



Increasing the regulated prices of BT Openreach is unnecessary and will undermine Digital Inclusion

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About Dr. Chris Doyle

Dr. Chris Doyle is an economist specialising in regulation and competition issues relevant to network industries in general and telecommunications in particular. He obtained a PhD in Economics from Warwick University where he is an Associate of the Centre for Management under Regulation at Warwick Business School and an Associate Fellow in the Department of Economics.

He has written extensively in the field of telecommunications regulatory policy and published numerous articles. He has held senior academic posts at Cambridge University and London Business School, and held visiting positions at Queen's University, Canada, Charles University, Prague and INSEAD in Paris.

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Foreword

Dr. Chris Doyle, was retained by TalkTalk (part of the Carphone Warehouse Group plc) to comment on Ofcom's proposals *A New pricing Framework for Openreach*, (Second Consultation) 5 December 2008.

In particular TalkTalk asked Dr. Doyle to examine international benchmarking evidence used by Ofcom. Additionally TalkTalk inquired into the likely impact Ofcom's proposals might have on broadband uptake in the UK.

This report was completed following a brief period of desk research and the views expressed herein are those of the author and do not necessarily represent those of Warwick Business School, Warwick University or the Carphone Warehouse Group. All errors are the sole responsibility of the author.

Dr. Chris Doyle
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Findings

This brief report examines two issues within the far reaching Ofcom consultation *A New Pricing Framework for Openreach*. First, International benchmarking is examined and secondly the impact of the proposed price increases for the core MPF product on broadband uptake is assessed.

On international benchmarking the conclusions drawn suggest that BT Openreach is a relatively poor performer, languishing mid-table in EU wholesale price comparisons. This is surprising given there are several factors that suggest the UK should be top of the league. In particular:

- (i) The UK introduced competition into telecoms markets before almost every other EU member state;
- (ii) High population density in the UK (and in particular England, the highest in Europe) favours lower cost network service costs;
- (iii) The size of the UK population enables Openreach to benefit from considerable scale economies; and
- (iv) Ofcom's elaborate regulatory oversight in the form of functional separation.

The international benchmarking data when assessed in a wider context indicate that Openreach is performing below its full potential. Put differently, Openreach is delivering services at claimed costs which are too high relative to potential. I conclude that either BT is much less efficient than it should be, or it is exaggerating its costs or it is being allowed to make excess profits by the regulator. The case for the 18% to 36% increases proposed by Ofcom over the next 3 years are – given prices are expected to be flat elsewhere – run counter to the evidence and if they are imposed will mean that by 2012 the UK would be languishing towards the bottom of the price league.

With regard to Ofcom's proposals for increased wholesale prices, the impact is likely to lead to a marked reduction in subscriber uptake of broadband services. I estimate that there could be up to 1 million fewer households subscribing to broadband services by 2012/13 when compared with the status quo of maintaining the current charge controls.

As all political parties support the policy of Digital Inclusion, it is unfortunate that the proposals put forward by one government agency (Ofcom) are likely to run counter to this policy.

If anything, in common with other European regulators of telecommunications companies, Ofcom should acknowledge the scope for price reductions and not price increases. Given the international benchmarking data suggest there is fat within Openreach – Ofcom should move to incentivise lower prices which would benefit all customers and strengthen Digital Inclusion initiatives.

1. Background

This brief report is concerned with Ofcom's pricing proposals for Openreach. The wholesale products supplied by Openreach are the main building blocks used by communications providers (CPs) in the UK, including BT Retail, Carphone Warehouse (Talk Talk), and others to supply customers with retail broadband packages.

The retail broadband markets are intensely competitive, with providers offering customers a wide range of options and discounts. However, over 60% of the cost base of a CPs broadband DSL package is determined by charges set by Openreach, a division of BT.

Openreach is regulated by Ofcom and adheres to legal undertakings that formed part of the creation of Openreach in late 2005. The current charge controls applied by Ofcom on Openreach for its core wholesale products predate the creation of Openreach.

One of the core wholesale LLU products purchased by competitive operators is known as MPF – Metallic Path Facility – which is the rental of the twisted copper pair cable (local loop) connecting the customer's premises with the BT local exchange.

Prior to a review of the MPF charge in 2005, BT was not allowed to set an annual rental charge above £105.69. Following a review by Ofcom in 2005 this was decreased to £81.69.

Ofcom started another review of the charge controls for Openreach products in 2008 and has recently proposed a new pricing framework for the company. In this review Ofcom is proposing to increase the price ceiling for the MPF product from £81.69 to between £85-£91 on 1 April 2009, and permitting further increases to between £97 and £111 by April 2012.

Ofcom has relied largely on evidence provided by Openreach to justify the change in the charge controls. Nevertheless, it has also taken account of the comparison of Openreach regulated prices with comparable regulated products in other EU member states.

While the financial data provided by Openreach indicate the need for a price increase, the international benchmarking data suggest otherwise. In the following section I argue why the international benchmarking data should be given more weight in Ofcom's assessment.

2. International benchmarking

Openreach provided Ofcom with Current Cost Accounting Fully Allocated Cost (CCA FAC) data to justify changes in the regulated prices for Core Rental Services. Ofcom has presented reasons for accepting the use of CCA FAC data largely on the grounds of transparency and practicality.

I note, however, a number of respondents to Ofcom's consultation on this matter have queried Ofcom's reasoning in favour of CCA FAC. Notwithstanding, while Ofcom has placed considerable weight on this evidence it also takes account of other factors.

In section 6.2 of the Second Consultation document Ofcom states:

"it will also take account of other sources of evidence, including international price benchmarking"

Two charts were presented by Ofcom in its First Consultation comparing Openreach Local Loop Unbundling (LLU) prices (MPF) with those offered by regulated operators in other EU member states. Section 6.15 in the Second Consultation states:

"As the first chart illustrates, Openreach's tariff for MPF rental appears close to the European average, but in the upper half of the range. Openreach's tariff sits in the middle of the range of charges for the "Big 5" European nations."

Ofcom identified a number of deficiencies with the European data comparisons and Openreach also claimed shortcomings and commissioned the Yankee Group to perform more detailed comparisons. This resulted in Ofcom undertaking further analysis and refinements of the international benchmarking data.

Figure 6.4 in the Second Consultation presents the outcome of the analysis undertaken by Ofcom, reproduced below:

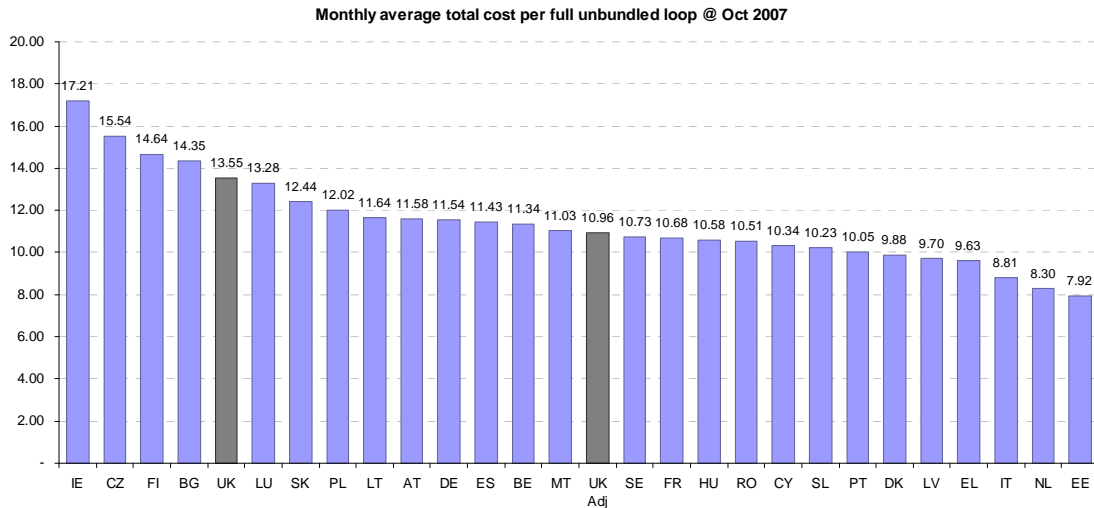


Figure 6.4 in *A New Pricing Framework for Openreach*, Second Consultation, Ofcom, 5 December 2008

Ofcom has produced an adjusted figure for the UK (Openreach) which is more consistent with the other figures in the chart. This figure adjusts an estimate made by the European Commission in its annual Implementation Report.¹

The adjusted figure for the UK shows Openreach to be exactly in the middle, slightly cheaper than Deutsche Telekom but more expensive than France Telecom and Telecom Italia, and over 30% more expensive than the regulated price in the Netherlands.

It is worth considering how exogenous factors such as population size and density might affect the UK's position.

It is often claimed that population density is a factor that favours countries such as the Netherlands. It is well known that local loop prices may be lower in more densely populated areas as average loop lengths tend to be shorter.² The population density of the UK is 246 km² and in the Netherlands it is 395 km².³ However, most of the Openreach products are sold within England where population density has reached 395 km².⁴

¹ 13th Report on the Implementation of the Telecommunications Regulatory Package – 2007 at http://ec.europa.eu/information_society/policy/ecomm/library/communications_reports/annual_reports/13th/index_en.htm

² For example, see regression estimates reported in Jerry A. Hausman, J. Gregory Sidak and Timothy J. Tardiff (2008) "Are Regulators Forward-Looking? The Market Price of Copper Versus the Regulated Price of Mandatory Access to Unbundled Local Loops in Telecommunications Networks", *Federal Communications Law Journal*, volume 61, pp. 199-228.

³ According to Wikipedia at http://en.wikipedia.org/wiki/List_of_countries_by_population_density

⁴ Daily Telegraph at <http://www.telegraph.co.uk/news/newstoppers/politics/2967374/England-is-most-crowded-country-in-Europe.html>

Of course other factors also influence the costs of unbundling products. Another important factor is total population (or number of households). The larger the market to be served, the greater the likelihood scale economies can be enjoyed in both customer service, systems and procurement. In serving a population of around 60 million BT is able to enjoy considerable scale economies.

Other factors playing a role include the extent of competition in the market place. The UK has enjoyed liberalisation in telecommunications markets dating back to 1981, considerably before most other European member states.

In addition the UK was the first member state in the EU to apply functional separation resulting in the creation of Openreach as a stand alone closely supervised wholesale access network division within the BT group.⁵

All of the above factors lead to the prediction that Openreach ought to have among the lowest unbundling prices in the EU. However, this is not borne out by the international benchmarking analysis undertaken by Ofcom. Indeed, somewhat disappointingly despite the many years of competition in, and regulatory oversight of, the UK telecommunications sector, Openreach's performance is relatively mediocre.

The international benchmarking data when assessed in a wider context indicate that Openreach is performing below its full potential. Put differently, Openreach is delivering services at costs which are too high relative to potential.

Alternatively it may be the case that the international benchmarking data show BT is exaggerating costs or is being allowed to enjoy excess profit. While I am not able to disprove these suggestions, I am inclined to support the hypothesis that the international benchmarking data point to inefficiencies within BT.

My concerns are magnified by Ofcom's proposals for future price changes. Ofcom proposes increasing MPF charge controls by between 18% and 36% over the next 3 years, though, as Ofcom has noted, other countries are holding MPF prices flat:

*"charges elsewhere are generally falling in real terms"*⁶

Thus if we were to redraw the benchmarking table above in 2012, BT would be languishing towards the bottom of the pack.

The international benchmarking data suggest that Openreach is underperforming and MPF costs are too high relative to potential.

⁵ See SPC Network Report "Equivalence of Input and Functional Separation: A Framework for Analysis" Prepared for BT Global Services 26th February 2009 at <http://www.spcnetwork.co.uk/uploads/20090226EFSReport.pdf>.

⁶ Second Consultation paragraph 6.24.

Rather than sanction price increases, Ofcom should re-examine all of the evidence and consider maintaining the current charge controls or even lowering the price ceilings in line with the actions of regulators in other EU member states.

3. The impact of Ofcom's pricing proposals

In paragraph 6.36 of the Second Consultation Ofcom states "*demand for broadband is likely to be more price sensitive than voice*". The regulator therefore acknowledges that its sanctioned wholesale price increases will flow through to retail and will lower demand for broadband connectivity.

The proposed changes to the charge controls for the MPF product (as described by Ofcom in Table 1.1 of the Second Consultation) will lead to the price varying from £81.69 to £85-£91 on 1 April 2009 rising to between £97 and £111 by Apr 2012. I assume that the MPF annual rental would increase to £104 by April 2012, an increase of around £22 annually or around £1.80 per month. As the MPF is used to service both voice and data, I assume that half the additional cost (i.e. 90 pence) would be passed through to the retail charge levied for broadband.

Current retail broadband charges typically lie in the range £5-10 per month.⁷ Assuming the current average retail broadband package is £7.50 per month, this would increase under Ofcom's pricing proposals for Openreach to £8.40 per month. Thus Ofcom's pricing proposals suggest a retail price increase of 12%.

Having identified the likely impact on retail broadband prices of Ofcom's pricing proposals for Openreach, I next assess the effect this will have on broadband subscriptions. To do this I make use of information about the sensitivity of broadband demand to price changes, that is I make use of information about the own-price elasticity of demand for retail broadband services.

In analysis undertaken by Frontier economic consultants for Carphone Warehouse and submitted in response to the Ofcom First Consultation, it is reported that own-price elasticities for retail broadband lie in a range -0.14 through to -2.62. Taking the midpoint of this range suggests an own price elasticity of demand for broadband connectivity of approximately -1.25.

However, some caution needs to be exercised with respect to the -1.25 mid-point estimate. As it is extracted from statistical studies based on (recent) historical data, it is likely to overstate the sensitivity of connectivity with respect to price for customers already subscribing to a broadband connection. I therefore assume a more conservative and realistic estimate of the own-price elasticity of demand value is lower and likely to be around -0.40.

What remains to assess is the growth in retail demand for broadband in the UK and how this will be affected by the proposed changes to the charge controls. Two scenarios are considered. In the first scenario I assume wholesale charge controls remain at the current levels and prices remain at

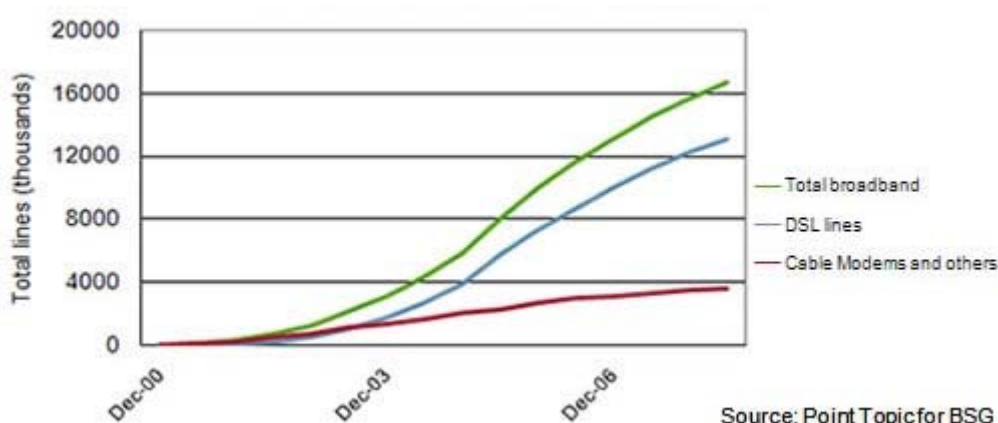
⁷ Data on retail offers are provided at http://www.top10-broadband.co.uk/types/cheap_broadband/

current levels. In the second scenario I assume Ofcom's pricing proposals as stated in the Second Consultation apply and MPF prices set by Openreach move in line with the charge controls.

According to official government statistics 56% of all households (13.8 million households) in 2008 had a broadband connection.⁸ The increase in broadband connections over the previous year was around 1.5 million households. These data were similar to those reported by Ofcom in 2008.⁹

The Broadband Stakeholder Group (BSG) has published statistics which feature a breakdown of broadband connectivity according to type of connection (DSL, cable modem, other).¹⁰ The products offered by Openreach are used in the provision of DSL products. Using the BSG data suggests around 12 million DSL are likely to be in service currently, with the rate of growth declining as the market matures.

Figure 1: Broadband connection type and volumes in the UK



Assuming 8 million households currently do not have a broadband connection and that many of these do not have an Internet connection (as the official data would suggest), then the price increases proposed by Ofcom are likely to be injurious to Digital Inclusion initiatives as championed in the recent *Digital Britain Interim Report* by Lord Carter.¹¹

According to Ofcom estimates presented in the Second Consultation, the number of wholesale broadband lines in 2012/13 will lie in the range 17.6 to 19.2 million. I assume that absent price changes to the Openreach core rental products, growth in broadband connections would result in the number

⁸ National Statistics at <http://www.statistics.gov.uk/CCI/nugget.asp?ID=8> and <http://www.statistics.gov.uk/pdfdir/intc0209.pdf>

⁹ Page 18 Ofcom Communications Market Report 14 August 2008 at www.ofcom.org.uk

¹⁰ At <http://www.broadbanduk.org/content/view/268/55/> Note that retail DSL products are the only ones that rely on MPF or SMPF wholesale products.

¹¹ DCMS and BERR Digital Britain: The Interim Report, January 2009 at http://www.culture.gov.uk/images/publications/digital_britain_interimreportjan09.pdf

of broadband subscriptions rising to between 17 and 20 million households in 2012/13, a net increase of between 5 and 8 million DSL broadband subscriptions.

If the current Ofcom pricing proposals for Openreach were accepted, the effect would lead to a 12% increase in the average retail broadband price and lower subscription demand by almost 5%. This is because the own-price elasticity of demand of -0.4 would translate into a demand fall of 5% when price increases by 12%.

I therefore estimate that the impact of Ofcom's pricing proposals for Openreach will lead to a reduction of between 800,000 (i.e. 17m x 5%) and 1 million fewer households in the UK subscribing to broadband services.

The impact of Ofcom's proposed changes to the Openreach charge controls would impact negatively on aspirations for broadband universality and undermine wider Government policies aimed at Digital Inclusion.