**Abstract**

The provisions in the early 1980's to end British Telecom's monopoly of telecommunications services in the UK resulted in the setting up of OFTEL, a regulatory body. This article looks at competition in the UK telecommunications industry and highlights the roles of a regulatory body, in terms of regulation as competition is developing, and as a competition authority after competition has set in.

In the early 1980's provisions were made to end British Telecom's monopoly in the supply of telecommunications services in the UK. The first development was the separation of British Telecom from the Post Office in 1981. This was followed by the privatisation of British Telecom and the market entry of a new firm, Mercury, in 1984. This article will consider competition in the UK telecommunications industry, the role of regulation as competition is developing, and the role for a competition authority after competition has set in.

The argument for introducing competition to an industry is that this will result in an outcome which tends towards economic efficiency, something which might not otherwise ensue. There are two criteria for efficiency: allocative efficiency, which requires that prices equal costs and productive efficiency, which requires that production takes place at minimum cost. We might expect the introduction of competition to the British telecommunications industry to yield an efficiency outcome eventually. Competition was however limited initially with Mercury as British Telecom's only rival. Mercury was a much smaller company than British Telecom and was unable to enter the market on a large scale.

In the absence of competition both of the economic efficiency criteria may be violated. For example, a monopolist may raise prices above costs in order to gain super normal profits (defined as profits over and above the level required for the firm to survive), or to settle for some organisational slack, which raises costs above minimum levels. This provides the motivation for regulation: a regulator imposes constraints upon companies with a high degree of market power in order to mimic competitive pressures and to try and achieve a competitive outcome. Due to the limited competition in the British telecommunications industry immediately after privatisation, a regulating body was set up called the Office of Telecommunications (OFTEL). OFTEL has since regulated, amongst other things, British Telecom's retail prices and interconnection charges, aiming to bring these in line with costs and to encourage cost reductions.

Regulation is however, never perfect because the regulator cannot fully mimic competitive pressure. Under regulation, there is a degree of gaming between the regulator and the regulated firm, with the result that the regulator does not get perfect information about the regulated firm's costs and the levels to which these might be reduced. This is the basis for the famous quote from Stephen Littlechild, now the electricity regulator, relating to the telecoms industry: "Competition is indisputably the most effective means - perhaps ultimately the only effective means - of protecting consumers against monopoly power: Regulation is essentially a means of avoiding the worst excesses of monopoly; it is not a substitute for competition. It is a means of 'holding the fort' until competition arrives."
This idea has been adopted by OFTEL which has repeatedly stated its aim to achieve a fully competitive and unregulated telecommunications market. For example, in a recent OFTEL publication it was written that "OFTEL recognises that competition is a better incentive mechanism for restraining prices than price control. Rivalry promotes a search for previously unidentified efficiency gains, ensures they are passed on to customers and stimulates innovation and choice in the process of seeking competitive advantage".

Regulation and competition in an industry do not operate independently of each other. Stronger regulation in the form of lower price caps yields lower short term prices for consumers but also reduces profit margins for potential market entrants. As market entry is dependent on profit margins, then strong regulation reduces incentives for new firms to enter the market, so that lower prices associated with competition may be foregone. Regulators must balance protecting the short term interests of consumers with the longer term interest, setting price caps which prevents consumer exploitation and encourage new firms to enter the market.

The most recent price caps for British Telecom were set in 1996 by OFTEL in which it recognised the need to allow a profit margin sufficient to bring about a competitive industry and designed retail price caps with this in mind. The proportion of British Telecom's business to be covered by price caps will be reduced to 25% by revenue, that accruing from low to middle user residential customers, and regulated markets will be capped relatively leniently when compared to previous price caps. Price caps will apply till the year 2001, after which there will be no more price control.

In unregulated markets (accounting for 75% of British Telecom's revenue), firms will be disciplined by the threat of competition. Competition in the industry is increasing – new firms have gained market share, new technologies are beginning to have an influence - and OFTEL did not want to reverse this trend by setting price caps that would be too low.

In the longer term, OFTEL views itself as becoming a competition authority for the telecommunications industry. There is a need for a competition authority to ensure that anti-competitive practices do not take place and thus that consumers gain the maximum benefit from competition. There are two major areas where anti-competitive practices could occur, these are interconnection and retail pricing.

As regards interconnection, the incentive is for British Telecom to raise prices here in order to increase profits. This is something that is recognised by OFTEL and their response has been the development of models to identify British Telecom's costs to which prices can be aligned. Another incentive is for British Telecom to charge its rivals a higher price than itself for network access, in order to raise the relative costs of its rivals and reduce relative profits, potentially to the point that rivals leave the market and British Telecom becomes a monopoly.

The network and retailing businesses of British Telecom are ring-fenced and OFTEL has taken advantage of this to try and ensure that British Telecom's network business charges its own retailing business and rival business the same price for network access. Another possibility is that British Telecom could act anti-competitively by dragging its feet over interconnection requests from its rivals. OFTEL is presently trying to speed up and strengthen its processes for dealing with such behaviour.
In the area of retailing, there is the possibility that British Telecom might try and deter new firm entry by adopting a policy of predatory pricing, that is, charging a price which is less than cost. Under predatory pricing, an incumbent firm forsakes profit whilst the price is reduced in order to earn profit in the future. In this situation, an entrant will anticipate losses contingent upon entry and will stay out of the market, the incumbent is then free to enjoy monopoly profit. If an entrant knows that every time there is an entry threat the incumbent will cut price, then entry may be deterred. OFTEL recognises the potential for predatory pricing, particularly given the financial muscle of British Telecom, and is presently developing methods so that cases, where there is a suspicion of predatory pricing, can be dealt with quickly and effectively.

In summary, competition in the privatised UK telecoms industry was limited initially and in order that efficiency gains be made and prices fall, the dominant supplier – British Telecom – was regulated. The regulating body, OFTEL, intended that in the longer term a fully competitive market would evolve. Regulation can have an effect on the development of competition because it affects profit margins; in turn, these determine the level of market entry by new firms. In recognition of this, OFTEL set price caps which preserved reasonable profit margins and, in some markets, did not set price caps at all.

Conclusion
In the future OFTEL will concentrate on working as a competition authority, focusing on areas such as predatory pricing. As technology advances and consumers respond to this, it is likely that the sphere of operation for OFTEL will broaden. The degree of substitutability between telecommunications services, internet services, interactive television, faxes and other products has increased in recent years. As the boundaries between these markets become more blurred, it makes more sense to look at the communications market as a whole, this is probably what OFTEL will begin to do.