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Agenda

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The end of the line: deregulating telephony charges

Ofcom, the UK communications and media regulator, is proposing to remove price controls in all retail fixed telephony markets (access and calls). Ofcom's view is that competitive pressure and consumer switching behaviour, together with wholesale regulation, should be sufficient to keep BT's position of significant market power in check. Is this at last the beginning of BT's freedom to price, or rather a change of focus for regulation?

Sector-specific regulation in UK telecoms was originally envisaged as a transitory instrument, in anticipation of the establishment of effective competition. Indeed, a key objective of these regulatory controls has been the promotion of competition, with the underlying expectation that regulatory intervention would only be necessary until there were conditions that would ensure effective competition. So why did it take 22 years for the regulator to lift the retail price controls on BT,[1] especially when in other sectors (particularly energy) regulatory controls at the retail level were introduced after those of BT, but lifted around four years ago?

Scope for reducing regulation

The rationale behind the EU Electronic Communications Framework Directive is that ex ante regulatory obligations should only be imposed where there is no effective competition—ie, in markets with one (or more) undertaking(s) with significant market power (SMP).[2] When regulators intervene in a market not considered to be subject to effective competition, there is a belief that the intervention will increase consumer welfare. However, regulatory intervention could also hinder the development of competitors rather than promote it. For example, price caps that force down prices of a regulated company might deter other companies from entering the market. Consequently, central to the assessment of the benefits of regulatory intervention is a benchmark for determining the effectiveness of competition.

All EU Member States have to review all the 18 markets defined by the European Commission. The assessment of effective competition in retail fixed telephony markets has been carried out by the majority of Member States. Table 1 summarises some of the remedies identified by a

Table 1 Retail price regulation of European incumbent fixed telephony providers

Country	SMP in access markets?	SMP in call markets?	Price control (access)	Price control (calls)
Austria	✓	✓	✓[1]	✓[1]
Denmark	✓	✓	✓[2]	Withdrawn[3]
France[4]	✓	✓	No	Fixed to mobile calls only
Ireland	✓	✓	✓	✓
Italy	✓	n/a	✓	n/a
Netherlands	✓	✓[5]	✓	✓
Portugal	✓	✓	Residential	Residential (local & national calls)
Spain	✓	✓	✓	Withdrawn[6]
Sweden	✓	No	No	Withdrawn[7]
UK	✓	✓	Withdrawn	Withdrawn

Note: [1] No price cap but cost-oriented tariff obligation and ex ante regulatory approval. [2] Subscription charges cannot exceed the maximum 2003 charges. [3] Only call set-up charges were subject to price regulation prior to the market review. [4] France Telecom should inform the regulator, ARCEP, about tariffs of all access and calls products prior to their entry into force [5] No SMP was found in international call markets. [6] A price cap currently applies to local, national and international calls. [7] Price regulation was lifted in 2004.
Source: European Commission, DG Information Society, Article 7 Procedures; and Ofcom.

selection of EU regulators (and notified to the European Commission) for the retail fixed telephony markets—both access (ie, the provision of connection to a fixed telephony network to end-users) and services (ie, local, national and international calls)—and states whether price controls have been imposed or lifted.[3] The table shows that an increasing number of regulators have found that, in line with Ofcom's recent proposals, there is scope for reducing regulation in retail markets, even in cases where the incumbent operator was found to have significant market power (SMP). This is the case, for example, of Denmark and Spain, where the national regulator considered that price caps would be unnecessary and/or disproportionate for solving the competition problems identified in the relevant markets.[4]

Is wholesale regulation sufficient?

Where wholesale markets are in effect regulated—in the sense that the vertically integrated incumbent regulated company would not be able (or have incentives) to leverage its SMP into the retail markets—would wholesale regulation act as a surrogate for retail regulation? In other words, if an incumbent still has SMP at the retail level—which in itself would not warrant the withdrawal of regulation at this level—could regulation of the underlying wholesale services be relied on as a substitute for regulation of retail services?

The electronic communications Universal Services Directive states that regulatory controls on retail services should be imposed only where relevant wholesale measures would fail to achieve the objective of ensuring competition and protecting the public interest.[5] This would suggest that retail regulation should be imposed only to the extent that wholesale remedies are ineffective.

Wholesale regulation could take different forms, including:

– mandating access to different elements of the incumbent's network (eg, local-loop unbundling, LLU);
– controlling the prices that the incumbent could charge other operators to use parts of its network;
– controlling the charges of wholesale inputs required to provided retail services (eg, interconnection charges);
– requiring a vertically integrated incumbent to provide wholesale products to competing downstream operators on the equivalent basis (in terms of price and non-price features) as its own downstream division (ie, equivalence of access).

The issue would then be to assess whether wholesale remedies would be sufficient to address any anti-competitive concerns in the retail market. A case-by-case analysis would be required. Indeed, there are a number of cases where regulators have concluded that wholesale regulation could not act on its own as a surrogate for retail regulation. These include, for example, the Spanish regulator (CMT), which considered that the development of LLU would not be sufficient to constrain the pricing behaviour of the incumbent operator in the retail access markets, hence the need for price control of retail access.[6] Similarly, the Irish regulator, ComReg, while recognising the potential impact of wholesale line rental (WLR) and carrier pre-selection (CPS) in making retail markets competitive,[7] considered further remedies (including price caps) necessary to prevent the incumbent blocking entry.[8]

Other regulators (eg, in France and Denmark) have considered that the remedies imposed in the wholesale market (ie, including WLR, CPS, LLU, and control of interconnection charges) would be sufficient to address any potential market failure downstream. Ofcom's recent proposals are more in line with this approach.

Ofcom's withdrawal of price controls in retail fixed telephony markets relies on certain types of regulatory intervention—notably regulation of wholesale markets (LLU, network charge controls) and tackling perceived barriers to entry (eg, mandating WLR, CPS, and equivalence of access). These types of intervention share certain characteristics with the regulatory withdrawal adopted by the UK energy regulator, Ofgem, in gas and electricity supply (ie, retail markets) in the late 1990s.

In the footsteps of the energy sector

Addressing perceived barriers to the development of competition in retail markets has been a major theme in the UK energy sector. The electricity sector was privatised in 1990–91, resulting in a number of public electricity supplier (PES) businesses that bundled distribution and retail services (although with separate licences and price controls for distribution and supply). However, by the late 1990s, it was argued that these arrangements were not conducive to the development of competition in the supply market. In particular, it was believed that the PESs could gain an unfair advantage in the supply market as a result of operating both businesses such that the distribution business could grant preferential treatment to its own supply business at the expense of competitor supply businesses.[9]

As a result of the competition problems identified with the structure of the PES, the companies were required to separate the distribution and supply businesses into different companies and licences, which could be commonly owned. These proposals introduced separated management structure, restrictions over the ability to share information, and operational separation. Subsequently, many of the retail businesses were sold to other energy groups.

Market indicators to assess effective competition

1. ***Vertical links*—the extent to which wholesale/upstream regulatory measures have yielded competition in retail markets (eg, WLR influencing access markets, and CPS influencing retail call markets).**
2. ***Customer experiences and switching behaviour*—the extent to which customers have switched, or are aware of switching alternatives and are able to switch.**
3. ***Market shares*—changes in the incumbent's market share over time may indicate that it is facing competitive pressures.**
4. ***Price and non-price offers*—the existence of a range of price offers would tend to suggest that customers were able to benefit from the operation of a competitive market. A range of non-price offers could be an indication of competitive pressure, responsiveness to demand, and innovation.**
5. ***Whether existing price controls are binding*—price controls that are not binding could indicate that existing competitive pressures would be sufficient to ensure that the company cannot profitably increase prices above the competitive level.**
6. ***Entry and exit of suppliers*—the number of competing suppliers and changes in this number can be an indicator of the degree of competition.**
7. ***Barriers to entry*—the greater the anticipated return from entry, compared with all other investments, the more likely it is that entrants will enter the market.**

Similar issues to those addressed in the energy sector were recently considered by Ofcom. During the 2004/05 Strategic Review of Telecommunications, Ofcom identified problems with BT's vertically related structure similar to those identified in the energy sector. In particular, the regulator considered that there were enduring economic bottlenecks in the fixed telephony markets, and that without regulation to ensure equality of access, BT 'would have an incentive to provide [access to parts of its network] on inferior terms compared with the service it provides to its own retail activities, disadvantaging its competitors in the retail market'.[10] Therefore, 'solving the problem of lack of equality access to bottlenecks holds the key to further relaxation of regulation in the sector.' The Strategic Review concluded in the creation of a number of undertakings for BT, which effectively resulted in a managerial, operational, and informational separation, resembling the separation adopted in the electricity sector.[11] In this regard, Ofcom appears to have exceeded the measures of other EU regulators, which relaxed regulation in the retail markets without mandating equivalence of access.

Which indicators?

In assessing the scope for deregulation in a market, the key question is whether, in the absence of regulation, the regulated company could profitably increase the price of a given product.

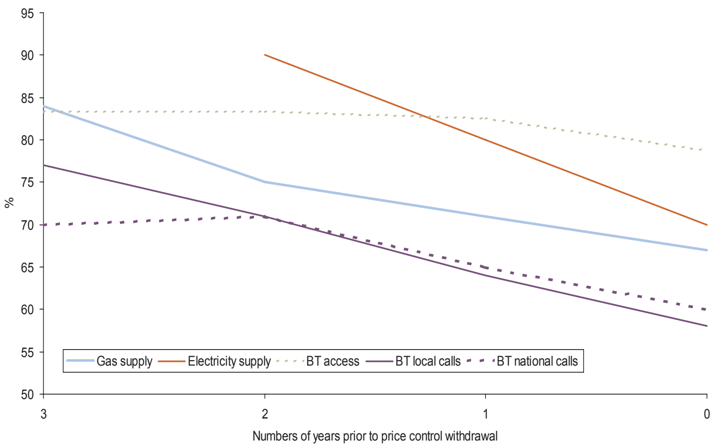
In practice, many regulators in the UK, and more generally in the EU, have focused on indicators of market structure to determine the need for regulatory controls and the scope for a reduction in regulation (see box above).

In the case of the UK, it is interesting to compare some of the indicators considered by Ofcom and Ofgem. A key aspect considered by both regulators is the evolution of the incumbents' market shares. Indeed, while the level of market share for incumbents remained/remains high (relative to that held by the largest player in most markets), these had/have nevertheless fallen significantly during the control period. This is shown is Figure 1, which presents the market shares over the three years prior to the regulator's proposal to withdraw the retail price controls.

Over this period, the incumbent market share fell by an annual average of 7–12% in energy, and by 2–9% in the case of BT.[12]

Another key set of indicators considered by both regulators focused on the role of consumer behaviour in constraining the incumbent's pricing behaviour. Ofcom and Ofgem pointed out the high levels of consumer awareness of alternative providers (ie, over 90% of consumers). In the past, lack of awareness has been

Figure 1 Market shares before price control withdrawal



Note: Market shares for gas correspond to domestic gas supply by customers. For electricity, figures correspond to shares of the ex-PES suppliers 'in area'. BT's market shares are measured by volume.
Source: Ofgem and Ofcom.

Table 2 Market indicators at the time of proposed price control withdrawal

	Gas supply (2001)	Electricity supply (2001)	Retail fixed telephony (2005)
Customer experiences			
Customer awareness (1+ providers)	96%	97%	87%
Ease of switch (% of switchers who found it 'easy')	88%	88%	92%
Switching rates			
% switched (at least once)	37%	38%	39%
Prices			
Evolution of prices	Stable	Nominal increase	Rebalancing of access and calls (call prices reduction)
Prices relative to price cap	n/a	Below cap[1]	Near capped level[2]

Note:[1] In 2000 the majority of supply companies were pricing at the cap, while in 2001 a number of companies were pricing below the cap by up to 2.2%. [2] Price changes were below the cap by 0.22% and 0.19% in 2002 and 2003 respectively, and 0.46% above the cap for 2004, which includes an unused allowance of 0.41% carried forward from the previous year.
Source: Ofgem (2001), 'Review of Domestic Gas and Electricity Competition and Supply Price Regulation: Evidence and Initial Proposals', November; Ofcom (2006), 'Retail Price Controls: Explanatory Statement and Proposals', March; BT (2005), 'BT Group plc Annual Report and Form 20-F'.

considered by Ofcom and its predecessor, Oftel, as an important barrier to switching. Furthermore, both Ofcom and Ofgem found evidence that switching service provider was significant in both sectors. Indeed, very similar levels of switching were evident (see Table 2), as well as a similar switching experience (ie, around 90% of switchers consider switching to be 'easy').

In terms of prices, both regulators found that price competition was developing well, with consumers able to benefit from a range of offers and discounts, and with some incumbent pricing (especially in electricity supply) remaining below the levels allowed by the price cap. Similarly, Ofcom noted that BT's prices for local, national and international calls have been falling at a significant rate over the last three years (on average by between 7% and 24% per year).

Conclusion

Ofcom's final proposals are not expected until the summer. It remains to be seen what approach the regulator will ultimately adopt following the consultation process. The current proposals appear to reflect a change of direction—considered during the Strategic Review of Telecommunications—which aims to avoid regulatory intervention that might be costly for the development of competition in the retail markets.

Ofcom's proposals do not imply that BT would have freedom to set all its prices. Instead, the proposals appear to rely on the notion that wholesale regulation and the reduction of perceived entry barriers could provide the answer to reducing intervention in the retail markets. This view is consistent with the approach adopted by the UK energy regulator when the price controls in the energy supply (retail) markets were lifted in 2002, and also the philosophy underpinning the EU Electronic Communications Framework Directive.

Arguably, regulatory withdrawal could be easier in situations where regulators have implemented effective wholesale regulation, and have addressed perceived entry barriers, as the UK energy and fixed telephony cases might suggest. However, this article shows that an analysis of whether wholesale regulation would be sufficient to constrain the pricing behaviour of the incumbent in the retail markets would need to be undertaken on a case-by-case basis, as demonstrated by the experience of other EU telecoms regulators.

[1] Ofcom (2006), 'Retail Price Controls: Explanatory Statement and Proposals', March 21st.
[2] Directive 2002/21/EC, OJ L 108/33, 24/04/2002, recital 27.
[3] Various other remedies have been considered by EU regulators, including the publication of tariff plans, non-discrimination requirements, cost-oriented tariffs and accounting separation.
[4] See, for example, European Commission, cases DK/2005/0268, DK/2005/0183, ES/2005/0326 to ES/2005/0329.
[5] Directive 2002/22/EC, Universal Service Directive, OJ L 108/511, 24/4/2002, recital 26.
[6] Comisión del Mercado de las Telecomunicaciones (2006), 'Definición de los mercados de acces a la red telefónica pública en una ubicación fija para clientes residenciales y acces a la red telefónica pública en una ubicación fija para clientes no residenciales, el análsis de los mismos, la designación de operadores con poder significativo de mercado y la propuesta de obligaciones específicas'.
[7] WLR allows another telecoms operator to rent a line from the incumbent operator and then provide its own phone line services to customers. It also allows the other operator to differentiate its products from the incumbent and to offer a single bill for rental and call charges. CPS allows customers to rent a fixed line from the incumbent but use a different operator to make calls.
[8] European Commission, Cases IE/2005/158 to IE/2005163.
[9] A number of additional problems were identified. See, for example, Department of Trade and Industry (1998), 'A Fair Deal for Consumers: Public Consultation of the Future of Gas and Electricity Regulation', October.
[10] Ofcom (2004), 'Strategic Review of Telecommunications', Phase 2 Consultation Document, November 18th.
[11] The key BT undertakings include setting up a new and operational separate business unit ('Openreach'), which is responsible for the operation of BT's local access network. Openreach is required to support all providers (including BT Retail) on a precisely equivalent basis. A further requirement is the creation of an Equality of Access Board to monitor BT's compliance with the undertakings. Ofcom (2005), 'Final Statements on the Strategic Review of Telecommunications, and Undertakings In Lieu of a Reference under the Enterprise Act 2002', Statement, September 22nd.
[12] Similar market share changes were observed in other EU fixed telephony markets where price controls were lifted (eg, in Sweden, Telia Sonera's market share in national and international calls fell by between 12% and 15% per year, while in Spain, Telefónica's share in access and national calls fell by around 3% per year).

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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