The review of the market for standalone landline telephone services

Executive Summary

1. This consultation raises some important policy issues that have relevance beyond the specific intervention contemplated. Rather than respond to the questions posed in the consultation, we tackle these issues below and then comment on particular elements of Ofcom's analysis.

The Risk of Contagion

2. In the Digital Communications Review Ofcom appreciates that competition between *different* networks is the best way to encourage investment in high quality, innovative services for consumers. This has prompted a *major shift* in its strategy, namely: to encourage the large-scale deployment of new ultrafast networks, including fibre direct to homes and businesses. We support this objective, although we believe that it has been undermined by Ofcom's proposed regulation of the wholesale input supplied by Openreach for superfast broadband.

3. Ofcom has been explicit that it wants 40% of premises passed by three or more providers of FTTP (or ultrafast broadband). This obviously takes time. In the WLA consultation Ofcom says that *"investment in new fibre networks will take time"*[1] and *"given in particular the time it takes to deploy new networks, …. we therefore do not expect to see competitive fibre investment across a significant proportion of the country in the period of this review".*[2] It also requires significant amounts of risk and capital with payback periods of double-digit years.[3]

4. Ofcom is obviously mindful that the investment period for its 'full fibre' ambition will straddle a number of market review periods (even, presumably, if these extend to every five years). For this reason, Ofcom appears at pains, as far as possible, to reassure[4] investors that regulating the price of BT's wholesale products will not necessarily become a Sisyphean endeavour:

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[1] 1.32
[2] 4.20
[3] In its April 2016 note on BT (Glass Ceiling?) HSBC assumes an incremental capital expenditure for BT's FTTP (i.e., over and above G.Fast) of £500 per premises passed; this equates to approximately £6bn for 40% of premises. See also the heavily redacted paragraph A8.12 in the annexes to the WLA consultation, where it is at least apparent that investment in FTTC had an expected payback period of "double-digit" years
[4] 1.53 and 1.54

> *"Investment decisions being made now are affected by expectations of demand, competition and regulation long into the future. An important part of our approach is to provide, to the extent we can, certainty about the future regulatory framework.*
>
> *We cannot prejudge what actions we will take in the future, as any pricing decisions in future reviews will be made in the light of the circumstances and legal framework applicable at that time. However, in the interests of regulatory certainty and consistency, we think it is useful to set out our initial thinking on the future regulation of broadband."*

5. However, Ofcom will recognise that *this* consultation—proposing the reinstatement of retail price caps—marks a Red Letter Day for telecommunications regulation in the UK, and one that could also weigh on investors' minds. Although the scope of the regulation is limited to a single and declining service (solo voice) and one Communications Provider (BT), current and potential investors will worry about future contagion to other services. This concern may be exacerbated by a) the possibility that Ofcom will gain new powers post Brexit and b) new Government powers to set the 'strategic priorities' of Ofcom (and to determine the outcomes that it expects to see). This latter legislation will also weaken CPs' appeal rights.

6. Investors will also note the parallels with the CMA's Energy Market Investigation. In the latter the CMA found that *"weak customer response [to price changes] gives suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies"*.[5] In a similar vein, Ofcom finds that its "*…research has shown that 71% of consumers who use standalone landline services have never switched providers or considered doing so. We are concerned that these customers are receiving poor value for money given the rising line rental charges which they face*".[6] More generally, "*SFV customers in general are relatively disengaged and unwilling to switch compared to other types of fixed voice customers. CPs other than BT face additional obstacles in that BT customers appear to be particularly loyal and less engaged than non-BT SFV customers."*[7]

7. However, of particular concern might be that Ofcom intends to go further than the CMA (other than for customers on pre-payment meters) by imposing a price cap rather than seeing whether customers can be encouraged to switch suppliers. We comment on Ofcom's 'belt and braces' approach below.

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[5] CMA Energy market investigation Summary Report 24 June 2016 paragraph 160
[6] 2.7
[7] 4.47

8. Put simply, investors will be concerned about a commitment (or time-inconsistency) problem i.e., that the conditions for investing in broadband could worsen after their capital has been committed. David Newbury explains this better:

> *The political demands for….“fair” or non-exploitative prices means that investors must expect that after they have sunk their capital, they will be limited in the prices that they can charge and subject to possibly onerous obligations to supply, to guarantee security, stability, and safety. If these investors are to be induced to invest, they need the reassurance that future prices will be set at a sufficiently remunerative level to justify the investment. Once capital has been sunk, the risk that the balance of advantage will shift toward those arguing for lower and possibly unremunerative prices……What would be needed to persuade investors to sink their money into an asset that cannot be moved and that may not pay for itself for many years? The investors would have to be confident that they had secure title to future returns and that the returns would be sufficiently attractive. Durable investments require the rule of law, and specifically the law of property, which is provided by the State.* [8]

9. Ironically, addressing this problem provides a rationale for the independence of economic regulators; as the UK government put it in 2011[9]:

> “*A solution to this time inconsistency problem is to design regulatory frameworks that prevent unexpected changes to the rules of the game, thus offering a credible commitment to investors. In the UK the statutory framework of independent economic regulation encapsulates a commitment by the UK Government not to intervene other than in clearly specified ways.”*
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> *“Given these features, investors will price any risk of political intervention and demand higher returns for their investment or, in the most extreme cases, might even decline to invest. This is likely to be detrimental to consumers and to the economy in the long-term. Given the scale of the regulatory asset base and of the investments needed, small changes to the cost of capital can have a significant impact on the propensity to invest and on the bills consumers pay.”*

10. If Ofcom wishes its strategic shift to be successful, it is in its own interest to reassure actual and potential investors that the price capping of this retail

[8] David M. Newbury Privatisation, Restructuring, and Regulation. Walras-Pareto Lectures Chapter 2: The Problem of Regulatory Commitment. pp. 28-29.

[9] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

service is an 'isolated incident' that it does not expect to apply to other services. Other than simply stating this, Ofcom could go further and in its final statement it could draw a clear distinction between the energy and broadband markets. For example: the reduction in unit prices over time; the differentiated nature of services provided; the higher levels of engagement (including amongst consumers with lower incomes) etc that characterise the broadband market.

11. We recognise that Ofcom cannot fetter its future discretion, but (as in the WLA consultation) it can indicate how it expects to *think* about an issue. Failure to address the risk of contagion will leave investors to draw their own conclusions.

Other Issues

12. We make two other general comments on the consultation:

- Could Ofcom have sought a more targeted remedy? Some customers are rationally inert; they choose not to switch (even when they could save money) because they: trust their existing provider, can't be bothered to switch, feel safe, or are just satisfied with the service that they are getting because they've never experienced any problems. There are others—the elderly or vulnerable—who may lack the wherewithal to switch, even if they want to. It is this category of customer that Virgin Media has addressed through its Talk Protected tariff.

- Ofcom should avoid a belt and braces approach to regulation; either it believes that remedies to encourage greater switching will be effective or it does not. If it is the former it should desist from implementing a price cap and allow for a period of experimentation and trial. If it is the latter, it should not waste BT's time and money. Having a price cut and a cap will make switching less attractive and probably pointless and so there is no point in assessing other behavioural remedies.

<u>Assessment of Ofcom's Analysis</u>

We set out below our comments on particular elements of Ofcom's analysis.

Market Definition – General Comments

Ofcom provisionally concludes that there is a separate market for standalone fixed voice ("SFV") services in the UK, excluding Hull, which is comprised of voice-only customers and split-purchasers. In Virgin Media's view, this conclusion is not supported by the evidence Ofcom puts forward. That evidence demonstrates that the customer demographic composition, customer motivations and the extent of engagement differ significantly between voice-only customers and split-purchasers[10] of communication services. On any reading of theory or established practice, these facts, and others that we discuss below, dictate the defining separate markets - and that remedies applicable to one would not necessarily be appropriate or even relevant for the other.

Instead, Ofcom too readily groups these disparate customer groups into one market and has proposed the imposition of a highly invasive remedy on an inappropriately broad category of customers. This is not only disproportionate, but gives rise to significant potential for unintended consequences and regulatory risk being introduced to the market for bundled services – a market that Ofcom itself acknowledges is working well.

If Ofcom considers it necessary to impose such intrusive remedies, it should do so in the most targeted and surgical way possible, to avoid the risk of other markets becoming collateral damage or other regulatory failure.

Rationale for Defining a Consolidated SFV Market

The evidence gathered by Ofcom suggests that the two categories of SFV customers exhibit significantly different demographic characteristics across a broad range of measures, purchase different communications services and are measured to have significantly different levels of engagement. It also shows that they are at opposite ends of the spectrum on attitude to the ease of switching and whether or not they are actively looking to switch.

According to established practice and theory, these factors should give rise to separate market definitions, however, Ofcom rejects this evidence on the basis that:

- A price differential remains between dual-play bundles compared to two services purchased on a standalone basis;
- SFV volumes have declined over previous years, but in the most recent quarters the rate of this decline may have slowed. Based on this information Ofcom concludes that, on a forward-looking basis, the remaining split-purchasers are not sufficiently likely to switch to constrain a SSNIP; and
- Voice-only and split-purchasers pay the same price for the service and therefore this does not provide evidence of CPs seeking to price discriminate (which may indicate distinct markets).

Virgin Media has a number of observations regarding Ofcom's reasoning in relation to this assessment.

[10] For the purposes of this response, we do not distinguish between customers that purchase multiple, unbundled, services from the same supplier or customers that purchase separate services from multiple CPs.

(i) CPs' Costs

As we note below, it is conceivable that customers may find it utility enhancing to split-purchase, even if the result is a higher overall price for the combined set of services when compared to an 'equivalent' dual-play bundle. It is also reasonable for a CP to, effectively, charge more for two separate services than for a single bundle of services.

To a significant degree, marketing, account creation and management as well as customer service support costs would be expected to vary with respect to customer volumes and not service volumes. Account setup, engineering visits, billing management and a range of other activities which generate cost are dependent on the marginal customer, not on the marginal service addition. It is likely, therefore, that the costs to the CP(s) of providing two services on a standalone basis, as opposed to in a bundle, are necessarily (and justifiably) higher.

(ii) Switching Between Services

Ofcom suggests that the rate of decline of SFV switching to dual-play has slowed, from 20% in Q4 2015 to 15% in Q3 2016. Ofcom suggests that this indicates that SFV customers do not respond in large numbers to specific bundled dual-play offers. In our view, this conclusion is premature. Ofcom's own analysis shows that between Q1 2013 and Q3 2016, the volume of SFV lines has fallen by more than half.

Furthermore, Figure 2.2 of Ofcom's consultation document shows that approximately 43% of SFV customers fall within the 75+ age group. When considered in the context of SFV demographic information (discussed below), it seems clear that Ofcom's SFV retail market definition could more reasonably be considered as two distinct markets; voice-only and split-purchasers.

This distinction may instead lead to the conclusion that in the context of a trend towards bundled services, split-purchasers have historically been switching from split-purchasing to bundled packages and it is voice-only customers that are not responding. As a growing proportion of Ofcom's amalgamated grouping, over time this group of less engaged customers may generate a drag effect on overall switching statistics.

In para 3.4, Ofcom notes that there is evidence that split customers "are on average younger and of a higher socioeconomic grade than voice-only customers". Ofcom notes that these customers, by definition, have internet access and they are statistically significantly more engaged in the market than voice-only customers.

Evidence provided in the annex to the consultation indicates that Ofcom could draw stronger conclusions than this: Not only are there substantial (or extreme) differences between voice-only and split-purchasers, but there are remarkably few differences between split-purchasers and customers who purchase bundled dual-play services - whether looking at demographics, engagement or attitudes to switching[11].

Beyond noting that the amalgamated market for SFV continues to decline overall, Ofcom's analysis does not provide robust evidence that remaining split-purchasers are unresponsive to price increases. As discussed above, the most recent SFV statistics may simply reflect the fact that voice-only customers increasingly constitute a larger proportion of the combined market. This does not indicate that current split-purchasers are distinct from individuals that previously split-purchased.

(iii) Service and price differentiation

Ofcom suggests that a factor in its conclusion that voice-only and split-purchasing customers are in the same market is that they effectively buy the same service and that CPs do not discriminate or distinguish between these segments of customers. Virgin Media does not agree. Absent Ofcom's proposed intervention, competitors to BT, such as Virgin Media, have in fact taken action to innovate in the market.

Virgin Media's Talk Protected tariff[12] addresses the subset of customers that comprise the majority of the voice-only segment, according to Ofcom's survey research[13].

These customers receive a differentiated service offering, pricing and an ongoing commitment to protect them from future price rises. Ofcom's research notes that this subset of customers is less engaged, less likely to switch and more likely to report high-levels of satisfaction with their existing service and supplier. Talk Protected acknowledges and accommodates these factors to address this low propensity to engage and switch.

Ofcom's approach is not conducive to promoting this type of innovation going forward. Its approach will make it even less attractive for CPs to participate and innovate in this market and therefore further strengthen BT's market power.

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[11] In the annex to this response, we provide a non-exhaustive summary of some relevant findings in Ofcom's analysis to illustrate this comparison.

[12] http://www.virginmedia.com/corporate/media-centre/press-releases/virgin-media-freezes-line-rental-for-elderly-and-disabled-landline-customers.html

[13] In our view it is very unlikely that a customer will be purchasing voice-only from Virgin Media and a broadband service from another CP. Beyond any broadband services quality advantages, which arguably Virgin Media has, a customer would typically be liable for an (additional) line rental charge when purchasing retail broadband from an Openreach-based CP: This would lead to a significant premium for split-purchasing voice-only from Virgin Media and broadband from another CP.

The Rationale for Split Purchasing

Below we discuss why it is entirely feasible that a customer may find it welfare enhancing to pay more for two separate services. We go on to discuss why the (higher) aggregate price charged by the separate CPs providing split-purchasers is also likely to be reasonable. Finally, we note again that Virgin Media has in fact sought to serve these subsets of customers differently through both price and service differentiation.

Ofcom dismisses out of hand, the prospect of customers having an economically justifiable reason for split-purchasing. However, in practice, any effective premium observed from purchasing two separate services may be entirely economically rational for the consumer and justified on the basis of costs for the CP.

Services available from different providers are not identical. In Ofcom's recent Service Quality report and consultation on Automatic Compensation, it expresses concern that customers' purchasing decisions are, in its view, driven too heavily by price, subject to behavioural biases and that CPs should differentiate and compete more based on service quality factors.

If a customer is satisfied with their fixed voice line provider but switches broadband supplier to achieve a better service quality and incurs a premium to do so, this is surely the consumer revealing their preferences correctly, even if it is at a higher price.

As an example, a customer may desire access to Virgin Media's broadband services. From Ofcom's Service Quality report they would observe that in terms of overall speed, customer satisfaction, complaint volumes, time to install and a wide range of other metrics these services may be viewed as distinct from and objectively better than alternatives.

As Ofcom notes, Virgin Media offers broadband-only **[✂]**. If a customer is satisfied with their existing fixed voice supplier, values specific aspects of the service **[✂]** they may opt to purchase our broadband-only service and consequently split-purchase.

We anticipate that Ofcom would welcome this decision. It demonstrates consumer choice and it acts as an incentive on BT (or another CP) to improve its service offering by putting at risk the retail (and in the case of BT, wholesale) revenues of its existing customers.

It is therefore entirely possible that customers may achieve a utility improvement in opting, for example, to purchase a broadband service from Virgin Media and a fixed voice service separately from another CP. In A8.29 Ofcom notes that its estimates of split-purchasers may range between 0.7-1.1 million customers. **[✂]**. While we are unable to determine how many of these customers take a voice-only service from another provider, it seems logical, given that Ofcom's survey research shows younger customers make up a larger share of split-purchasers than other groups and are equally engaged, that customers may be making a conscious, proactive and informed choice to split-purchase – for example if they desire specific aspects of a CP's service offering.

Analysis of Costs

Ofcom notes that it does not consider it to be appropriate to undertake detailed cost modelling in relation to its proposals. Given that Ofcom is proposing one of the most intrusive forms of regulatory intervention in a retail market in which the underlying wholesale service is also subject to remedies, Virgin Media has significant concerns about the robustness of the approach to specifying the proposed remedy.

As currently specified, Ofcom's proposals will undoubtedly have an impact on the broader market for fixed voice and bundled communications services: It is therefore critical that it designs any intervention carefully and in a way that uses the full evidence base available to define the remedy. We recognise that it would not be 'straightforward' to allocate retail costs across the multiple products that BT provides. However, this is precisely the reason why it is necessary to do so.

Encouraging Competition

Ofcom suggests that its analysis of the appropriate pricing level will lead to adequate profitability to enable competition to develop. Setting aside our concern that Ofcom's proposals will further undermine any incentive customers have to switch in response to price changes, its conclusions do not appear to be aligned with the commercial realities of a CP making a decision to invest.

The analysis does not take account of the fact that the economically rational decision for a CP to target this segment of the market (which, even under current pricing levels, many/most do not) would be based on a consideration of the opportunity cost of doing so.

Developing market propositions and targeted marketing strategies for voice-only customers and split purchasers (which from Ofcom's analysis exhibit clearly distinct characteristics across almost every conceivable dimension) would be expensive. Ofcom notes that a significant proportion of voice-only customers are older and the recent trend of split-purchasers is one of high-engagement and switching to bundled services. It is therefore not clear that a rational CP would opt to target entry into this market with the profit margins Ofcom is proposing, particularly when doing so would lead to the deprioritisation of other strategic priorities.

The fact that Ofcom has proposed extensive, and in our view excessive, regulatory intervention at the retail level of this market is certain to curtail any prospect of further entry. It is not market forces that would determine the success or failure of any business case that a CP constructs for entry to this market, instead it is Ofcom's intention to intervene in a way that will suppress returns.

Summary

Voice-only customers, on average, stand out in the market as less engaged, relatively unlikely to switch and more loyal to their longstanding and existing supplier. As a customer segment they are significantly older on average than other segments of the market, they are also potentially less likely to be specific targets for aggressive competition amongst suppliers. While we have principled reservations about the form of regulatory remedies Ofcom proposes, we can understand that a policy response for this sub-set of customers may be required.

However, in no way has Ofcom made the case that the same response is required for split-purchasers. Ofcom acknowledges that it has no evidence that this customer segment is not getting improved value for money over time. Ofcom's research shows this segment is entirely distinct, both behaviourally and demographically, from voice-only customers.

Furthermore, it is not clear that migration from split-purchasing to bundled services has even slowed. The slower decline in overall SFV volumes in recent quarters may simply be indicative of the growing relative proportion of voice-only customers that make up the overall pool of SFV. Furthermore, as noted previously in our response, it is not clear to us that, from a consumer choice perspective, the absence of split-purchasing would be a positive outcome.

As a result of the discussion above we have significant concerns with Ofcom's proposals. Ofcom has brought together two very different segments of the market, which have both fundamentally different characteristics and require a different policy response. Ofcom's proposals undermine the ability for CPs, such as Virgin Media, to differentiate in this market and stymie incentives for CPs to compete and for consumers to switch. **[✂]**.

Annex

Below we provide a short summary of the survey evidence Ofcom presents in the annex to the consultation and the extent to which it demonstrates distinctions between voice-only, split-purchaser and dual-play bundle customers.

Customer demographics

Ofcom's survey evidence (Fig. A8.49-50) appears to show that the profile of split-purchasers is remarkably similar to dual-play bundle customers in terms of age[14], employment status, income and socio-economic grade. As a consequence, from the evidence collected by Ofcom, it is clear that the characteristics of split-purchasers and dual-play customers are closely aligned and both are distinct from voice-only customers.

Customer Engagement

Considering engagement levels (Fig. A8.51), both dual-play bundle and split-purchasers are measured to be equally as likely to be 'inactive' (notably, both measures are lower than that for voice-only customers) and as Ofcom notes, there is no statistical difference in engagement between dual and split-purchasers, whereas there is for voice-only.

Switching Activity

Reviewing switching activity measures (Fig. A8.55-7), again, it is clear that split-purchasers and dual-play bundle customers are closely aligned to one another and voice-only customers are self-reporting very different behaviours.

Looking at switching activity responses in the past 12 months (Fig. A8.55), split-purchasers are close to the overall sample average in terms of some form of engagement in the switching process (16% as compared to 19% reported by all landline respondents). Again, there is a considerable contrast with voice-only customers (5%).

We would also note that split-purchasers reported the highest "actively looking [to switch]" response of all segments. This is counter to Ofcom's suggestion that SFV customers overall are not engaged. This further reinforces the premise that split-purchasers are a distinct segment, which is engaged and is willing and able to switch in the face of increasing prices.

[14] Ofcom notes that split-purchasers are younger than voice-only customers, but Ofcom's survey evidence appears to indicate they are more likely to be younger than dual-play as well.

Reasons for Not Considering Switching

Despite this evidence, Ofcom presents voice-only information responses to represent its entire SFV segment in Fig. A8.59 on “reasons why not interested in changing provider”. Doing so is misleading. It is no surprise that voice-only customers might have a disproportionately high propensity (62%) to report “staying with a trusted provider” as a reason for not switching, when previous results for this subset of SFV customers show that they are relatively more un-engaged and unlikely to have switched: Assigning this viewpoint as also being representative of split-purchasers would be counter to the evidence previously discussed.

Views on Ease of Switching

Fig. A8.60 presents self-reported views on the ease of switching. The split-purchasers segment reported the highest rates of “very easy”, followed by dual-play customers. Voice-only customers were the least likely to report switching was “very easy”.

1% of split-purchase customers identified switching providers as “very difficult”, the lowest propensity of the entire sample, followed by dual-play. Voice-only customers were most likely to suggest it was “very difficult”, ten times more likely than a split-purchaser.

Customer Satisfaction

Fig. A8.62 presents survey responses regarding overall landline satisfaction. Overall, landline customers on average reported 57% “very satisfied”, of which 54% of dual-play and 58% of split-purchasers gave this rating. 74% of voice-only customers self-reported as “very satisfied”. This surely brings into question the extent to which there is a market failure.