQ users saying it was "important" that they received the number at the time they requested it[8] and many believing they did not have alternatives available or at least readily available depending on how the survey result is interpreted.

17. Since the ending of BT's monopoly on DQ services, competition has led to significant improvements in quality of service and greater product choice for customers..[9] As found by Kantar, customers value DQ services for a variety of reasons including speed, convenience and accuracy. TNUK's ongoing investments in improved systems and quality has led to TNUK's average speed of answer and call number accuracy continuing to improve over time with call accuracy [✂]% in 2017.

[✂].

18. TNUK has also introduced a range of new product features over time including provision of call completion, number by SMS, international directory enquiries (IDQ), train/cinema times, phonetic spelling of data listings, partial address searches, category searches, 'no quibble' refunds, per call price caps.[10] In 2015, TNUK introduced IDQ with no additional cost on the same number as national directory enquiries – a contrast with BT's service. In 2015, TNUK also introduced an innovative DQ voice app with unlimited calling at a monthly subscription fee of £2.48 per month. Investments in a proprietary database of listings managed by an in-house team at TNUK as well as multiple third party data sources have also led to [✂].[11]

19. More generally, there is a significant variety in the service offers and prices across DQ providers (see Table 1). A number of services are available for significantly less than Ofcom's proposed cap.

7 Information provided by TNUK to CEG.
8 Kantar Report, p. 12.
9 [✂]
10 Information provided by TNUK.
11 Information provided by TNUK.

Table 1: Comparison of service offerings, by DQ provider

DQ Code/ Provider	Service charge	IDQ	Cinema / Train info	CC/ SMS	No. of searches per call	Voluntary call cap	Return to call centre	Pricing announce-ment
118118/TNUK	£4.49/call+£ 4.49/min (min 60)	YES	YES	YES	Unlimited	YES	YES	Automated
118500 / BT	77p/call + £1.55/min (per sec)	NO	NO	YES	Unlimited	YES##	YES	Verbal
118212 /Maureen	£4.49/call+£ 4.49/min (min 60)	NO	NO	YES	2 per call	Unknown	YES	Verbal
118247 / Yell	£2.75/call+£ 2.75/min (min 60)	NO	NO	YES	Unlimited	NO	YES**	Automated
118402 /O2	£1.50/min (per min)	NO	NO	YES	2 per call	Unknown	YES	Verbal
118111 /TalkTalk	77p/call + £1.55/min (per sec)	NO	NO	YES	Unlimited	NO	YES**	Automated
118018 / Telecom 2	£2/call + £2/min	YES^	NO	YES#	1 per call	Unknown	NO	Automated
118180 /Virgin	£1.50/min*	NO	NO	YES	2 per call	Unknown	YES	Verbal
118707 /BT	£1.45/call	NO	NO	NO	1 per call	NO	NO	N/A
118811 / TNUK	£1/call	NO	NO	NO	1 per call	NO	NO	N/A
08001183733 / TNUK	Free	NO	NO	NO	1 per call	NO	NO	N/A

*Source and notes: Information provided by TNUK. IDS: International Directory Services, *10 free calls for Virgin customers, **For 'number unobtainable' requests only, ^ Can find the number but not able to connect to number, # Telecom 2 does not offer SMS, ## Cap only applies on BT landlines.*

20. While there are services offered today that are below Ofcom's proposed cap, the Consultation raises concerns with price rises for popular services over recent years albeit without any analysis of what is driving these price rises. DQ call volumes have been declining rapidly and this decline shows no sign of abating.[12] The fact that 98% of the population do not use DQ services reflects the ready and increasing availability of alternatives which can be accessed for free or at relatively little cost. 85% of UK adults use a smartphone and this is expected to rise to 90% by 2020.[13] Nine in ten people have access to the internet in their home and 96% of adults have mobile phones where they store important numbers for ease of calling.[14] BT distributes phone books for free.

21. While some services have increased prices, price rises have not been sufficient to maintain the viability of many providers in the face of declining volumes. The

12 The Consultation, para 1.10.

13 Deloitte, Global mobile consumer survey 2017, p. 3.

14 Ofcom, Communications Market 2018, p. 6 and p.11.

PSA has reported the exit of providers over the past several years.[15] Many of the remaining retail providers rely on wholesale services provided by the larger players such as TNUK. This reflects that in the face of declining industry volumes, the costs of maintaining the systems and trained call centre staff are no longer viable for smaller DQ providers. [✂]. As set out in Table 1, in addition to its main 118 118 number, TNUK offers a 118811 service for £1 per call and a free, advertising-supported service. [✂].[16]

22. Finally, as noted in the Consultation (para. 3.47-3.48), some providers such as TNUK already offer a range of customer protection measures including caps on total call charges and compensation systems for customers who have issues with their charges.

15 For example, the PSA's Annual Market Review 2016-17 (p. 32) notes that "a number of DQ services closed during FY16-17" and their Market Review 2015-16 (p.40) notes that DQ services have consolidated.

16 Information provided by TNUK.

2 A framework for considering regulatory intervention

23. Ofcom states:

> *The benefits for citizens and consumers are potentially largest where markets are open, new entrants can compete against incumbents, investment is encouraged and innovation flourishes. For this reason, we are committed to promoting open and competitive markets.*[17]

24. Compared with a monopoly, competition creates pressure to align prices with costs (economists refer to this as a static or allocative gain in efficiency). However, of greater importance are dynamic efficiency gains from competition in terms of the incentive for firms to continue to develop new products, improve quality and identify cost-saving innovations over time. As an OECD report notes: "*From a long-run perspective, one can see that gains from competition-enhancing regulatory reform are likely to exceed static gains observed in the short run since firms will continue to innovate in ways they would not have under regulation.*"[18] Ofcom has similarly noted:

> *However, whilst downward pressure on pricing can be achieved by a combination of regulation and arbitrage-based services competition, we concluded that the choice, diversity, and innovation required by consumers in today's much more diverse and fast-moving market could not be achieved in this way. Innovation in particular cannot be imposed on a market as a regulatory requirement.*[19]

25. The benefits of competitive markets imply that regulators should be cautious in intervening particularly to ensure that they do not undermine competition either directly in the market or by making firms more reluctant to enter and invest more generally. Ofcom has also previously set out the importance of undertaking an impact assessment of significant regulatory proposals:

> *The decisions which Ofcom makes can impose significant costs on our stakeholders and it is important for us to think very carefully before adding to the burden of regulation. One of our key regulatory principles is that we have a bias against intervention. This means that a high hurdle must be overcome before we regulate. If intervention is justified, we aim to choose*

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17 Ofcom, *Better policy making,* para. 1.10. July 2005.

18 OECD, *Competition, innovation and productivity growth – a review of theory and evidence,* 2002, para. 3.

19 Ofcom, *Strategic Review of Telecommunications Final Statement*, 2005, para. 3.11.

the least intrusive means of achieving our objectives, recognising the potential for regulation to reduce competition.[20]

26. Ofcom states that its impact assessments will generally:

- *identify the impacts of each option on the interests of particular groups of stakeholders;*
- *identify any impacts which each option would have on competition;*
- *identify and, where possible, quantify the costs and benefits flowing from the impacts which each option would have;*
- *assess the key risks associated with each option.*[21]

27. The European regulatory framework for electronic communications was intended to provide a clear and predictable framework by which market participants could make investment decisions with limited uncertainty in relation to when regulation may be imposed and the form of such regulation. Under the framework, the European Commission identifies a limited number of markets susceptible to regulation, national regulators assess the competitiveness of those markets and only where a firm is found to have significant market power may that firm then be subject to regulatory obligations from a list of potential obligations that are proportionate in relation to the nature of the problem identified. As the Framework Directive states: "*it is essential that ex-ante regulatory obligations only be imposed where there is no effective and sustainable competition, i.e. in markets where there are one or more undertakings with significant market power*".[22]

28. The European Regulators Group (ERG) notes that proportionality requires that "measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question, it being understood that when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued." [23]

29. The remedies in the Access Directive have been described as an 'ascending list of remedies[24] with the price control remedy being the most interventionist. The

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20 Ofcom, *Better policy making,* para. 1.1.

21 Ofcom, *Better policy making,* para. 2.1.

22 EC Framework Directive, recital 27.

23 ERG, *Revised ERG Common Position on the approach to Appropriate remedies in the ECNS regulatory framework*, Final Version, 2006, p. 55-56.

24 Streel, *Remedies in the European Electronic Communications Sector*, p. 32. (Published in D. Geradine (ed.), Remedies in Network Industries: EC Competition Law vs. Sector-Specific Regulation, Intersentia, 2004, p.32.

potential remedies include transparency, non-discrimination, accounting separation, access obligations and, finally, price control and cost accounting obligations. The ERG notes "*NRAs should also be aware that the obligation to grant access at a cost-oriented price is probably the most intrusive measure an NRA can impose within the new regulatory framework*" and "*The key problem with this obligation would appear to be identifying a price control level which facilitates services competition without reinforcing network market power and the distortions which can result from setting charges too low or too high.*"[25] The ERG also notes that "'*Regulatory controls on retail services can only be imposed where relevant wholesale or related measures would fail to achieve the objective of ensuring effective competition.*"[26]

30. Streel comments on cost oriented price controls:

> *…this last variation of price control is very intrusive, it should only be used with extreme parsimony and be confined to costs close to the existence of an essential facility. That may be the case for the different types of access to the fixed local network (call termination, unbundling of the local loop, bitstream) provided that one operator enjoys a monopoly or position of super-dominance in the relevant geographical area. On the other hand, when there is network duplication like in the mobile industry, non-discrimination or other forms of price control may be preferable.*[27]

31. The design of the European framework recognises the significant risks of price regulation. Regulation that prevents multiple competitors from remaining viable would both reduce product variety available to customers and lose the significant dynamic efficiency benefits of competition. While a price control may be sufficient to support the delivery of a service at one quality level, it may not be sufficient to support higher quality of service. A regulator that develops a reputation of making heavy-handed interventions even in relation to relatively minor problems risks deterring investment in the sector more generally.

32. Price controls fundamentally change competitive market dynamics by reducing firms' flexibility in developing product offers to enable a reasonable return on their current and past investments. In recognition of the risks to quality of service, product choice, investment and competitive dynamics, price controls are typically used sparingly by regulators in order to address identified competition problems. Applying price controls in the absence of a finding of a significant competition problem is highly unusual. Where there is not a problem of enduring

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25 ERG (2006) *Revised ERG Common Position on the approach to Appropriate remedies in the ECNS regulatory framework*, Final Version, ERG (06) 33, p. 79.

26 Ibid, p.48.

27 Streel, *Remedies in the European Electronic Communications Sector*, p. 35. (Published in D. Geradine (ed.), Remedies in Network Industries: EC Competition Law vs. Sector-Specific Regulation, Intersentia, 2004, p.35.

significant market power, any benefits of price regulation are likely to be too limited to justify its costs and risks. I discuss the specific risks of Ofcom's proposal in Section 4.

33. It is the case that inefficiencies may result even in markets with many competing providers because of customers having insufficient information. Consumer protection laws and regulations prohibit unfair trading and misleading conduct. Sector regulators often make available significant information such as that provided by Ofcom on choosing the best telecoms provider, broadband and mobile quality and coverage information and list of price comparison sites. Such measures target the information problem and avoid the significant risks of price regulation.

3 Ofcom's analysis of consumer harm has serious flaws

34. In the Consultation document, Ofcom notes that the prices of DQ services have increased significantly since 2013 and consumer price awareness is low. Ofcom considers that this results in the following consumer harm:

    - 'Bill shock', i.e. receiving a bill for a DQ call that is higher than expected;
    - Affordability issues;
    - Bad debt, and;
    - Incentives for fraud and misuse.[28]

35. I discuss Ofcom's analysis and the evidence of each in this Section.

3.1 Consumer harm as a result of 'Bill Shock'

36. Ofcom defines a bill shock as paying a higher cost for a call than expected and considers it as consumer harm, although it does not fully explain the mechanisms by which the harm arises. Paying more than expected may surprise consumers but calling each such instance a 'bill shock' is likely to overstate the actual extent to which customers' welfare has been harmed.

37. The discrepancy between answers to similar questions in the Kantar survey suggest that Ofcom's definition of bill shock does not provide a reliable basis on which to infer material consumer harm. When respondents were asked (Question 1a) whether in the preceding 12 months they had spent more than they had expected for any telecoms service, only 10% of these DQ users indicated DQ services as being one of these services. Ofcom states: "*The results showed that while DQ is not one of the most likely causes of bill shock in the telecoms sector as a whole, one in ten DQ users recalled bill shock from calling a DQ service at this question*" (3.39).

38. Using responses from Question 17 and 18b, Kantar media reports that 39% of DQ users suffered a 'bill shock' in terms of paying more for at least one DQ call in the 12 months prior to interview.[29] The Kantar report (p.14) discounts the answer to the first question (i.e. that 10% of users that experienced prices higher than expected for DQ services) as only capturing particularly memorable 'bill shock' experiences or people who had not had other more significant 'bill shocks' (although the question enabled respondents to provide multiple prompted or

[28] See Consultation, e.g. paragraphs 1.12-1.13, 3.6, 3.70.

[29] Kantar Media (2018), Directory Enquiries Services MCMR/180 Technical Report, p. 13.

unprompted sources of paying more than expected).[30] In my view, the 10% figure is more likely to capture instances of actual shocks, i.e. a surprise with a significant negative effect.

39. The size of the 'bill shocks' is also limited particularly as Kantar's definition includes customers who paid both a little or a lot more than expected. On average, the last call cost £5.44 more than expected.[31] This is modest in comparison with the total telephone bill, and the size of some other telephone charges. Average annual spending on telephone services is £634.40.[32] Even if there are two average 'bill shocks' a year, this would amount to less than 2% of an average annual telephone bill.

40. I note that the PSA adopts a threshold for intervention based on a significant level of consumer harm which the PSA refers to in relation to financial harm as a "high one-off cost" or a "high cumulative cost".[33] This is more restrictive than Ofcom's definition of bill shock and would better capture material consumer harm. The PSA also notes that instances of bill shock, while significant to the consumers concerned, are "low in number".[34]

41. Ofcom has also ignored the possibility that the bill may have been higher than expected because of unexpectedly high call length. The literature on bill shock in the mobile telephony industry has shown that many people underestimate usage.[35] Ofcom finds 33% of bill shock complaints concerned call connect even though the customers are informed of the price at the time and then choose whether or not to proceed.[36] While some customers may not understand the pricing information, others who report an unexpected cost may have underestimated their call duration.

42. More fundamentally, 'bill shock' as defined by Ofcom will capture two situations:

    i. where customers were not aware of the price but would have made the call even knowing the price; and

30 The percentage of DQ users giving another reason is still low (17%) and that includes 5% of respondents who said they had bill shock "yes for another reason" (it would seem strange for a respondent who had suffered bill shock because of DQ calls to have ignored the prompted response of DQ calls as a cause of bill shock and then put "yes for another reason").

31 Consultation, para 3.38, footnote 70.

32 Average weekly spending on telephone services in the UK is £12.20 (Source: Family spending in the UK: financial year ending March 2017, ONS).

33 PSA, *Consultation on new Special conditions for Directory Enquiry Services*, 13 June 2018, p.12.

34 Ibid, p.11.

35 Michael D. Grubb and Matthew Osborne, 2015, Cellular Service Demand: Biased Beliefs, Learning, and Bill Shock, American Economic Review, 105(1): 234–271.

36 Ofcom consultation document, paragraph 3.54.

ii. customers who made calls that they would not have made had they known the price.[37]

43. In the first situation of customers who would have made the call anyway, these customers would not be financially any worse off from a bill shock compared with having known the price before making the call. A consumer who is willing to pay up to £5 for a product and pays £5 for the product is not financially worse off simply because they believed the price would be lower. The evidence Ofcom has gathered suggests that many customers who paid more than they expected would still have been prepared to use the service if they knew the price. Among those customers whose bill was higher than expected, around two thirds were either satisfied or neither satisfied nor dissatisfied with only 32% being dissatisfied.[38] A majority of DQ users expect charges to be expensive but still use the service for the value it provides them: out of those DQ users who did not know how the services were priced, 61% thought that it was expensive, and only 4% thought they would be cheap.[39]

44. In the second case, consumers will be worse off by the extent of the difference between the value of the call to them and the price they paid. Ofcom focuses on the £5.44 difference between the average price paid and customers' average expected price for the service recalled by respondents in the Kantar research (the Consultation, footnote 70). It is reasonable to infer that these customers would have been willing to pay *at least* the price that they expected the service to cost as otherwise they would not have made the call. In fact, demand for a product generally declines gradually with price. Further, as noted above, it is likely that many of the 'bill shock' customers would still have acquired the DQ service had they known its price in advance. For the other customers who would not have called at its actual price, the average difference between the actual price and what

37 A different issue to 'bill shock' is where consumers pay more for a service than they could have paid had they used a different DQ service number. Given that most consumers who use DQ services at all do so infrequently, and given that they are more likely than average consumers to value speed and/or convenience, it would not be surprising if many users of DQ services did not choose to devote time to identifying a lower cost DQ service number and then noting down, or remembering, that number to use when required in the future. But this is likely to be a feature common to many markets involving services bought infrequently and for immediate convenience, and is not generally thought to require regulatory intervention. In any event, since there are already DQ services available at less than Ofcom's price cap (albeit they may differ in terms of service features and quality from more expensive services), any regulatory concern about this issue could be better addressed through increasing awareness of these cheaper services amongst consumers. Consumers who are price-sensitive and use DQ services from time to time would be able to respond effectively to such awareness by choosing a low cost DQ service or TNUK's freephone DQ service.

38 Kantar Report, p. 30.

39 Kantar Report, p. 47.

those customers would have been willing to pay would be £2.72 (i.e. half of the £5.44 difference Ofcom focuses on).[40]

45. While Ofcom could seek further evidence on these questions, if it assumed that half of the 'bill shock' customers would still have made the calls anyway and that for the other customers, the average difference between the price paid and the price they were willing to pay is £2.72 then Ofcom's estimate of the impact of 'bill shock' of £2.4 million would equate to harm of £0.6 million – one quarter of Ofcom's figure.

46. Ofcom also seeks to support its proposed approach by citing complaints about DQ received by Ofcom. However, Ofcom receives very few complaints, around 10 per month, on the volume of 650k calls (1.95 million per quarter). That means that the rate of complaints is negligible (0.002%). Ofcom argues that the complaints it receives are "the tip of an iceberg" and that the potential number of complaints is much larger. However, this claim is not supported by any evidence other than the qualitative "in-depth interviews", which are of a limited value as argued below. The PSA found complaints at 5.6 per 100,000 users and that the average spend per DQ complaint it receives was £53 in 2017 – this level of spend seems to have been affected by incidents of fraud.[41] Bill shock caused by fraud would only be eliminated through measures to stop fraudulent providers.

47. Ofcom also relies on the anecdotal evidence of ten "in-depth interviews" of consumers experiencing a bill shock. Such interviews or complaints can only be a source of hypotheses of possible harm, which then should be tested with respect to wider market evidence. The Kantar researchers themselves state:

> *Given the low sample size of the telephone depth interview, results should be viewed as qualitative only and not be relied on as conclusive and provide directional insight only.*[42]

48. Further, even in this limited role as a source of insights of possible factors explaining customer behaviour, I disagree with Ofcom's view that it suggests users may be disassociating their experience of the service from the cost of the call. In particular, while many interviewees did report experiencing negative emotions when seeing the bill, many of them also admitted that they knew that DQ services were expensive, but decided to use the service because of its benefits.[43] The evidence presented on slide 31 of the Research Report indicates that users who are satisfied with the service recognise that it is a good service that comes at a price e.g. "*It's expensive but it's good*", "*They gave us a service and that's their charge. They give you the number really quickly*" and "*I asked*

40 This assumes a linear demand curve for ease of calculation. The relevant curve for this calculation is the relationship between demand for calling and the willingness to pay a particular price.
41 PSA, *Consultation on new special conditions for directory enquiry services,* June 2018, para. 15-16.
42 Kanter Media (2018) *Directory Enquiries Services*, Technical Report (MCMR/180), June, p. 14.
43 Kantar Research Report, slide 31.

for X and I got X". Most of them were also satisfied afterwards with the quality service they received. This suggests that at least these customers recognise DQ to be a premium service with a premium price attached.

3.2 Other types of harm would also not warrant price regulation

49. In addition to 'bill shock', the Consultation identifies two other types of consumer harm:

    - Consumer harm caused by high prices and uncertainty about the level of charges for DQ services which lead to affordability issues for some users including bad debt; and
    - Consumer harm caused by increased incentives for unscrupulous providers to engage in fraud and misuse on the 118 range.

50. I consider that Ofcom's analysis overstates the magnitude of these issues and ignores alternative remedies that could effectively address the concerns.

3.2.1 Affordability and bad debt

51. Ofcom raises two main concerns in relation to affordability:

    - Some customers do not use the service because of the perceived price;[44] and
    - Some low-income customers use the service and this creates budgeting issues for them.[45]

52. I discuss these issues in turn.

3.2.1.1 Extent of harm from customers being deterred from using DQ services

53. Evidence from Ofcom's survey indicates that of consumers that did not use DQ services, only 1% indicated that their choice was due to DQ services being unaffordable.[46]

54. An additional 9% of these non-DQ users indicated that the reason they did not use DQ services was that they were too expensive.[47] It is not clear the extent to

44 The Consultation, para 3.59.
45 The Consultation, para 3.61.
46 Kantar research report, p. 58.
47 Kantar research report, p. 58.

which this reflects affordability issues. For instance, it could be that the service was perceived as too expensive relative to free or cheaper alternatives.

55. For the sub-group of non-DQ users that did not use DQ services for cost reasons, only 2% indicated that not being able to use the service was a problem for them.[48]

56. This suggests that the percentage of the population for which a lack of affordability is creating a problem for them is between 0.02 and 0.2%.[49] This is a very small percentage of the population and much lower than the proportion of the population who do make DQ calls (2%). The much larger number of DQ users risk being harmed by the impact of the proposed price cap on the availability and quality of DQ services (I discuss these risks in Section 4).

57. It is also necessary to consider the likely extent of harm to this small percentage of non-DQ users who do not make calls to DQ for cost reasons and who said this created a problem for them. First, the fact that 98% of the population do not use DQ services suggests alternatives are readily available. Most of these alternatives are free or relatively cheap including phone books delivered by BT, information on the internet and asking family or friends to obtain the number. Ongoing declines in call volumes suggest remaining users are not locked in to these services but either prefer using the service over alternatives or are slowly taking up internet access. Providers indicated to the PSA that they see the decline in volumes as continuing.[50]

58. Further, in today's market, there are DQ services available at prices even lower than Ofcom's proposed cap. Thus people who need to call DQ services can access them at low prices.

59. The Consultation emphasizes the importance attached to the use of DQ services, e.g. "*four in five DQ users (82%) said it was important they received the number they requested, at the time they requested it*" (para. 3.23). However, while customers may highly value DQ services, they are unlikely to represent an essential service particularly in light of the availability of alternatives that 98% of the population manage to survive with. Earlier Ofcom research found that DQ calls were viewed as 'essential' by only 3% of people.[51] This data is reproduced in

48 Kantar research report, p. 61.

49 This is calculated as 98% of population that has not made a DQ call in the past 12 months multiplied by the between 1% and 10% of non-DQ users who do not make calls for affordability reasons multiplied by the 2% of those customers who said it creates a problem for them. Even if the 1% of customers who said not calling DQ services slightly inconveniences them (Kantar, p.61) were added in, this range would increase only to 0.03% to 0.29%.

50 PSA, *Consultation on new special conditions for directory enquiry services,* June 2018, para. 9.

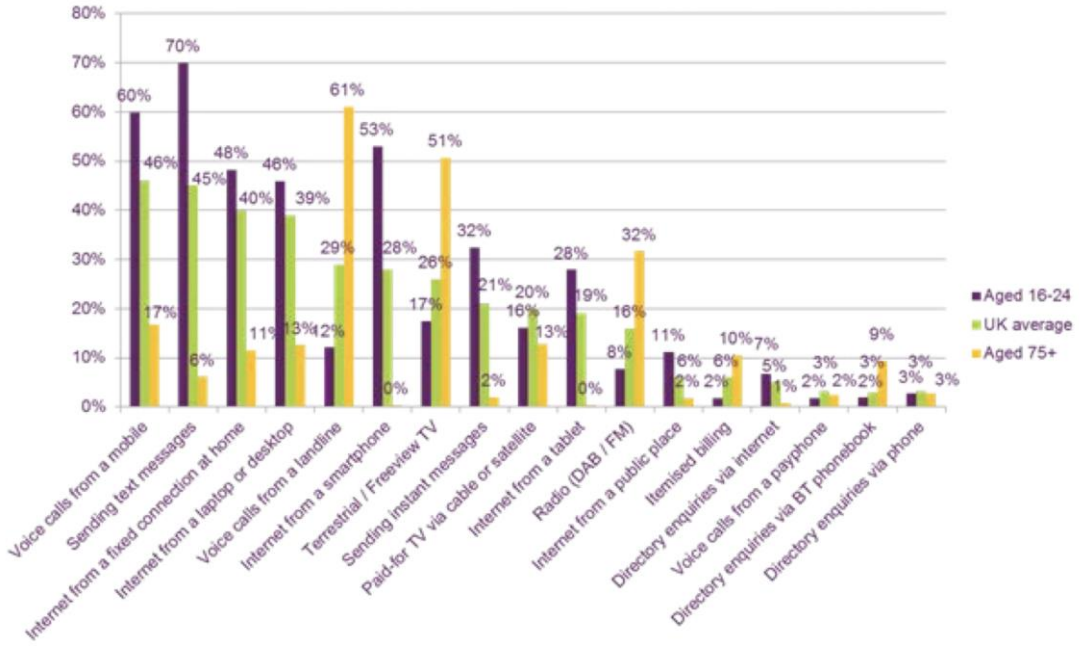
51 The consumer survey also asked what services should be considered 'essential' for society. DQ services by phone were rated 'essential for society' by 7% of survey respondents.

Figure 1. In addition, a large majority of people surveyed (81%) considered DQ services by phone to be 'personally unnecessary' or 'personally nice to have'.[52]

> *Participants said they had multiple alternatives to directory enquiries and the printed directory and saw no obvious benefit to society, except for some of the oldest participants who could see some value to these services in case of an emergency or as a safety net, although they also used these services rarely and kept their important numbers in an address book in any event.*[53]

60. TNUK's own data on the most popular call categories for its 118 services as set out in Figure 4 shows the percentage volume share for the top 15 categories for calls to 118. [✂].

Figure 1: Services and devices seen as personally essential, by age group



Source: Jigsaw, Affordability of Communication Services Essential for Participation, July 2014. *[✂].*

61. [✂].

[✂]

[52] DQ services by phone were considered 'unnecessary for society' or 'nice to have for society' by 63% of survey respondents.

[53] Ofcom (2014) *Research into consumer views on the importance of communications services and their affordability*, para 4.54, p. 25.

62. Finally, the proposed price cap is only a partly effective remedy to improve use. The Kantar research indicates that many non-DQ users who do not call for cost reasons would still not call with the proposed price cap. When non-DQ users who do not call for cost reasons were asked for their estimate of the cost of a DQ call 'just under one minute', 54% of callers from a fixed phone and 43% of callers from a mobile phone estimated the cost at less than £1.99.[54] If the proposed price cap applied then the actual cost per minute would be £2.06. Thus the proposed price cap would still leave around 50% of non-DQ users deterred from using the service.[55] Moreover, DQ services already exist that are priced below Ofcom's price cap including an advertising supported free service offered by TNUK. [✂]. Greater knowledge of these free and low cost DQ services would support more non-DQ users in using the service than Ofcom's price cap. In addition, Ofcom's price cap will not lead to these consumers using DQ services without being made aware of the cheaper prices. Given that publicity is needed in any event, Ofcom should focus on measures to publicise the existing cheaper DQ services and thereby improve use for a greater share of non-DQ users.

3.2.1.2 Extent of harm caused by low income DQ users encountering budgeting issues

63. The second potential affordability issue would arise from low income DQ users for whom call costs cause them budgeting issues. Ofcom estimates the extent of harm by reference to the following evidence:

- 8% of DQ users have faced affordability issues because of DQ services and the impact on these individuals has been severe;
- A 90 second call to some services would equate to approximately 9% of the weekly disposable income of the bottom 10% income group; and
- Consumer bad debt was in excess of 1% of total revenues from 118 calls in 2016/17.

64. I consider each of these findings in turn below.

65. Ofcom refers to the Kantar research to conclude that 8% of DQ users (and 13% of users in the C2DE socio-economic group) have faced affordability issues and "*the impact on these individuals has been severe*" (the Consultation, para. 3.61). However, it is not clear to what extent the actual impacts have been severe for these customers. Of the 8% of DQ users reporting that they have been "affected financially", half (i.e. 4% of users) had said that they had cut back on other expenditure. An economist might view 100% of people purchasing a product as being affected financially by doing so and spending money on any product

54 See Kantar report, p. 59-60. I note that some respondents estimated DQ costs of £0 but still did not call DQ services for cost reasons (2% of respondents for landline and 1% of respondents for mobile).

55 Noting that 59% of calls to DQ services are from fixed phones (Kantar Report, p.19).

implies less income will be available to spend on other products. A further quarter of these users reported the financial effect as borrowing money to pay for the telephone service. Around half of UK households (in each income decile) have financial (non-mortgage) debt.[56] Again, any expenditure by these households would have contributed to them needing to borrow. It is not clear why DQ calls should be singled out or whether the act of borrowing should be regarded as a severe impact. The remaining quarter of these DQ users experiencing 'affordability' issues is split between those who delayed payment of the telephone service and those unable to pay their telephone service. It is only in relation to the latter group, i.e. 1% of DQ users, for whom there appears to be a clear affordability issue. This is not to understate that the cost may have caused a significant problem for these customers or for some of the other customers Ofcom considers to have been affected. However, it is important to understand both the number of customers affected and the extent to which they have been affected and Ofcom's conclusion is not supported by the evidence it has presented in the Consultation.

66. Ofcom does argue that a single 90 second DQ call to some providers would amount to £11.23 which is approximately 9% of the weekly disposable income of the bottom 10% income group (the Consultation, para. 3.60). Given that the majority of users make DQ calls only once or twice a year, annual expenditure on DQ for these users would be less than 0.4% of annual income for the bottom 10% of the income group. Ofcom argues that weekly income is particularly relevant for those on pre-paid plans and those that get paid on a weekly basis (the Consultation, footnote 101). However, Kantar found that 59% of calls to DQ services are from landlines and that 89% of calls to DQ services by people aged 65+ are from landlines. ONS data also shows that only 13.6% of employees get paid on a weekly basis.[57] Thus consistent with the Kantar evidence of reported affordability issues it is likely that only a very small proportion of users are likely to face budgeting issues because of the cost of DQ calls.

67. The very small percentage of customers who are affected needs to be kept in mind in determining how best to target any remedy to address this concern and to avoid undermining the availability and quality of services valued by users more generally (I discuss these risks in Section 4).

68. Ofcom has also found that BT customers' bad debt for DQ calls at somewhat over 1% of total DQ revenues, while declining, was higher than the equivalent data on bad debt for 'geographical calls' and 'all calls' at somewhat less than 1%.[58] It is

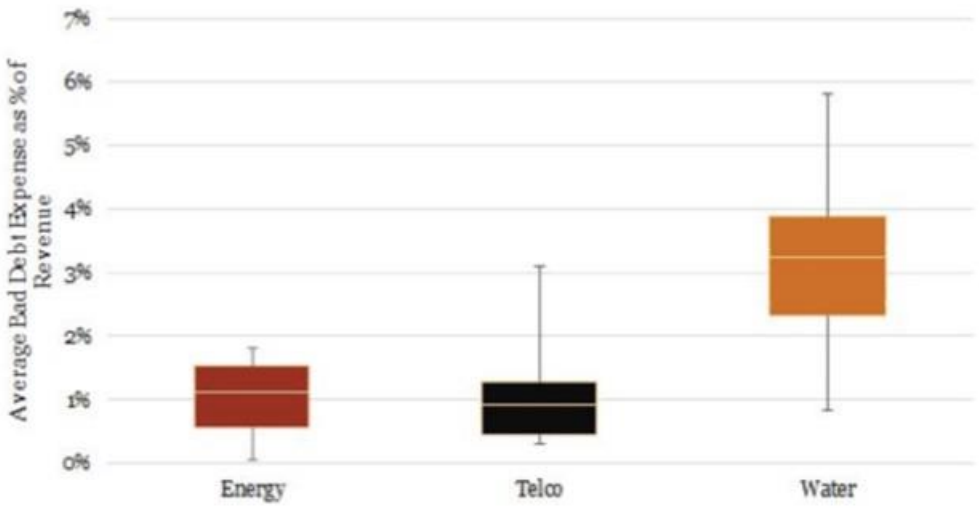
56 ONS, *Percentage of households with debt and median household debt by debt type by net equivalised income deciles, July 2012 to June 2014*, 12 July 2017.

57 ONS, Annual Survey of Hours and Earnings (ASHE) – Proportion of all employee jobs with weekly, fortnightly, four-weekly and monthly pay periods, UK, April 2017.

58 The Consultation, para 3.63.

not surprising that relatively higher priced services (such as DQ services) would have a higher proportion of consumers experiencing bad debt compared with other types of calls. However, the data referenced by Ofcom suggests that consumer bad debt from the use of DQ services is not significantly higher than that which exists for other call types. The level of bad debt for DQ services as reported by Ofcom also appears to be consistent with bad debt for telecoms services generally and less than for water services (see Figure 5).

Figure 2 : Average Bad Debt Charges in the UK as % of Revenue: Water, Energy and Telecoms industry sectors



Source: PwC Retail Services Efficiency benchmarking (2017) p. 28.

3.2.2 Misuse

69. Ofcom also raises a concern that high service charges create an incentive for unscrupulous providers to engage in fraud and misuse.[59] Ofcom has received complaints from callers who have been induced to call a 118 number after misdialling and hearing recorded message saying for example, 'we suggest you hang up and dial 118 xxx'.[60] PSA notes however that "these practices are at present relatively rare".[61] PSA figures show an increase of fraud-related complaints in the period 2015-2017 as compared to 2010-2012, although the number of complaints to PSA seems to have fallen in 2017.[62]

59 The Consultation, para 3.68.
60 The Consultation, para 3.66
61 PSA, *Consultation on new special conditions for directory enquiry services,* June 2018, para. 32.
62 The Consultation, Figure 10.

70. Fraud seems to arise from a few companies: "*Fraud/misuse complaints are reported in respect of a handful of DQ numbers, with some of these numbers linked to the same companies*".[63] As such, it seems that likely that swift action to end the practices of those few rogue providers could fully or largely eliminate fraud.

71. In the adjudications cited by Ofcom, the companies guilty of misuse were ordered to change their practices, pay fines and compensate the customers. Another number, 118 004, was withdrawn and replaced by a much cheaper service after PSA started investigating it.[64] Therefore, instruments to fight fraud and misuse already exist. In addition, PSA has recently proposed introducing new requirements for DQ services to further prevent fraud.[65]

72. Regulating the price of all providers so as to reduce the incentive for fraud seems disproportionate, particularly given that it is arising from a few companies. Where a fraudulent company seeks to charge DQ prices without providing a DQ service, Ofcom's price cap would only reduce the amount of profits they can generate. The market-wide price cap also risks significant costs including to the availability and quality of the services on offer as I discuss in the next Section. Actions by the PSA instead hold the prospect of eliminating the fraudulent practices and to do so without undermining the viability of the vast majority DQ providers that do not engage in fraud.

63 The Consultation, para A5.15.

64 https://www.theguardian.com/money/2017/mar/26/118-directory-enquiry-numbers-cost-more-premium-rate

65 Consultation on new Special conditions for Directory Enquiry Services, PSA review of Directory Enquiry services, 13 June 2018.

4 The proposed remedy is not proportionate

73. Ofcom is required to ensure that any regulation is proportionate, targeted, non-discriminatory and consistent with its duties including to further interests of citizens and consumers including by promoting competition, to secure a wide range of electronic communication services and to have regard to encouraging investment and innovation and the needs of vulnerable customers.[66]

74. In this section, I consider the likely effects of the proposed price cap and whether other options could address Ofcom's concerns at lower cost.

4.1 Price regulation would have limited benefits at best

75. As discussed in the previous Section, the proposed price regulation is being put forward on a highly unusual basis. The Consultation does not find that any provider has Significant Market Power and the discussion of the effects of the proposal does not consider any effects on competition. The only references to competitive effects are in relation to the 2013 policies.

76. As described in Section 1, the current market is delivering significant benefits for users:

- *High customer satisfaction:* seven in ten DQ users said that they were satisfied the service and only 15% indicated that they were dissatisfied. The PSA found that for 63% of users DQ "*was exactly what I was expecting*" and there was no problem for a further 18% or 82% in total.[67] Satisfaction with DQ services was in line with the average found by the PSA for phone paid services and better than other services which raised greater problems such as tarot and astrology services and dating services.[68] High customer satisfaction is likely to reflect that current services are delivering the speed, convenience and accuracy valued by customers.

- *Competition has driven the quality of the DQ services now available* and has led to a wide variety of providers that differ in their service features and prices with a number of services available at prices below that of Ofcom's price cap.

- *Significant measures already exist to protect consumers* including both call cost caps and compensation policies offered by some providers and the powers of the PSA to address fraud.

66 The Consultation, Annex 9.
67 PSA, *Annual Market Review 2016-17*, p. 32.
68 PSA, *Annual Market Review 2016-17*, p. 22-23.

77. In this context, the proposed price cap would have limited benefits at best.

78. The price cap would reduce the prices paid for some DQ services although it would not eliminate 'bill shock' as defined by Ofcom as the difference between the price paid and what customers' expect the price to be. Eliminating 'bill shock' would require greater publication of prices to customers. As discussed in Section 3, the harm attributable to bill shock has also been substantially overstated by Ofcom and might be around £0.6 million – one quarter of Ofcom's figure.

79. Only 1% of DQ users have suffered a clear affordability issue because of the cost of DQ calls (see Section 3). The price cap would reduce the prices in the market that are above the level of the cap. However, there are already DQ services available at prices below Ofcom's cap. Making consumers aware of these cheaper services would better address affordability issues.

80. Between 0.02% and 0.2% of the population do not use DQ services for cost reasons and this creates a problem for them (see Section 3). Ofcom's price cap would not lead to these consumers using the service unless they are aware of the prices available after the cap. However, if price publicity is needed then why not make these consumers aware of the cheaper prices that already exist in the market. These cheaper prices would presumably better support low income customers accessing the services. As noted in Section 3, the Kantar report shows that around half of the consumers who chose not to use DQ calls because of the perceived cost will continue not to make DQ calls under Ofcom's cap. This is because the proposed cap is higher than what they think current prices are.

81. The price cap would reduce but not remove the incentive for fraud. Swift action against the handful of fraudulent companies would have better prospects of eliminating fraud.

82. In a market that is working well for the vast majority of residential and business customers, Ofcom should be careful to ensure that any intervention does not lead to unintended consequences that undermine the current range and quality of services available. The price cap would address issues for a small minority of users and even then the cap would only be partially effective. The small size of any benefits from the proposed price cap suggests that there is a very real risk of intervention resulting in greater overall costs than benefits. I now turn to consider the likely costs and risks of the price cap.

4.2 The Consultation does not properly assess the costs of price regulation

83. The Consultation contains little assessment of the costs and risks of a retail price cap on DQ services. In summary, I believe that the proposed price cap is likely to:

- [✂];
- lead to the loss of cheaper DQ services and reduce competition and quality of service; and
- reduce returns on previous investments and raise perceived regulatory risks to new investment in the sector generally.

4.2.1 [✂] DQ providers

84. In the Consultation, Ofcom considers financial information for BT and TNUK to "*form a view on the impact of the cap on cost recovery for the wider DQ sector*" (para. 4.43) and concludes that the information it has currently does not "*provide a sufficiently robust basis to adjust the proposed level of our cap on the grounds it would threaten cost recovery and thereby outweigh the consumer benefits it is intended to achieve*" (para. 4.47).

85. DQ volumes have been declining significantly for a number of years and this is leading to the exit of DQ providers[69] as revenues fall below the level required to recover providers' fixed and common costs. In particular, while some costs of providing a DQ service will vary with call volumes, other costs would be incurred to provide any DQ service volume. [✂].

86. Ofcom's proposed price cap of £3.10 per 90 seconds (including VAT) would impose a 72% cut to the price received by the TNUK on calls to its flagship 118118 market-leading retail DQ service, with greater and smaller impacts on other providers depending on their current prices.[70] [✂].

87. Ofcom states that it has only considered the impact on BT and TNUK to date. These are the two largest retail providers of DQ services and I understand the two main wholesale providers. Most other retail providers rely on the wholesale services of BT and TNUK to supply their services.

88. [✂].

89. [✂].

[✂].

90. The financial data covers both TNUK's retail and wholesale DQ services. The Consultation makes some comments on TNUK's financial data and wholesale

69 The PSA's *Annual Market Review 2016-17* (p. 32) presents the annual decline in revenues and notes that "*a number of DQ services closed during FY16-17*". The PSA's *Market Review 2015-16* (p.40) notes that DQ services have consolidated.

70 The Consultation, footnote 4 notes the May 2018 price for a 90 second call for TNUK of £11.23 including VAT.

prices although Ofcom did not have available to it at the time a split of costs between costs which are incremental to the DQ business in the UK and costs that are shared with other activities of the company both in the UK and internationally. A business can be expected to continue an activity provided that it generates revenues to cover at least the incremental cost of that activity. A business may also be prepared to price some of its services at a level that covers its incremental costs. [✂].

91. [✂].

92. [✂].

93. [✂]. Dominant wholesale suppliers of services can have the incentive to offer terms and conditions for wholesale access that prevent downstream firms from being effective competitors (or to deny access outright). This is clear from the numerous abuse of dominance cases taken against telecom incumbent operators (such as the European Commission's *Telefonica* and *Deutsche Telekom* margin squeeze cases and its case against *Telekomunikacja Polska* for refusal to grant access to its wholesale broadband products). Regulatory intervention to seek to prevent such harm is often only partly effective and not timely. Ofcom spent over a decade in introducing measures to seek to prevent BT's Openreach favouring BT's own downstream operations.[71] Determining reasonable access prices is a significant undertaking and, as with price regulation generally, carries a significant risk of error. Regulatory solutions are also unable to match effectively competitive wholesale and retail markets in providing customers with a choice of high quality services.

94. [✂]. For example, the European regulatory framework recognises the importance of allowing for cost recovery and competition in imposing price controls. In particular, Article 13 of the Access Directive requires that national regulators "*shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits*".

95. In regulating Openreach, Ofcom states that "when setting charge controls we aim to promote efficient investment by both Openreach and competitors to Openreach whilst allowing Openreach the opportunity to recover efficiently incurred costs" and that:

> *"A LRIC+ approach allows the recovery of Openreach's incremental cost plus an allocation of its common costs on a forward-looking basis. By allowing the recovery of both Openreach's incremental and common costs in the charges for services, we do lose some allocative efficiency, but we*

[71] For example, Ofcom's , *Digital communications review – Initial conclusions*, 2016, stated "*We are concerned that the current model of 'functional separation' has failed sufficiently to remove the incentive and ability to discriminate against competing providers"* (para. 1.39).

preserve Openreach's incentives to invest. Setting prices at this level is also more likely to be consistent with other telecoms providers having incentives to invest in competing networks, which is beneficial for dynamic efficiency."[72]

96. [✂]. In this regard, the proposed price cap for DQ is much harsher than the pricing approach that Ofcom considers reasonable for Openreach.

4.2.2 Effects on service accessibility, quality of service and prices

97. [✂] Ofcom notes "*…consumers use DQ services when they have few alternatives and when finding the number is important to them. Consumers also call the number they can remember…*" and that "*31% of DQ users called the only number they knew*".[73] [✂].

98. [✂].[74]

99. [✂]. These low cost services are likely to be particularly valued by customers who are most price sensitive and/or use DQ services more frequently. The Consultation does not show any evidence that Ofcom has considered the harm of its price cap to these customers.

100. [✂]. Ofcom may believe that this would cause little harm to customers because they assume that the DQ services are "quite similar" (The Consultation, para. 4.52(b)) on the basis of BDRC's Mystery Shopping survey. The BDRC report however states "*The research was not designed in order to test accuracy of numbers provided, or to test more challenging numbers to locate*" (p. 15). In addition to any differences in accuracy or ability to address challenging numbers, there are also differences in features as set out in Table 1 in Section 1. In contrast with Ofcom's view, the PSA found:

A wide range of DQ services currently exist, varying considerably in price, but also in functionality. There may be variation in terms of speed by which a call is answered, or the quality of lookups, or even the number of lookups they are allowed, in addition to price variation.[75]

101. [✂]

102. The proposed price cap would carry a cost to customers to the extent that it leads to the loss of features and quality of service they value either through the exit of providers or through providers reviewing what features and quality remain

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72 Ofcom, *Wholesale Local Access Market Review Statement - Volume 2*, 28 March 2018, para. 2.43 and para. 2.58.

73 The Consultation, para. 1.3 and 3.27.

74 [✂]

75 PSA, *Consultation on new special conditions for directory enquiry services,* June 2018, para. 34.

profitable to offer. Both residential and business customers can be expected to value convenience, speed and accuracy. The Consultation does not properly consider the risks to business customers who account for a significant share of overall DQ users.

103. The economic literature identifies that price regulation adversely impacts on quality of service, particularly if there are not additional measures to maintain quality. For example, Armstrong and Sappington state:

> *Under price cap regulation, the regulated firm bears the full costs of increasing quality, but the price cap constraint prevents the firm from recovering the full value that consumers derive from the increased quality. Therefore, the firm generally will have insufficient incentive to deliver the welfare-maximizing level of service quality.*[76]

104. Providers incur costs to maintain quality of service including in relation to the number and training of call centre staff and the quality of their systems. High quality of service can deliver a return in terms of additional calls being made by both the original customer and potential new customers who may hear about the quality of the service through reviews and word of mouth. Poor quality of service may lead to few subsequent calls. However, the return on expenditure on quality of service depends on not only the number of subsequent calls but the price charged for those calls. A price cap reduces the return on expenditure on quality of service and can be expected to lead providers to reduce that expenditure. This could lead to longer wait-times for calls to be answered and fewer calls successfully finding the required number.

105. Earlier I referred to evidence of the impact of competition in improving the quality of DQ services available in the UK. I also note the finding of the Kantar Report that "*Seven in ten (71%) DQ users said they were satisfied with their last experience of calling 118 DQ services*" (p.12). The accelerated exit of providers would also be expected to weaken incentives to maintain quality of service by weakening the competitive constraint on remaining providers. Ofcom has elsewhere noted that "*A key driver of service quality is competition*."[77]

4.2.3 Other risks to competition

106. Ofcom's earlier consideration of the markets for non-geographic calls identified a number of significant risks to competition from setting price caps:

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76 Armstrong and Sappington, "Recent developments in the Theory of Regulation" in *Handbook of Industrial Organization*, 2007, Volume 3, p.1636-1637.

77 Ofcom, *Digital communications review – Initial conclusions*, 2016, para. 1.34.

> *…[setting maximum prices] would be a highly interventionist approach which could potentially have a negative impact on competition, harming consumers' interests in the long term.*[78]

> *… under the system of maximum prices that we are considering, the actual pattern of retail prices is largely determined by the regulator. Whilst in principle regulation could also lead to an efficient pattern of prices, in practice there is a significant risk of regulatory failure…there is a risk that regulated prices are not set at the correct level and regulation may also be less agile in responding to changing circumstances.*[79]

> *… there was a very real likelihood that the maximum prices would become the focal points for actual prices to be set (which would mean that actual prices were set by the regulator rather than by competition). We were also concerned that there would be limited potential for phone companies to compete on prices for these services.'*[80]

> *… Ofcom's principal duty in carrying out its functions includes the promotion of competition, where appropriate, and therefore we need to give very careful consideration to any option that could negatively impact competition. We remain of the view that there is a material risk that in setting maximum retail prices for these number ranges we will choose prices that will not benefit consumers in the long term, so as to compensate for the reduced scope for competition.* [81]

107. In light of Ofcom's earlier concerns, Section 4 of the new Consultation which considers the effects of the proposed price cap is remarkable in that it does not include any assessment of the likely impact of the price cap on competition.

108. Ofcom previously recognised that a risk of a price cap is that it becomes a focal point. In some markets, firms may be able to reach and maintain a coordinated position ('tacit collusion') in which they charge prices above competitive levels even without any explicit collusion. As the European Commission has noted:

> *According to the Court of Justice, such tacit collusion is more likely if competitors can easily arrive at a common perception as to how the coordination should work, and, in particular, of the parameters that lend themselves to being a focal point of the proposed coordination.*[82]

78 Ofcom Consultation (2012)- Simplifying Non-geographic Numbers - Detailed proposals on the unbundled tariff and Freephone, Para 9.51.

79 Ibid, para 9.147.

80 Ibid, para 9.126.

81 Ibid, para 9.150

82 European Commission, *Guidelines on market analysis and the assessment of significant market power under the EU regulatory framework for electronic communications networks and services*, para. 67.

109. [✂], there is a heightened risk of a coordinated market outcome in which providers that currently offer lower prices increase their prices to the level of Ofcom's cap. The economics literature shows that such risks can eventuate:

> *…one commonly held conception is that their* [i.e. price ceilings'] *effect on prices can only be negative…The results support the focal point hypothesis. Our model estimates a statistically and economically significant probability of tacit collusion. In the early years of the sample, we estimate that tacit collusion is quite common; a large fraction of issuers match their ceiling even though it is not binding…We also find that tacit collusion is more likely as concentration and issuer-level costs rise, and that tacit collusion is less likely in periods of high demand.*[83]

110. The price cap may also have wider effect on competition in the telecoms sector. Ofcom is proposing the level of the price cap partly based on BT's prices (the Consultation, para. 1.15). Offering the services at this level may be sustainable for BT, at least for the time being, given its scale and scope economies. [✂]. While the price cap would bring a one-off price cut for some DQ users, telecommunications consumers would be worse off in the long run to the extent that competition is weakened with a consequent reduction in ongoing pressure to improve services and maintain competitive costs and prices over time.

111. BT historically priced its service significantly above the proposed cap and Ofcom seems to have chosen the level of the cap partly in response to the new price adopted by BT in the lead-up to the consultation. I note that the economics literature has identified that a firm can have the incentives to seek to influence regulatory outcomes so as to raise the costs of their rivals or otherwise competitively disadvantage them even where there is some direct cost to the firm. For example, a review of the literature notes:

> *There is nothing remarkable in this—having rivals with higher costs, other things being equal, is likely to be beneficial. What is more interesting is that actions that raise rivals' costs will generally increase the instigating dominant firm's own costs. Some kinds of cost-raising strategies can obviously be very cost-effective (i.e., actions that lead to governmental actions that exclude your rivals, or impair their ability to compete with you).*[84]

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83 Knittel, C and V. Stango, "Price ceilings as focal points for tacit collusion: evidence from credit cards", *The American Economic Review*, Vol. 93, No. 5 (Dec 2003), pp. 1703-1704.

84 Scheffman and Higgins, "*Twenty Years of Raising Rivals' Costs: History, Assessment, and Future*", 12 George Mason Law Review, No.2, 2003, p. 375-376.

4.2.4 Ofcom's approach raises regulatory risk

112. In considering how to regulate Openreach, Ofcom states "Dynamic efficiency is promoted by a consistent and stable regulatory framework over time, which is more likely to be favourable to investment by both Openreach and other telecoms providers."[85]

113. Ofcom's proposed price cap for DQ calls does not reflect a consistent and stable regulatory framework. The DQ market was liberalised in 2002 with new providers such as TNUK entering. The supply of non-geographic calls was reviewed over 2010 to 2013 with Ofcom deciding against setting maximum prices for DQ calls because it would:

> *…come with a number of significant drawbacks. In particular, setting maximum prices for all non-geographic number ranges would be a relatively interventionist approach which increases the risk of regulatory failure, relative to other approaches that achieve the same objective. There is a risk of prices not reflecting the preferences of consumers and reducing flexibility to respond to competition and innovation in the market. The regulatory burden associated with this approach would also be substantial, as it would not address the issues at the wholesale level, which is likely to lead to ongoing disputes and significant costs and uncertainty for stakeholders.*[86]

114. Providers such as TNUK have invested substantial amounts to build their business in the UK. As noted earlier, TNUK has spent £[✂] on brand advertising, wages and fixed/operational expenses since entering the UK.[87] Ofcom is now proposing to upend the regulatory framework for DQ calls with little consideration to date of the likely impact on competitors in the market. Ofcom is also proposing the sharp reduction in prices for providers such as TNUK be implemented with only a 4 month period following its final statement. This will curtail the return that TNUK receives on its earlier investment. While TNUK was successful in building a large customer base, there were significant risks to its entry particularly to compete against the incumbent leading position of BT. Consumers benefit from TNUK's marketing expenditure in being able to quickly remember and reach a DQ service.

115. The proposed price cap regulation is to be imposed on all DQ providers without any having been found to have Significant Market Power (SMP). In this regard, the proposal is at odds with a core principle of the European regulatory framework that "*It is essential that ex ante regulatory obligations should only*

85 Ofcom, *Wholesale Local Access Market Review Statement - Volume 2*, 28 March 2018, para. 2.47.
86 Ofcom, *Simplifying non-geographic numbers - Policy position on the introduction of the unbundled tariff and changes to 080 and 116 ranges*, 2013, para. 8.14.
87 Information from TNUK.

be imposed where there is not effective competition, i.e. in markets where there are one or more undertakings with significant market power, and where national and Community competition law remedies are not sufficient to address the problem."[88]

116. If this proposal is implemented, potential investors in the UK's electronic communications sector should take into account the risk that, after investing, Ofcom may with little notice intervene to impose a large reduction in price without any finding of market power and on the basis of limited evidence of harm to a small group of customers. The proposal also follows other examples of regulatory measures that reflect the departure from the SMP-based threshold for economic regulation established by the Framework Directive. For example, regulation of retail prices for roaming services and net neutrality rules are also imposed on all providers regardless of whether they hold SMP, albeit that both measures introduced at the European level were subject to significant consultation and review and neither has significant risks of forcing market exit.

117. A high and established threshold for significant regulatory interventions is necessary to reduce the perceived risk of arbitrary regulatory action that would deter investment. A leading paper on regulatory commitment by Levy and Spiller notes:

> *We argue that the credibility and effectiveness of a regulatory framework and hence its ability to facilitate private investment-varies with a country's political and social institutions. Further, we argue that performance can be satisfactory with a wide range of regulatory procedures, as long as three complementary mechanisms restraining arbitrary administrative action are all in place: (a) substantive restraints on the discretion of the regulator, (b) formal or informal constraints on changing the regulatory system, and (c) institutions that enforce the above formal-substantive or procedural constraints. Our evidence suggests that regulatory commitment can indeed be developed in what appear to be problematic environments, that without such commitment long-term investment will not take place, that achieving such commitment may require inflexible regulatory regimes…*
>
> and
>
> *The combination of significant investments in durable, specific assets with the high level of politicization of utilities has the following result: utilities are highly vulnerable to administrative expropriation of their vast quasi-rents. Administrative expropriation may take several forms. Although the easiest form of administrative expropriation is the setting of prices below*

88 Framework Directive, 2002, recital 27.

> *long-run average costs, it may also take the form of specific requirements concerning investments, equipment purchases, or labour contract conditions that extract the company's quasi-rents. Where the threat of administrative expropriation is great, private investors will limit their exposure.*[89]

118. Market-wide price regulation below the cost of service provision for a major provider risks being seen as a concerning new precedent for investors. This is even more concerning as it is being put forward on the basis of evidence of relatively limited consumer harm in terms of some consumers paying more than they expected and of a very small percentage of consumers experiencing affordability issues for a non-essential service. It is likely that similar 'harm' could be found for many products and hence Ofcom may be called upon to address such 'harm' throughout the sector. Even the perception that Ofcom may apply market-wide price regulation in other markets would risk deterring investment from the sector.

4.2.5 Summary on the likely effects of the price cap

119. In section 4.1, I summarised the evidence showing that the proposed price cap would have limited effects at best including in terms of reducing 'bill shock' for the 10% of DQ users who identified DQ services as leading to spending more than expected and in terms of improving affordability for the 8% of users who encountered budgeting issues and the 0.02% to 0.2% of non-users who had a problem in being put off calling DQ for cost reasons. Even for this small share of affected consumers, the actual harm suffered may be relatively mild such as a call somewhat above the expected price or a delay in paying their phone bill. In this section, I noted that the price cap carries a significant risk of:

- [✂];
- reducing quality of service for all DQ users both because the cap would directly reduce the return to investment in quality [✂];
- reducing competition and potentially increasing prices of some cheaper services to the focal point created by the price cap; and
- raising the perceived regulatory risk of investing in the UK telecoms sector more generally.

120. This analysis suggests that there is a significant risk that the cap would generate greater costs than benefits. In the following sections, I consider further specific

89 Levy, B and P. Spiller, "The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Regulation", *Journal of Law, Economics, & Organization*, Vol. 10, No. 2 (Oct., 1994), p.202 and 204.

issues in the design of the proposed cap and alternative regulatory measures that could address Ofcom's concerns at lower cost.

4.3 Issues in the design of the proposed cap

121. In this section, I assess Ofcom's approach to determining the level of the proposed cap and the proposed 4 month implementation period.

4.3.1 The proposed cap level

122. In designing price caps, regulators including Ofcom generally recognise the need to take into account a range of objectives which may need to be carefully balanced. For example, in designing price caps for BT's Openreach, Ofcom stated that it was seeking to promote competition by reference to four key objectives: (1) preserving investment incentives faced by competitors to BT, (2) preserving the investment incentives faced by BT, (3) protecting customers against the risk of high prices and (4) protecting retail competition.[90] Particularly where regulation would impact multiple providers, Ofcom also considers what scale economies to assume. For example, in setting mobile termination charges, Ofcom estimates the costs of an operator with an average market share, consistent with supporting the viability of the current number of mobile operators.[91] Ofcom also recognises the need for operators to recover their common costs through an efficient allocation of these costs across the services they provide.[92]

123. In contrast with Ofcom's standard approach to price regulation, Ofcom has put forward a peculiar approach to determining the level of its proposed price cap on DQ services. The Consultation shows little assessment of the likely effects of different cap levels and how competing objectives could best be balanced. Consideration of costs is limited to an assessment of whether the price level would cover Ofcom's assessment of the incremental costs of BT and TNUK. However, as discussed earlier in this section, [✂] the Consultation does not discuss the extent to which DQ should be allowed to contribute towards the recovery of common costs.

124. The Consultation instead presents three motivations for the proposed price level.

125. First, Ofcom states:

> *As noted, BT (the second largest DQ provider) reduced its DQ charges on 1 June 2018 so that the cost of a call to its 118 500 DQ service now equates to £3.10 for a 90-second call. We welcome this move on the part of BT, which*

90 Ofcom, *Wholesale local access market review statement - Volume 2*, 28 March 2018, para. 2.5.
91 Ofcom, *Mobile call termination market review statement*, 28 March 2018, p.80.
92 Ofcom, *Wholesale local access market review statement - Volume 2*, 28 March 2018, para. 2.60.

is in the interests of consumers. In the interests of pragmatism and with a view to securing, as far as possible, speedy implementation of the price cap in order to reduce the scope for further consumer harm, we are proposing a cap that is consistent with the existing price point that BT has now moved to (para. 1.15).

126. A problem with setting a charge cap to accommodate BT is that the charge level may prevent other providers from recovering their efficient costs. [✂]. Further, there is danger that if BT enjoys scope and scale economies that other providers cannot match, then a price cap that accommodates BT may prevent all DQ providers but BT from remaining in the market. When BT was previously the monopoly provider of DQ services, its quality of service was significantly lower than the quality achieved under competition (as discussed in Section 1).

127. Second, Ofcom notes that its proposed price level is around the average of consumers' expected price for DQ services (the Consultation, para. 4.14). This is certainly one way of reducing differences between actual and expected prices (the other way being to improve customer knowledge of actual prices). However, consumer expectations reveal nothing about the objectives that regulators normally consider in designing regulation particularly identifying the efficient level of prices required to ensure cost recovery and promote competition and investment. Consumer expectations of a price for a product bought infrequently risk being based on inferences using the price of seemingly similar products without regard for significant differences in the cost of provision. Some consumers may also answer surveys strategically or have unrealistic expectations. For example, the Kantar research noted respondents who believed the price should be free: "*Everything should be upfront…but it should be free*" and "*She would like to see a free service provided*" (Kantar Report, p.66, p.68).

128. In addition, Kantar reports that a large share of their results on expected call costs came from customers who were prompted with number ranges rather than customers who gave unprompted costs. Kantar's Technical Report (p.7) states 28% of responses were after prompting compared with 40-42% of respondents who gave unprompted answers. The prompted answers may have been influenced by the way the number ranges were presented in the questionnaire rather than reflecting customers' existing expectations of DQ call costs.

129. Third, Ofcom suggests that setting current DQ prices at levels that existed in 2013 would reduce the consumer harm they have identified. However, setting current prices at 2013 levels adjusted only by inflation and VAT does not provide a sound basis for determining reasonable prices today as Ofcom itself acknowledges *"it is not clear to us that inflation measures such as CPI would be closely associated with the evolution of costs in the DQ sector*" (4.50). [✂]. Further, I understand that Ofcom's assumptions regarding 2013 prices are incorrect. In particular, TNUK has advised that from 1 February 2013 calls to 118 118 were charged at £2.58 for the first minute and £1.79 for subsequent minutes

and that BT landlines were charged on a per minute basis for both 118 118 and 118 500 at the time. This would result in customers paying £4.37 for a 90 second call in February 2013. Similarly, a 90 second call made from a BT landline to 118 500 would have cost £4.60 in Q1 2013. Thus, if Ofcom's reasoning to set prices with reference to their 2013 level is accepted, it would imply a higher cap than what the Consultation proposes.

130. The Consultation also sets out two main arguments against setting a cap for DQ calls at the same level as the existing cap for 09 calls (para. 4.19-4.20). Ofcom's first argument is that the higher cap for 09 calls is needed to support the full range of services available on that range whereas Ofcom regards DQ services as much more homogeneous with little evidence of innovation since the higher charges were in place from 2015. However, as set out in Section 1, there are significant differences in the service features of the different DQ providers and there has been continuing innovation in the market. Further, many customers call TNUK because of the significant investment by TNUK in building the memorability of its number – a feature which significantly benefits consumers who can quickly recall and make DQ calls whereas this might not otherwise be possible for a service used infrequently. [✂].

131. Ofcom's second argument against setting the DQ cap at the level of the 09 cap is that the 09 cap was designed to prevent "demonstrably exploitative pricing" whereas the DQ cap is intended to address other consumer harm regarding consumer price expectations and affordability. I do not find Ofcom's reasoning compelling. Ofcom's stated reason for introducing the 09 cap was: "*We consider that such a cap will have a positive impact on confidence in the market, reduce the potential for fraud and bill shocks for consumers and help Originating Communications Providers ("OCPs") to minimise their risk of bad debt.*"[93] Fraud and bill shock are two of the main reasons now being put forward for the DQ cap. A price cap below current market prices reduces 'bill shock' and the lower the cap the less risk of actual prices for any service being above expected prices.

132. Ofcom also stated in 2012 that "*In relation to 118 numbers, our assessment is that the advantages of caps at the same levels as for 09 also apply*."[94] Ofcom may believe that the current survey evidence of consumer expectations of the price of DQ calls warrants a lower cap now. However, as discussed above, consumer expectations do not provide a sound basis for price regulation and the high share of prompted responses raises doubts over whether the survey was accurately capturing prevailing consumer expectations. I have also not seen

93 Ofcom, *Service charge caps for 09 and 118* services, 25 July 2012, para. 1.11. See also Ofcom, *Simplifying non-geographic numbers – Policy position on the introduction of the unbundled tariff and changes to the 080 and 116 ranges*, 15 April 2013, para. 1.27.

94 Ibid, para. 1.14.

evidence that consumer expectations of the price of DQ calls differ significantly to those for the price of 09 calls.

133. While Ofcom decided in 2013 not to introduce a cap for DQ calls, this was because of the limited evidence of consumer harm including that "*the characteristics valued by consumers of 118 service are speed and convenience and so there are less incentives for long calls or repeat calling patterns.*"[95] The shorter and less frequent nature of DQ calls relative to 09 calls would limit their cost and hence limit bill shock and affordability issues. This would suggest a higher per minute cap for DQ calls relative to the 09 cap.

134. In relation to affordability, it seems Ofcom has two concerns. One is that some low income consumers are making DQ calls and the cost is causing them budgeting issues. Such budgeting issues would presumably also arise from low income people calling 09 numbers and hence I do not see why this would warrant a lower cap for DQ calls than for 09 calls. The other concern is that some customers may be deterred from calling DQ for cost reasons even when the call is important. In 2012, Ofcom did not consider this type of concern relevant to DQ calls: "*loss of access to socially important services, particularly for vulnerable consumers: the focus of our concern under this heading in the April 2012 Consultation was the 084 and 080 number ranges. As discussed below, we do not consider this harm is relevant to 09 and 118 calls*".[96] To ensure that low income people can access socially important services it is generally considered sufficient for there to be available affordable services (e.g. affordable health and transport options). Currently, there are affordable ways to obtain telephone numbers including phone books distributed for free by BT and relatively low cost DQ services. Whole markets are not normally regulated so that costs remain low for any option that a consumer might take.[97] It might be argued that DQ calls are a special case where customers are calling TNUK's flagship 118118 service because that is the only number they know. In which case, Ofcom needs to recognise the expenditure of TNUK on building number memorability [✂].

4.3.2 The proposed 4 month implementation period

135. Ofcom proposes a 4 month implementation period oddly on the basis of "*the rapidly declining sector*" and its view that all that is required is a "*relatively limited number of price points that need updating*".[98] Ofcom seems to view the effect of its proposal as simply requiring a few price points to be updated.

95 Ofcom, *Simplifying non-geographic numbers – Policy position on the introduction of the unbundled tariff and changes to the 080 and 116 ranges*, 15 April 2013, para. 9.94.

96 Ofcom, *Service charge caps for 09 and 118* services, 25 July 2012, para. 4.5

97 In any event the motivation for such regulation would relate to the first concern to avoid budgeting issues which does not provide a basis for a lower cap for DQ than 09 calls.

98 The Consultation, para. 1.17 and 4.36.

However, the proposed cap would impose a 72% reduction in the prices charged by TNUK and higher reductions for some other providers. [✂].

136. The DQ market today exists as a result of Oftel/Ofcom's actions. Under the existing regulatory framework, people made investments in the DQ businesses, the businesses will have entered into contracts such as for offices (which may be for multiple years) and employees will have made decisions such as entering into mortgages based on expectations of their employment continuing for some time. Against this background, it seems reasonable to expect that, if a price cap were to be introduced, it would take effect only after a substantial implementation period. That is especially so in the case of a price cap set at a level that is lower than prices being paid by many service users at present. Such an implementation period would enable investors to continue earning reasonable returns on recent expenditure by the businesses, whilst also enabling both the businesses and employees to make arrangements in anticipation of the likely impacts of the change in regulation. Ofcom's proposal to introduce the price cap with only 4 months' notice serves only to heighten the reasons for doubting that the proportionality of the impacts of the cap have been given due consideration.

137. Ofcom has applied implementation period and glidepaths of 3 years and other lengths in other decisions, although these generally do not involve such large reductions in prices [✂]. Compared with other regulation imposed by Ofcom, the proposed price cap for DQ has substantial risks of market disruption and imposing significant costs on investors and employees. Ofcom would better support future investment in the sector if it demonstrated a commitment to allowing for at least a 3 year implementation period for regulatory interventions that require large changes in prices or in other aspects of business' operations. As Ofcom has recognised: "*Investors value predictable and stable policy interventions: significant and poorly signalled changes of policy can damage investor confidence, and may increase the risk associated with new investments.*"[99]

4.4 Other remedies would better address Ofcom's concerns and carry less risk

138. As set out earlier in Section 4, Ofcom's proposed price cap would reduce the degree of bill shock and affordability issues for the small minority of customers that face such issues, while it carries significant risk of harm to DQ users generally including [✂] reductions in quality of service such as longer call answer times.

99 Ofcom, Strategic Review of Digital Communications discussion document, 2015, para. 10.12.

139. I note first that the PSA is proposing to introduce enhanced measures to target the factors such as fraud that are leading to the high call costs that it has found are associated with complaints - the PSA found that the average spend per DQ complaint was £53 in 2017.[100] In assessing the benefits and costs of alternative options, Ofcom should take into account the extent to which the PSA's measures will address Ofcom's concerns.

140. The proposed price cap does not eliminate bill shock or affordability issues. Bill shock can only be eliminated by customers knowing the actual prices of DQ services. Ofcom could support this through publishing the prices of DQ providers through a comparison table on its website and encouraging news organisations to make this information available as for instance they did in response to Ofcom's earlier media release.[101]

141. Pre-call announcements (PCAs) offer a more direct way to inform customers of the price of a call. The Consultation finds that generic PCAs provide only general information on charges and not the actual service charge while they may lengthen the time before customers obtain the number. The Consultation also finds that a tariff based PCA would provide the actual charge but it may not be understood by some callers and it would extend the length of the call. PCAs seem to offer some benefit and some cost and thus warrant further investigation as to whether they can ameliorate the issues identified by Ofcom without causing the large costs likely to result from a price cap. One form of PCA that the Consultation does not consider is a PCA that informs customers of a voice-based number checker which customers can call to hear the actual charge. This would offer the benefits of alerting customers to premium charges and of providing the option to hear the actual charge while not unduly extending the length of calls for customers who value getting the number quickly.

142. Ofcom could better address affordability issues through helping to publicise the current DQ services that are priced below Ofcom's price cap. TNUK currently offers DQ services below Ofcom's price cap [✂].

143. The Consultation also refers to the compensation policies of TNUK and BT. Requiring such compensation policies to be offered across the sector would also help address budgeting issues for the small group of affected customers. Ofcom argues that "*while TNUK's compensation policies appear generous, consumers may be unaware that they exist or reluctant to contact an SP.*"[102] Given that dealing with customer complaints in the sector is a core responsibility of Ofcom and the PSA, it would seem that Ofcom and the PSA have a role to play in ensuring customers are informed of the available compensation policies.

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100 PSA, *Consultation on new special conditions for directory enquiry services,* June 2018, p.14.

101 See, for example, https://www.bbc.co.uk/news/business-39842723.

102 The Consultation, para. 3.48.

144. As noted in relation to section 3.2.2, misuse seems to be an issue arising from a handful of rogue providers who account for a small share of total calls. There already exist measures to address this problem including fines, compensation and the PSA is bringing in additional measures. These measures can effectively end such practices. In contrast, price regulation only reduces the amount of profits available from misuse and would still leave customers vulnerable to fraud. Price regulation is thus both less effective and carries greater unintended costs than the more targeted measures. It is equivalent to banning the sale of expensive bicycles as a measure to reduce bicycle thief.

5 Concluding comments

145. The market for DQ calls is in decline. Internet access, both at home and on mobile devices, is almost universal, and as a result, consumers increasingly prefer to use online directory searches to find the number they need. BT still distributes a phone books for free. For most DQ users, the market functions well. It provides a valuable service to its users, allowing them to find the number they need quickly, conveniently and accurately. As a result, the substantial majority of DQ users are satisfied with the service. Despite declining volumes, providers have to date been able to provide a high-quality service and invest in innovative services such as directory apps for smartphones or international directory services.

146. Ofcom's proposal to regulate is based on three theories of harm. The first theory of harm is that because of a low awareness of DQ prices, some consumers experience a "bill shock", i.e. pay more than expected for a call. 10% of DQ users identified DQ calls as causing bill shock and the difference between the expected and actually paid price, is modest accounting on average for less than 2% of their annual telephone bill. However, many of these users are likely to have made the call had they known the price. A lack of price awareness only causes financial harm to a customer if they make calls they otherwise would not have made. Further, the harm is only the difference between the price they paid and the price that they would be willing to pay. Thus the actual number of consumers who can be considered financially harmed by bill shock from DQ calls is small and the extent of the harm is likely to be modest.

147. The second theory of harm is related to affordability and the impact on bad debt. A small proportion of consumers (potentially just 1% of users), especially low-income consumers and heavy users, may experience financial problems due to the bill being larger than expected. An even smaller proportion of consumers do not use the service because they cannot afford it. While this may be a real problem for the affected customers, it does not seem to be a market-wide issue. Most customers know that DQ services are expensive and use it despite the high price because of the value it provides to them. While some customers may not be able to afford the service, there are no indications that access to the DQ calls would be indispensable for a majority of customers. It does not seem appropriate to impose a market-wide price regulation to address problems faced by a small proportion of customers. In other regulated sectors, affordability issues are solved with other instruments, with overall price caps being reserved for suppliers with a significant market power.

148. The third theory of harm is that high DQ charges encourage fraud and misuse. Again, while fraud and misuse are a serious problem, it has resulted from only a few DQ service providers and can be more effectively addressed through other measures.

149. The proposed price cap carries a significant risk of causing greater costs than benefits. [✂]. While the price cap may reduce prices for some customers, it may lead to higher prices for other customers. [✂]. The cap may also act as a focal point with remaining providers pricing up to the level of the cap. The cap also carries significant risks to quality of service.

150. Ofcom seems to have decided on the proposed level of the cap with little regard to the factors that are normally considered by regulators in setting price caps, particularly to ensure efficient cost recovery and promote competition. [✂]. Ofcom's understanding of 2013 prices also appears mistaken.

151. I believe that Ofcom should consider more widely the range of options for addressing its concerns and carefully assess to what extent each would effectively address the concerns as well as what would be their costs. As set out in this report, price regulation carries significant risks of causing harm to DQ residential and business customers generally while it would be only partially effective at remedying the identified concerns affecting a small minority of customers.

Annex – TNUK information on the impact of Ofcom's proposed price cap on its business

[✂]