

## UK Mobile Termination Rates Found Excessive

### Mobile Operators Reject Regulator's Price Controls Once Again

In September 2001 Oftel published two documents on competition in UK mobile services. The [Review of the charge control on calls to mobiles](#) proposed that the existing price cap on fixed-to-mobile termination charges due to expire in March 2002 be extended for another four years, tightened to RPI-12% from RPI-9%, and broadened to include One2One and Orange. Oftel's [Effective competition review: mobiles](#) concluded that while the mobile outbound market was prospectively competitive, it was not yet so, that both Vodafone and BTCellnet have market power, and therefore the obligation to provide carrier selection (indirect access using UK terminology) should continue. The UK mobile operators have rejected Oftel's proposals so the matter will be referred to the Competition Commission (formerly MMC) for a six and possibly twelve-month inquiry, as happened in 1998.

#### Effective or Identikit Competition

According to Oftel, the mobile industry consists of separate call origination and termination markets. Further, each mobile network operator has market power over the provision of wholesale termination services to fixed operators, principally because inbound callers have no choice of network due to Calling Party Pays (CPP).

The basis of Oftel's analysis is that in an effectively competitive market, operators would charge similar prices and earn zero economic (excess) profits. Thus Vodafone and BTCellnet's slightly higher prices and their ROCE in excess of the cost of capital were seen as evidence of market power. This is simplistic. Ignoring differences in costs and the difficulties in comparing mobile prices, prices would only be identical if the bundle of services offered by each operator is similar. However, this is not the case. First, there are quality differences, i.e. coverage, percentage of dropped calls etc. Second, some operators have a larger international footprint allowing them to provide more and better services than under international roaming. Third, all UK operators charge more for off-net than on-net calls; the larger operators can charge relatively more for on-net calls because they offer more on-net call opportunities (network effects). Fourth, although the later entrants (One2One and Orange) prices were initially lower to compensate for poor coverage and (perceived) service,

and to target lower value subscribers, these price differences have significantly narrowed.

Oftel's analysis of operators' profitability is even more contentious. First, Oftel declined to use actual profitability because it would reflect inefficiencies. Therefore, it adjusted each operator's profitability using the concept of reasonably efficient operator, which was deemed to be Vodafone. According to Oftel, the only unavoidable cost differential was the higher costs of running an 1800 MHz (One2One & Orange) compared to a 900 MHz (Vodafone & BTCellnet) network. This means, for example, that the superior management or strategy of Vodafone was assumed to be easily replicated by all operators and that in a competitive market there would be no sustainable differences between operators. That is effective competition means identikit competition!

The attempt by Oftel to equate high (efficiency adjusted) ROCE with market power is controversial. Mobile expenditure varies enormously across subscribers and since operators do not have the same mix of subscribers their profitability will vary also. For example, Vodafone and BTCellnet have a higher proportion of business customers, and for historical and technical reasons more international roaming traffic, while later entrants targeted new customers with lower margins, such as prepaid. As a result, operator profitability would differ markedly even in an effectively competitive market.

#### Termination Pricing

Oftel's competitive analysis of termination is essentially unchanged since the 1998 MMC Report. Oftel maintains that there is a termination market for each operator, there are no substitutes for a call to a mobile, and callback or closed user groups are insufficient to constrain the operators' market power under CPP. The operators responded that in assessing mobile pricing one must take into account all the services offered by a network. Thus, while the competitive constraints on fixed-to-mobile calls may be weaker than for other services, and prices relatively higher, they are used to recover fixed costs and compensate for network externalities. Artificially capping termination charges would have the effect of increasing or limiting reductions in retail and other charges. Further, and critically, mobile operators

claimed that the current structure of pricing was efficient because it broadly conformed to what economists call Ramsey pricing. These are prices for a multi-service operator with common fixed costs, which are set to maximise consumer welfare, subject to the network operator earning only a reasonable return to capital. The common costs are recovered through mark-ups set according to the inverse of the price elasticity of demand for each service or consumer group. Thus, less price elastic services where the operator has greater market power are priced higher! This is efficient (given the inability to cover common fixed costs with a government subsidy) because it minimises consumption distortions. While Oftel accepted that Ramsey pricing was efficient, it countered by saying a) that overall excess profits indicated that termination rates were being set at an excessive level, and b) that the proportion of common costs was small. These issues will be key areas of dispute before the Competition Commission inquiry in 2002.

#### **New troubles for LRIC**

Oftel based its price control proposal on forward-looking Long Run Incremental Costs (LRIC) with markups. Oftel's use of equi-proportionate mark-ups to allocate common costs is inefficient, since as noted above termination rates should be used to recover proportionately more common costs. Oftel sidelined this issue by claiming that common costs for mobile networks accounted for only 3-5% of all costs! If correct, it implies limited differences between termination charges set under either equi-proportionate or Ramsey mark-ups. However given that past experience has shown that LRIC cost estimates can vary by as much as 70%, and that LRIC is a price floor with attendant high error costs, Oftel's assumptions and calculations will be debated at length before the Competition Commission.

Oftel's LRIC estimates accept that 1800 MHz networks are more costly than 900 MHz networks, and that therefore higher termination rates for the former are

justified. This position is odd. This (unavoidable) cost difference has no relevance to determining the cost structure of a reasonably efficient operator or the prices to consumers. If Oftel's effective competition model requires that prices for similar services should be similar, it would not take account of the fact that one producer has higher costs than another, nor will consumers be interested in the reasons. On this score, it appears that some *ad hocery* and pragmatism has entered, which no doubt the 900 MHz operators will challenge before the Competition Commission.

#### **Carrier pre-selection**

Mandating carrier selection on Vodafone and BTCellnet could paradoxically decrease rather than increase competition by crowding out similar opportunities for Orange and One2One. Smaller networks are most likely to be interested in cooperating with service providers for several reasons. First, they have significant under-utilised capacity. Secondly, some are more likely to links with firms with strong brand names and marketing skills, as One2One did with Virgin. Indeed, when Oftel introduced [carrier selection](#) in 1999, it concluded that it would not reduce call charges much and could only be justified by the prospect that it would increase consumer choice. However, Oftel's model, and the impact of carrier selection, both push in the direction of harmonising prices and product choice!

#### **Conclusions**

Oftel had hoped to get agreement with the mobile operators to its proposals. However, they have concluded that with high penetration rates, call origination charges falling, and the future prospect of more competition, higher costs and greater regulation, they could not. In the three years since their last visit to the MMC, the views of Oftel and the operators have polarised. Again, the competition regulator has been called in as the umpire between warring parties!

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