

# Structure of Royal Mail's control: lessons from BT's price controls

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Royal Mail

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## Executive summary

In its June 2005 document, Postcomm suggested that the structure of the control be changed to two baskets for the third price control period: a basket of ‘captive’ products for those where Postcomm expects competition to be limited, and a basket of ‘non-captive’ products for those where Postcomm expects competitive entry.

This report looks at the regulatory precedent for the application of two baskets in the case of BT. It focuses on the regulatory treatment of BT’s retail tariff rebalancing since the first price control was established in 1984. It also makes reference to the regulation of BT’s network charges, comparing these cases with that of Royal Mail in the postal sector. On the basis of the review of the regulatory precedents in the fixed telephony market, several important observations can be made on the extent of tariff rebalancing before full market opening, and the length of time over which rebalancing took place before separate baskets were imposed.

- BT was able to, and undertook, a significant degree of retail price rebalancing in the period immediately after privatisation and the introduction of regulation, and prior to the opening of the market to competition, which took place after the duopoly review. From an economic standpoint, tariff rebalancing should be completed at the outset of the market liberalisation process, with the purpose of providing appropriate signals to competitors about their likely returns from long-term competition.
- BT was able to, and conducted, retail price rebalancing within a single tariff basket for the period 1984–97 (over 12 years) such that its retail prices were significantly more cost-reflective prior to the emergence of competition, which in most part took place after 1997. Oftel only gradually increased its regulatory control over BT during this period. This is also consistent with the economic theory, which suggests that there are benefits from a gradual rebalancing over time in circumstances where sharp price increases are not feasible.
- BT’s network charges reflected their (accounting) cost of provision at the time that Oftel introduced the different interconnection sub-caps.

These observations may be contrasted with the regulation of the UK postal sector to date, and Postcomm’s approach for the next price control put forward in its Initial Proposals.

- For BT, the maximum increase in prices of local peak calls was 17.3% in real terms (equivalent to around  $RPI - X + 8.5$ ) in the first three years of the first price control. In contrast, Royal Mail’s first price control allowed no rebalancing, while its second price control permitted a maximum of  $RPI - X + 2.5$ .
- Oftel has never applied a two-basket approach to BT’s retail prices. It eventually moved in 1997 to a re-weighted single basket after a period of significant tariff rebalancing. For the regulation of BT’s network charges, separate tariff baskets were introduced only after the respective charges were broadly reflective of their costs of provision. In contrast, Postcomm is proposing to apply two baskets now before prices become more cost-reflective and after only three years of limited price rebalancing.
- Economic literature shows that non-cost-reflective tariffs may be one of the most powerful sources of regulatory-induced problems with competition, by creating undesirable patterns of entry—too much entry in artificially profitable markets, and too little entry in loss-making markets. This link between the need to reduce cross-subsidies and liberalisation was acknowledged by the telecoms regulator.

In conclusion, it is not evident that Postcomm's proposal for the implementation of a two-basket tariff structure is in line with regulatory precedent in the telecoms sector. This precedent suggests that it is important to take into account the interactions between regulation and liberalisation, to avoid exposing Royal Mail to potentially undesirable levels of risk, and also to avoid jeopardising market development.

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# 1 Introduction

In May 2002, Postcomm partially opened the UK postal market to competition from January 1st 2003.<sup>1</sup> Subsequently, in its decision document of February 2005, it proposed to open up the UK postal market fully to competition from January 1st 2006.<sup>2</sup> In addition, for the first two years under regulation to March 2003, Royal Mail's price control consisted of individual price caps, with no price rebalancing. Under the current and second three-year price control, the maximum limit of rebalancing was set at RPI + 1.5% per annum (applied on a cumulative basis) within a single basket.

In its Initial Proposals, Postcomm suggested that the structure of the control be changed to two baskets for the third price control period.<sup>3</sup> As such, it is proposing to separate products into 'captive' and 'non-captive', whereby 'captive' products are those for which Postcomm expects competition to be limited and 'non-captive' products are those for which Postcomm expects competitive entry.

This report looks at the regulatory precedent for the application of two baskets in the case of BT. It focuses on the regulatory treatment of BT's retail tariff rebalancing since the first price control was established in 1984. It also makes reference to the regulation of BT's network charges, comparing these cases with that of Royal Mail in the postal sector.

<sup>1</sup> Postcomm (2002), 'Market Opening Postcomm's Decisions—Summary', May.

<sup>2</sup> Postcomm (2005), 'Full Market Opening on 1 January 2006', February.

<sup>3</sup> Postcomm (2005), '2006 Royal Mail Price and Service Quality Review, Initial Proposals', June 1st.

## 2 The regulation of BT's retail prices

### 2.1 First price control: 1984–89

BT's initial price cap was set at  $RPI - 3\%$  for a period of five years from 1984 to 1989. It covered residential and business line rental, and local and national direct-dialled calls. This control took the form of a single tariff basket that allowed BT relatively wide discretion to rebalance tariffs. BT's licence contained no specific rules about the prices of individual services covered by the price control formula, although it had given an undertaking, outside the licence, that it could not increase domestic line rentals by more than  $RPI + 2\%$  per annum (equivalent to  $RPI - X + 5$ ). This therefore established some limits on rebalancing.<sup>4</sup> Beyond this, the only further constraints on BT were that it could not discriminate call prices along similar routes, or vary rental or connection charges according to the cost of serving any given user. In addition, in the first instance, a number of further products and services were excluded from the tariff basket, including international calls and connection charges.

This regulatory environment, in the face of increasing competition, generated strong incentives for BT to rebalance its tariffs. Specifically, there was an incentive to lower prices on (peak-rate) long-distance calls, and to increase prices on local calls and rental charges (although the latter were limited by the  $RPI + 2\%$  sub-cap, referred to above). BT considered that such moves would eliminate inherited cross-subsidies and ensure cost-reflective pricing. Oftel concurred with BT that the rebalancing, which was similar to that experienced in other countries, was explained by two main factors:

- long-distance calls had been priced above costs in the past and the surplus had partly subsidised local call charges;
- changing technology was bringing down long-distance costs, relative to local costs.<sup>5</sup>

Furthermore, it was anticipated that competition from Mercury would be most extensive in the market for national (peak) calls, particularly for business customers.

Table 2.1 below shows the changes in price for various products over the first three years of BT's regulated prices. This shows that, within the first three years, the price of local peak calls increased by 17.3% in real terms (equivalent to about  $RPI - X + 8.5$ ). This table shows that BT undertook a substantial, and reasonably rapid, rebalancing of its retail tariffs in the years immediately after privatisation and prior to full market opening.

<sup>4</sup> Oftel was not keen to bring the price rebalancing under the control, as this would have required a licence amendment and the Director General did not believe that such an amendment could be justified. Indeed, the Director General stated: 'I would not seek an amendment to the licence in the interest of 'fine-tuning' because I do not believe that such an amendment would be in the interests of efficient regulation'. See Oftel (1986), 'Review of British Telecom's Tariff Changes', November, paragraph 5.

<sup>5</sup> Oftel (1985), op. cit., page 5.

**Table 2.1 Percentage changes in selected real BT prices**

	1984/85	1985/86	1986/87	Cumulative over three years	Greatest absolute annual change
X factor in RPI – X formula	3.0	3.0	3.0	–9.3	–3.0
Local peak calls	1.6	–0.5	16.0	17.3	16.0
Domestic rental charges	1.9	1.4	1.2	4.6	1.9
National peak calls	–18.2	–12.3	–18.0	–41.2	–18.2

Sources: Armstrong, M., Cowan, S., and Vickers, J. (1994), *Regulatory Reform*, MIT Press, and Oxera calculations.

BT’s rebalancing prompted a review by Oftel in 1986 in which the regulator scrutinised the cost models and methods of attribution of joint and common costs used by BT. The Director General approved the rebalancing, as he was ‘satisfied that rebalancing has not been carried beyond the point justified by costs, but there was no need for further substantial rebalancing between local and long-distance call charges.’<sup>6</sup> Furthermore, the regulator appeared to have dismissed some of the distributional concerns of the rebalancing. Indeed, the Director General stated that he could not reasonably object to a reduction in the cross-subsidy between long-distance and local calls, and that ‘telephone pricing would not be an efficient medium for wealth redistribution and would have uncertain and frequently anomalous effects.’ (paragraph 62)

However, the regulator was concerned about the speed with which the price changes were introduced. In particular, the Director General stated:

Nevertheless, I greatly regret the large jump in peak rate local call prices. *Even though the new price is justified as a final target, care is needed to introduce change in easy stages as far as possible* and to inform customers about future prospects, to avoid disruption. BT has told me that it could not adopt a more gentle transition in this case because of technical constraints. [emphasis added]<sup>7</sup>

In the absence of such technical constraints, it would appear that Oftel would have proposed a smoother change in prices than that undertaken by BT.

## 2.2 Second price control: 1989–93

For the second price control period (1989–93), connection charges and operator-assisted calls were added to the single tariff basket, with an overall cap of RPI – 4.5%.

In assessing the need for individual price caps, the Director General acknowledged that a basket formula, unlike individual caps, provides flexibility to change different prices at different rates, and that this ‘is desirable partly because prices today are not completely in line with costs. Significant progress has been made by BT in rebalancing price over the past few years, but exchange line rentals and connection charges appear still to be below costs and to be subsidised out of call charges.’<sup>8</sup>

Although the regulator considered it inappropriate to require the application of the overall price cap to every individual service, he saw the need for individual price caps ‘where prices continue to be too low in relation to costs but some assurance is needed to secure a reasonable transition in pricing, so that customers can plan with confidence that they will not

<sup>6</sup> Oftel (1986), op. cit., paragraph 108.

<sup>7</sup> Oftel (1986), ‘Review of British Telecom’s Tariff Changes’, November.

<sup>8</sup> Oftel (1988), ‘The Control of British Telecom’s Prices’, statement, July.

experience unreasonably sharp changes in prices.<sup>9</sup> Oftel identified that exchange line rental and connection charges were in need of individual price caps. As a result, BT's undertaking not to increase domestic rental charges by more than RPI + 2% (equivalent to RPI – X + 6.5) was extended to business line rentals and connection charges. In addition, BT was required to introduce a low-user scheme (mitigating the impact of the tariff rebalancing on qualifying users). As such, Oftel steadily tightened its regulatory control of BT, restricting its ability to set prices flexibly as the market was opened up to greater competition.

Similarly, in 1990, Oftel introduced a separate price cap of RPI – 0 on private circuits as a response to the demands of large business users to have more stable prices in this segment.

In the context of the 1991 duopoly review, international calls were brought under the control, into the single tariff basket, following a sharp increase in the contribution made by international calls to BT's revenue. In addition, the overall value of X changed to 6.25%. Residential and business single-line rental remained subject to the RPI + 2% cap, but changes in multi-line business line rental charges were subject to RPI + 5%. Furthermore, to capture the overall effects of rebalancing, the regulator decided to monitor the impact of price changes on the typical residential customer—for whom line rental represents a substantial proportion of the bill—by assessing a representative pattern of usage and measuring the increase in the bill for this usage. BT agreed to limit this increase so that it would not exceed RPI.<sup>10</sup>

### 2.3 Third price control: 1993–97

The price control cap for the period 1993–97 comprised a further tightening of the single basket, from RPI – 6.25% to RPI – 7.5%.<sup>11</sup> Within this basket, BT was constrained by regulation in its freedom to set prices through a series of secondary caps, limiting the price increases of individual elements in the basket.<sup>12</sup> These included:

- a continuation of the RPI + 2% (equivalent to RPI – X + 9.5) for residential and single-line business line rentals and RPI + 5% (equivalent to RPI – X + 12.5) for multi-line business line rentals;
- RPI + 0% for all other individual prices.

The basket covered both residential and business customers. The changes to the price represented a strengthening of regulation, compared with the second price control.

### 2.4 Fourth price control: 1997–2001

In the review for the fourth price control (1997–2001), the regulator stated that the price control benefits were enjoyed to a disproportionate extent by profitable customer groups for which BT was facing competition (business and high-spending residential users), as shown in Table 2.2 below.

<sup>9</sup> Oftel (1988), op. cit.

<sup>10</sup> See, for example Oftel (1993), 'BT's July 1993 Price Changes', June 3rd.

<sup>11</sup> The single basket covered line rental; local, national and international direct-dialled calls; operator-assisted calls; and directory enquiry services. In addition, Oftel stipulated that any quantity discounts offered by BT would not count when assessing compliance with the price cap.

<sup>12</sup> In addition, BT flexibility was limited by restrictions on discounts and on geographic tariff deaveraging.

**Table 2.2 Average effective value of X, 1990/91–1995/96**

	Value of X (%)
<b>Official X<sup>1</sup></b>	<b>6.6</b>
All business customers	9.3
All residential customers	4.2
First 80% of customers	2.7
Top 20% high-spending customers	5.7

Note: <sup>1</sup> This value corresponds to an average of X.

Source: Oftel (1996), 'Pricing of Telecommunications Services from 1997', statement, June, Table 5.1.

Oftel considered whether there should be separate caps for business and residential services because of the greater competition to provide services to businesses rather than households.<sup>13</sup> That is, given that business services would be in less need of regulation, if BT were free to determine the balance of prices within an overall price cap, it would choose to favour business customers over residential ones. This would suggest that either business services should be placed in a separate cap, or be removed from the cap altogether.

At the time, the regulator identified two reasons why separate caps for business and residential services would not be appropriate:

- the existence of common costs in the provision of essentially the same services to different categories of user;
- BT's residential users had historically been subsidised by business users, and therefore a move of prices in favour of business customers could be economically justified.

For the fourth price control, Oftel opted for a single price cap—covering the same services, but restricted to the revenues earned by BT from low- to medium-spending residential customers, who have similar spending patterns. To focus the price control on these types of consumer, the cap was applied using only the revenues and calling patterns of the first 80% of residential customers ranked by spend. Given the higher proportion of local calls and line rental in the bills of this customer group, reductions in prices of international and national calls would have less weight in the price cap formula.<sup>14</sup> Oftel considered that, in this way, there was a much smaller risk of the benefit of the price cap accruing disproportionately to high-spending customers because the customer profile was effectively a proxy for a sub-cap.

In addition, the regulator decided to remove the sub-cap of RPI + 2% on line rentals, arguing that it created 'seriously distorting effects' on the regulatory regime. Oftel considered that this sub-cap had 'disturbed the relationship between retail prices and underlying costs'.<sup>15</sup> Furthermore, it judged that it was not necessary to continue with the RPI + 0% secondary cap on individual services. According to the regulator, the original purpose of the secondary caps (sub-caps) was twofold:

- to limit the possibility of BT engaging in volatile pricing to disrupt the market and its competitors;

<sup>13</sup> Oftel (1995), 'Pricing of Telecommunications Services from 1997: Consultative Document on BT Price Controls and Interconnection Charging', December.

<sup>14</sup> Line rental accounted for 49% of the average quarterly spend of low and moderate residential users (first 80%), while for high users it represented 17% of their bill; national calls accounted for 15% of the bill of low/moderate users, compared with 24% of high users; and international calls represented only 3% of the bill of low/moderate users, while it accounted for 23% of the average high-user bill. Source: Oftel (1996), 'Pricing of Telecommunications Services from 1997: Oftel's Proposals for Price Control and Fair Trading', statement, June.

<sup>15</sup> Oftel (1995), 'Effective Competition: Framework for Action. A Statement on the Future of Interconnection, Competition and Related Issues', July.

- to ensure that, to the extent that some controlled services were more competitive than others, BT could not increase the prices of less competitive services and make additional price cuts to the competitive ones.

However, under the new proposals, Oftel assessed that the secondary caps were no longer necessary because:

- attempts to disrupt the market by volatile pricing would be controlled by the Fair Trading condition, which included the introduction of a licence condition on anti-competitive behaviour;
- there was less scope under the new control for focusing prices on national and international calls, which were the more competitive services, given the lower weight in the price cap formula.<sup>16</sup>

Table 2.3 summarises the development of BT's main markets during the fourth control period. As a result of increased competition, BT's overall market shares in local and national calls significantly diminished: from 85% to 71% in the former, and from around 76% to 54% in the latter market. The more profitable market segment of business customers witnessed a relatively more rapid reduction of BT's market share than that of residential customers. At the same time, the market of line rentals (access) was relatively stable, with BT losing only a few percentage points (but again, more intense competition occurred in providing services to business customers).

**Table 2.3 BT's market shares by revenues in 1997/98–2001/02 (%)**

Year	Residential customers			Business customers			Overall market		
	Local calls	National call	Access	Local calls	National call	Access	Local calls	National call	Access
1997/98	86.0	86.5	90.2	84.1	65.5	90.2	85.3	75.8	90.2
1998/99	81.9	84.3	88.2	79.8	60.9	88.7	81.2	72.0	88.4
1999/00	79.1	79.2	88.1	74.0	55.8	86.0	77.4	66.3	87.2
2000/01	75.2	71.5	85.5	68.0	51.5	85.0	72.8	59.8	85.3
2001/02	73.5	64.9	87.5	66.1	46.7	85.4	71.2	53.9	86.6

Sources: Oftel (2003), 'The UK Telecommunications Industry Market Information 2001/02', March, and Oxera calculations.

## 2.5 Fifth price control: 2002–06

During its 2002 price control review, Oftel found that the level of competition in the provision of fixed calls had steadily increased: consumers had a wide range of choice from other suppliers, BT's market share was gradually being eroded, consumers benefited from lower call and access prices, and BT's calls profits had fallen over time.<sup>17</sup> However, the regulator underlined the fact that BT still continued to have strong market position, with the result that lifting regulation at that stage could put consumers at risk. As well as some continued price regulation, the regulator believed that new measures were needed to promote additional competition from different service providers.

<sup>16</sup> Oftel (1996), 'Pricing of Telecommunications Services from 1997: Oftel's Proposals for Price Control and Fair Trading', statement, June.

<sup>17</sup> Oftel (2002), 'Protecting Consumers by Promoting Competition: Oftel's Conclusions', June.

The main element of the new control was to require BT to provide a new wholesale line rental (WLR) product, with the aim of enabling suppliers to provide a single bill covering both line rental and telephone calls.<sup>18</sup> The initial prices for the WLR were set by the regulator.

During the review, Oftel noted that it would be inconsistent with the emergence of increased competition in call markets to assume that BT would continue to make sufficient profits from higher-spending customers to subsidise lower-spending customers. Furthermore, the regulator considered that:

most customers would be better off than they are today if prices for lines and calls properly reflected costs. Thus, rebalancing within a vigorously competitive environment for calls would be to the benefit of most customers, as well as providing a more economically sensible structure of prices.<sup>19</sup>

As for retail prices, Oftel relaxed the control by introducing an RPI – RPI control (previously, it was RPI – 4.5%) applied to the bottom 80% of residential customers by expenditure.<sup>20</sup> This step was believed to allow more flexibility for BT to rebalance its tariffs, although, according to the regulator, it would not give BT an incentive to raise rentals and reduce call prices in the absence of vigorous competition in calls markets.

Oftel considered that full introduction of WLR would lead to a significant increase in competitive pressures on BT; therefore, an RPI – RPI control on the lowest spending 80% could become unduly tight, as the return made by BT on this group of customers is small. To provide further incentives to introduce WLR, the regulator considered that the RPI – RPI control could be reduced to RPI + 0% when a commercially viable WLR had been fully implemented by BT.

In 2003, a new European electronic communications regulatory framework entered into force, requiring regulatory authorities to undertake reviews of competition in communications markets to ensure that regulation remains appropriate in light of changing market conditions. Within this framework, Oftel's review of the fixed telephony market found BT to have significant market power in a number of markets, and BT was required to comply with the RPI – RPI control, set in the 2002 review, until July 2006.<sup>21</sup>

<sup>18</sup> Oftel's review identified that the inability of alternative service providers to provide a single bill for line rental and calls was inhibiting competition.

<sup>19</sup> Oftel (2002), *op. cit.*, paragraph 4.7.

<sup>20</sup> The regulator acknowledged that a RPI – RPI control could be unduly onerous for BT if inflation turned out to be unexpectedly high. Therefore, the control would be limited to RPI – 4% if inflation were greater than 4%.

<sup>21</sup> Oftel (2003), 'Fixed Narrowband Retail Services Markets. Final Explanatory Statement and Notification', November 28th.

## 3 The regulation of BT's network charges

### 3.1 Regulation of BT network access until 1997

Prior to 1997, unlike the retail price controls, BT's network charges were not subject to incentive regulation, but rather to detailed intervention by Oftel. In particular, interconnection charges for the use of BT's network were set every year on an accounting cost basis.

In 1991, Oftel introduced the access deficit contributions (ADCs) to be included in the network charges. The ADCs were aimed to take into account the losses suffered by BT as a result of being unable to raise its line rentals beyond RPI + 2%. However, from the outset, the ADC scheme was not very effective, since Oftel granted most operators a waiver from paying ADCs.<sup>22</sup>

As a result of the removal of the RPI + 2% cap on line rental charges in 1995 (see section 2.4), and concluding that the ADCs would be redundant, Oftel opted to abolish them.<sup>23</sup>

### 3.2 Regulation of BT network access after 1997

For the period 1997–2001, Oftel replaced the annual determination of charges with a network charge cap operating on the same principles as the retail cap. In addition, the charges were based on an economic incremental costs basis, rather than an accounting basis as was the case before the baskets were introduced. The long-run incremental costs (LRICs) were considered to reflect more accurately the basis on which commercial capital-intensive businesses in competitive markets make investment decisions.<sup>24</sup> The objective of this new approach was threefold:

- to provide BT with incentives to improve its efficiency;
- to supply improved investment signals to other operators;
- to reduce detailed regulatory intervention in the wholesale market.<sup>25</sup>

In addition, network services were placed into four categories according to the degree of competitiveness, with a different regulatory treatment for each category:

- **competitive services**—these would not be subject to controls;
- **new services**—these would not be subject to controls, although Oftel retained the power to impose a control if it found that the relevant market was not competitive;
- **prospectively competitive services**—the charges of each of these services would be subject to a safeguard cap of RPI + 0%;
- **non-competitive services**—these would be subject to three charge-control baskets of RPI – 8% (general, call-termination, and interconnect-specific).

<sup>22</sup> Valletti, T.M. (1999), 'The Practice of Access Pricing: Telecommunications in the United Kingdom', *Utilities Policy*, 8(2), pages 83–98.

<sup>23</sup> Oftel (1995), 'Effective Competition: Framework for Action: A Statement on the Future of Interconnection, Competition and Related Issues', July.

<sup>24</sup> Introducing the LRIC-based approach was a lengthy process. In August 1995 Oftel appointed consultants to evaluate a top-down model developed by BT and a bottom-up model developed by an industry working group. Oftel's final determination on LRIC came into effect in October 1997.

<sup>25</sup> Oftel (1996), 'Pricing of Telecommunications Services from 1997: Second Consultative Document on BT Price Controls and Interconnection Charging', March.

Oftel and BT agreed that the starting charges for the control period would be based on a forecast of the relevant incurred incremental costs plus a mark-up for each service. Thereafter, BT was free to set its own charges subject to the RPI – X control for non-competitive services and a ‘floors and ceilings’ test, based on a floor of LRICs and a ceiling of stand-alone costs. This new approach gave BT considerably more flexibility than it had had previously in setting charges, and, according to Oftel, it was ‘a move towards pricing arrangements appropriate to a competitive market’.<sup>26</sup> Therefore, when Oftel pressed ahead with the proposals for different sub-caps, BT’s network charges were already reflective of the underlying efficient costs of providing the service.

<sup>26</sup> Oftel (1996), op. cit., paragraph 2.21.

## 4 Of tel's approach to structure of BT's control, and relevance for Royal Mail's price control

On the basis of the review of the regulatory precedents in the fixed telephony market, several important observations can be made with regard to the extent of tariff rebalancing before full market opening, and the length of time over which rebalancing took place before separate baskets were imposed.

- BT was able to, and undertook, a significant degree of retail price rebalancing in the period immediately after privatisation and the introduction of regulation, and prior to the opening of the market to competition, which took place after the duopoly review. From an economic standpoint, tariff rebalancing should be completed at the outset of the market liberalisation process, with the purpose of providing appropriate signals to competitors about their likely returns from long-term competition.<sup>27</sup>
- BT was able to, and conducted, retail price rebalancing within a single tariff basket for the period 1984–97 (over 12 years) such that its retail prices were significantly more cost-reflective prior to the emergence of competition, which in most part took place after 1997. Of tel only gradually increased its regulatory control over BT during this period. This is also consistent with the economic theory, which suggests that there are benefits from a gradual rebalancing over time in circumstances where sharp price increases are not feasible.<sup>28</sup>
- BT's network charges reflected their (accounting) cost of provision at the time that Of tel introduced the different interconnection sub-caps.

These observations may be contrasted with the regulation of the UK postal sector to date, and Postcomm's approach for the next price control put forward in its Initial Proposals.

- For BT, the maximum increase in prices of local peak calls was 17.3% in real terms (equivalent to around  $RPI - X + 8.5$ ) in the first three years of the first price control. In contrast, Royal Mail's first price control allowed no rebalancing, while its second price control permitted a maximum of  $RPI - X + 2.5$ .
- Of tel has never applied a two-basket approach for BT's retail prices. It eventually moved to a re-weighted single basket in 1997 after a period of significant tariff rebalancing. For the regulation of BT's network charges, separate tariff baskets were introduced only after the respective charges were broadly reflective of their costs of provision. In contrast, Postcomm is proposing to apply two baskets now before prices become more cost-reflective and after only three years of limited price rebalancing.
- Economic literature shows that non-cost-reflective tariffs may be one of the most powerful sources of regulatory-induced problems with competition, by creating undesirable patterns of entry—ie, too much entry in artificially profitable markets, and too little entry in loss-making markets.<sup>29</sup> This link between the need to reduce cross-

<sup>27</sup> See, for example, Armstrong, M. and Sappington, D. (2004), 'Regulation, Competition, and Liberalization', mimeo, December. Available at [www.econ.ucl.ac.uk/downloads/Armstrong/reg2.pdf](http://www.econ.ucl.ac.uk/downloads/Armstrong/reg2.pdf).

<sup>28</sup> See Armstrong and Sappington (2004).

<sup>29</sup> See, for example, Armstrong, M. (2001), 'Regulation and Inefficient Entry: Economic Analysis and British Experience', in G. Amato and L. Laudauti (eds), *The Anticompetitive Impact of Regulation*, Cheltenham: Edward Elgar Publishing. Armstrong and Sappington (2004), op. cit., identified a series of problems that could be induced by prices that diverge from costs and cream-skimming: cream-skimming may put at risk the financial viability of the incumbent; prices that are not cost-reflective, coupled with cream-skimming, may increase industry costs by allowing inefficient entrants to serve customers; with cream-

subsidies and liberalisation was acknowledged by the telecoms regulator. Indeed, for BT, the prices were significantly more cost-reflective prior to market opening. In contrast, Postcomm has decided to open up the UK postal market fully prior to Royal Mail's prices being significantly more cost-reflective.

In conclusion, it is not evident that Postcomm's proposal for a two-basket tariff structure is in keeping with regulatory precedent in the telecoms sector. This precedent suggests that it is important to take into account the interactions between regulation and liberalisation, to ensure that regulation does not result in inefficient entry, which may be detrimental both to consumers and to the incumbent. Furthermore, it shows that the aim of liberalisation is to remove the need for regulation, with competition providing pricing discipline, driving quality improvements, and incentivising the development of new products.

skimming, customers of unprofitable services do not benefit from competition; and retail tariffs that do not reflect costs may complicate the design of appropriate access charges.

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