



Wholesale Broadband Access Market Review

TalkTalk response to Ofcom consultation paper

September 2017

NON-CONFIDENTIAL VERSION

1 Summary

- 1.1 This paper responds to Ofcom's consultation, dated 22 June 2017, regarding its proposals for the Wholesale Broadband Access ('WBA') market.
- 1.2 TalkTalk does not directly serve customers on the basis of WBA products, although some of our downstream wholesale partners, such as the Post Office, do so. However, it is important that significant market power ('SMP') in the telecoms market— whichever firm might hold it now and in the future— is well regulated and competition across the market is protected, and that Ofcom does not make poorly reasoned decisions which may be used as precedent in other market reviews, particularly in areas such as market definition where there can be direct read-across.
- 1.3 It is Ofcom's duty to use its regulatory powers to protect consumers from the exercise of SMP; Ofcom does not do so under its current proposals. In the absence of price regulation in Market A, TalkTalk would expect increased prices and reduced levels of competition in (the current) Market A areas.
- 1.4 Overall, Ofcom's consultation paper makes significant methodological errors, which have the potential to lead to incorrect conclusions. TalkTalk would be very concerned if these errors were not corrected, given their potential distortionary impact if replicated in other market reviews. In particular:
 - Ofcom has not conducted a meaningful market definition exercise. It has offered no evidence in support of its product market definition, which is counterintuitive and relies on assertion rather than evidence and analysis. These fundamental flaws at an early stage of Ofcom's assessment are sufficient, in and of themselves, to vitiate Ofcom's analysis throughout the rest of its paper, as they lead to an overestimate of the extent of substitutability between copper, FTTC and cable broadband products at the WBA market level. It would be a fundamental failure in the regulatory system for it to be accepted that market definition can be undertaken in the absence of evidential support.
 - Ofcom has concluded that exchanges are competitive even where there is currently no competition in the WBA market, on the basis of the threat of entry by providers using FTTC products, even where no providers other than BT are currently using these products. This is inappropriate without an analysis that shows in detail why this threat of entry is currently imposing a competitive constraint. Market A should be defined on the basis of actual levels of competition, rather than hypothetical competition which will not constrain BT from exercising market power.
 - Even under its own proposals, Ofcom will be leaving BT with unrestrained SMP in 2% of the UK, amounting to around 600,000 premises. It is unclear how this is consistent with Ofcom's duties to advance consumers' interests. Ofcom's proposed margin squeeze protections are not fit for purpose, and add nothing meaningful to the protection already given by the Competition Act.
- 1.5 Ofcom should therefore reconsult on revised proposals that will impose a charge control on BT in the WBA markets in areas which have not been unbundled by at

least two other principal operators ('POs'). While this is not deregulatory it would protect consumers in a manner which is consistent with Ofcom's overall duties. The WBA market is not one which is suitable for deregulation.

1.6 The remainder of this paper sets out TalkTalk's reasons for its views in greater detail.

2 Ofcom's market definition is flawed

2.1 Ofcom sets out its market definition at sections 3 and 4 of its paper; section 3 deals with product market definition, while section 4 considers geographic market definition.

2.2 Ofcom has made fundamental errors of methodology in both of these aspects of market definition; these methodological errors are likely to have led to errors in Ofcom's proposed market definition. Its consideration of product market definition is cursory, and it fails to consider almost all of the relevant factors which would enable Ofcom to reach a robust product market definition. Its geographic market definition exercise is confusing, and reaches an inappropriate conclusion as to the boundary between Market A and Market B.

2.1 Product market definition

2.3 The most important aspect of the product market definition exercise undertaken by Ofcom is the potential distinction between copper, FTTC and cable-based access to broadband. In its section on the retail market definition, at §§3.10-3.23, Ofcom largely avoids analysis, and instead merely cross-refers to the market definition sections of the 2017 WLA Review.

2.4 This approach means that Ofcom replicates and expands upon the errors in the WLA Review's product market definition, as set out at §2.5 of TalkTalk's WLA response:

- Ofcom does not clearly identify different focal markets, and therefore does not take into account the potential that there are asymmetric markets, where product A acts as a competitive constraint on product B, but product B does not act as a competitive constraint on product A. This failure to properly investigate market definition results in Ofcom's approach to SMP assessment being flawed, as it fails to recognise the strength of BT's market power.
- Ofcom does not reach a clear conclusion on market definition when it is imperative that they do so. The appropriate finding based on Ofcom's reasoning is that there is one market which contains all broadband products (when the focal product is standard broadband ('SBB')) and another market which contains only superfast broadband ('SFBB') products (when the focal product is SFBB). Ofcom's statement that '*SFBB is likely to be a stronger constraint on SBB during the review period and SBB is likely to exert a diminishing constraint on SFBB*' does not sufficiently state Ofcom's view of what the appropriate market definition is.

2.5 Ofcom's analysis of the wholesale product market, at §§3.24-3.32, is also fundamentally flawed due to its lack of empirical support.

2.6 At §3.26, Ofcom states that:

retail fixed line broadband services can be provided over copper, fibre and cable and all have broadly the same intended use. We therefore consider that WBA product provided over copper, fibre and cable networks would fall within the relevant wholesale market due to demand-side substitution at the retail level.

This statement is not further supported by analysis or evidence; but even as a theoretical statement it is clearly inadequate as a market definition exercise by a regulator. The mere fact that broadband services have '*broadly the same intended use*' says little or nothing about the appropriate market definition. For example, a BMW 7-series and a Nissan Micra have broadly the same intended use— they are both cars, which allow people to travel in them. However, it is inappropriate to conclude that the pricing of high end BMWs is constrained by the pricing of the Nissan Micra without detailed and compelling empirical evidence. The 'use' of a product is of very limited relevance when defining markets; rather, it is the willingness and ability of purchasers of one product to give up buying that product, and instead buy the other, which matters.

2.7 Indeed, it is not even clear that SBB and SFBB have the same intended use— as Ofcom states at §3.22-3.23 of volume 1 of its WLA Consultation '*There is a trend for new services needing ever more bandwidth. Some of these often only function well with SFBB speeds. For example, new Ultra High Definition (UHD) streaming services require download speeds of around 30 Mbit/s to work well.... some BT TV packages are only available with its fibre broadband*'. Ofcom concludes this section by stating at §3.29 that

usage trends suggest that SFBB speeds are becoming increasingly necessary in people's lives. Significant numbers of customers, including those in multi-user households, customers who carry out very high bandwidth activities and those with slower than average SBB, are likely to have a strong need for SFBB. Moreover, demand for higher bandwidth is likely to continue to increase substantially over the review period as new high bandwidth services develop, multi-usage continues to grow, and customer expectations around quality increases.

2.8 All of this points towards different usage cases for SBB and SFBB. Therefore even if usage cases were an appropriate way of defining markets, it is unclear that SBB would act as a competitive constraint on SFBB.

2.9 It is particularly unlikely that products with similar uses constrain one another when there are indirect constraints. Indirect constraints are inevitably weaker than direct constraints, and in general a very high own price elasticity of demand at the retail would be required in order to create an effective competitive constraint at the

wholesale level.¹ Ofcom has not undertaken any investigation of the levels of elasticities which would be required in order to create a single market including all types of wholesale broadband product, nor does it consider customers' elasticities of demand between cable, fibre and copper broadband.

- 2.10 The analysis also does not reflect the partial nature of overlap between Virgin Media and Openreach's retail broadband customers. Virgin Media is only present in around half the country, where it has a market share of just over 40%; this means that only around a third of retail broadband customers on the Openreach network could switch to Virgin Media, even if they wished to do so.² This will reduce the elasticity of demand facing suppliers in WBA markets, and make it more likely that wholesale copper and FTTC broadband are not constrained by cable broadband.³ The analysis also does not reflect the indirect nature of the constraint, with pass-through rates likely to be below 70%, and BT's wholesale products comprising half or less of the cost stack for retail broadband. These two facts mean that a 10% increase in the wholesale broadband price is likely to translate to a 3% or lower increase in retail prices, reducing switching and the extent of wholesale market constraints.
- 2.11 As a result of this error, §3.27 overstates the competitive constraints faced by BT. Cable services provided by Virgin Media should not be included within the same relevant market without detailed analysis of elasticities of demand, pass-through rates, and substitutability in order to provide evidence that they are indeed in the same market. Indeed, if Ofcom had considered evidence on the extent of overlap between Virgin Media and BT, pass-through rates by BT's wholesale customers, and BT's margins on broadband products, it would have found that Virgin Media does not act as a constraint on BT on a national basis. Rather, the WBA market should solely consist of products provided over the Openreach network.
- 2.12 Similarly, §3.30 is also wrong. A finding that there is a single WBA market for all speeds implies that SFBB and SBB must act as strong competitive constraints on one another, which is a finding which Ofcom has not reached— instead, it has found that SBB is a '*diminishing*' competitive constraint on SFBB. As Ofcom has set out in its March 2017 WLA consultation paper:

- SFBB will account for around three quarters of broadband lines by 2020/21;⁴

¹ Due to both pass-through of wholesale price changes being less than 100% in any imperfectly competitive downstream market, and that each individual wholesale input will make up a small proportion of the overall cost stack of the downstream product. For example, MPF typically makes up a third or less of the cost stack of a retail broadband product. If MPF were exactly one third of the cost of the downstream product, then a 10% increase in MPF prices, even if passed on in full, would only lead to a 3.3% increase in consumer prices.

² This refers to product market definition on the basis of a national geographic market. Clearly, where subnational geographic markets are adopted, there will be some areas in which a high proportion of customers on the Openreach network could switch to Virgin Media products, and other areas where low or even negligible proportions could do so.

³ When seen from the perspective of FTTC/ copper broadband. Substitution between different types of broadband at the wholesale level may be asymmetric.

⁴ Ofcom (2017), *Wholesale Local Access Market Review: volume 1*, §3.19.

- in many cases, SBB speeds will no longer be sufficient for household needs;⁵
- SFBB services may be needed for those with slower than average SBB speeds.⁶ Many of these are likely to be in Market A areas, given their rural nature;
- evidence from BT suggests that even low bandwidth demand households may need SFBB speeds by 2018 or 2019;⁷
- SFBB customers rarely downgrade to take SBB services;⁸
- only 8% of SFBB customers would consider switching to a cheaper but slower service;⁹
- there is a sizeable price premium between SFBB and SBB, which is likely to be increasing.¹⁰

2.13 In our view, the correct finding from Ofcom’s own observations of the market is therefore that there are two different relevant product markets for the WBA market review, both of which must be assessed by Ofcom— a market containing only SFBB products provided over the Openreach network, and a market containing all products provided over the Openreach network. The market definition in this case is almost certainly asymmetric, and Ofcom must fully assess SMP in each of these separate markets.

2.14 These very significant flaws in product market definition undermine the remainder of Ofcom’s analysis in the WBA Market Review proposals. Ofcom should readdress its market definition, and then amend the remainder of its proposals as required. The harm caused by these failings will likely persist not just in this market, but in other market reviews that build on the erroneous methodology and findings.

2.15 However, we include TalkTalk’s views on the remainder of Ofcom’s findings so that they can be taken into account at this stage in the consultation process.

2.2 Geographic market definition

2.16 Ofcom’s section 4 addresses geographic market definition. In effect, Ofcom concludes that it should revise its geographic market definition from the 2014 WBA to reach a narrower definition of Market A, representing a smaller proportion of the country.

2.17 This conclusion is flawed, and cannot stand, as it is based on a misunderstanding of the manner in which the major operators other than BT run their businesses. Ofcom should revert to the geographic market definition which it adopted in the 2014 WBA

⁵ Ofcom, *op. cit.*, §3.21

⁶ Ofcom, *op. cit.*, §3.26

⁷ Ofcom, *op. cit.*, §3.28

⁸ Ofcom, *op. cit.*, §3.34

⁹ Ofcom, *op. cit.*, §3.35

¹⁰ Ofcom, *op. cit.*, §3.43

review, amended if necessary to reflect further unbundling of the market and changes in product market definition since that earlier review.

- 2.18 Ofcom have assumed that a PO is present in an exchange if either that exchange is unbundled (for LLU) or if GEA is offered in >65% of homes. An exchange is then designated in market B, and hence will not be found to have SMP, if there are more than two POs in addition to BT. The effect of this methodology is that Ofcom considers exchanges where there is no unbundling but GEA is offered are competitive. This does not reflect the reality of how CPs (and most relevantly Sky and TalkTalk) actually offer services and act as a constraint on BT.
- 2.19 TalkTalk does not offer FTTC based broadband outside the areas which it has unbundled - we have divested our customers at exchanges where we have not unbundled, [redacted]. Based on our understanding of the market, and of Ofcom's §4.14, TalkTalk also understands that Sky and Vodafone also do not serve customers in these areas. Therefore it is incorrect to consider that there is any competitive constraint against BT in exchanges that are not unbundled but where FTTC is offered. These exchanges should be classified in market A rather than market B.
- 2.20 There is a clear reason why Sky, TalkTalk and Vodafone do not offer services to customers in non-unbundled areas. Irrespective of whether a customer takes an SBB or an SFBB service, we need to provide them with a copper line, which can be based on Openreach's WLR or MPF products. [redacted].¹¹[redacted].
- 2.21 At §§4.16-4.20, Ofcom assesses the common pricing constraint arising in different geographic areas. It correctly finds that BT charges different prices in different parts of the country across several of its brands, particularly those which compete on price more aggressively such as Plusnet, which leads to the prices in Market A areas being higher than those in Market B areas. In the same way, TalkTalk, Sky and Vodafone do not sell to consumers in most Market A areas. TalkTalk, for example, only sells at exchanges where we have unbundled. Ofcom is therefore correct to find that there is no common national pricing constraint.
- 2.22 Similarly, Ofcom is correct to find at §§4.26-4.37 that the exchange is the relevant geographic unit to consider when assessing geographic market definition. This is [redacted], and whether or not an exchange is unbundled is the crucial determinant of the extent of WBA market competition in a local area. A move to a cabinet level approach would add additional complexity to Ofcom's analysis without creating a meaningfully more accurate determination of the conditions of geographic market competition.
- 2.23 In light of the product market definition considerations outlined above, when it has redefined product markets, Ofcom should reconsider whether Virgin Media should be included as a PO for the purposes of the WBA market analysis. If it determines that cable broadband is not in the relevant product market, then Virgin Media should no longer be treated as a PO. If that is the case, then Ofcom may also need to

¹¹ [redacted].

reconsider whether a BT + two POs threshold should be used, or whether it would be more appropriate to move to a BT + one PO threshold.

- 2.24 TalkTalk therefore considers that the analysis of where POs are present, based on fibre coverage, is fundamentally flawed and should be restarted by Ofcom. It is only where a PO is willing and likely to sell FTTC based broadband that the PO should be considered to be present; and the mere presence of FTTC capabilities is insufficient to determine this. Ofcom has overstated the proportion of the country where there is competition in the WBA market. This leads to an underestimate of the geographical extent where SMP is held by BT.

3 Market power

- 3.1 Ofcom's approach to market power determination is appropriate. In particular, it is appropriate for Ofcom to find that BT holds SMP in Market A, but does not hold it in Market B. However, the multiple errors in Ofcom's in market definition mean that although it is correct that BT holds SMP in Market A, there will also be a number of Market B exchanges where BT holds SMP, but where Ofcom has incorrectly found there to be 2 POs present in addition to BT.
- 3.2 In particular, with respect to Ofcom's (overly narrow) Market A, Ofcom's review of BT's return on capital employed is an appropriate measure of market power to consider. It is also correct to find that there are significant barriers to entry into the WBA market, as such entry requires either network construction or unbundling exchanges and the associated costs of doing so. It is also correct to find that there is no countervailing buyer power. TalkTalk considers that similar findings are likely to be reached regarding an appropriately calibrated Market A, but that Ofcom should redo its analysis once it has redefined its product and geographic markets.

4 Remedies

- 4.1 This section addresses the remedies which Ofcom proposes to apply in Market A. It is without prejudice to Ofcom having understated the extent of Market A; however, it is likely that a similar set of remedies would be required in an appropriately delineated Market A.
- 4.2 Ofcom's findings regarding the potential competition concerns in Market A, at §6.6, is appropriate. In particular, Ofcom is correct to find that:
- BT would have the incentive and ability to... fix and maintain some or all of its WBA prices at an excessively high level or engage in a price squeeze.*
- 4.3 Ofcom is also correct to find (§§6.8-6.11) that competition law would be insufficient to address the competition concerns in Market A, and in particular that competition law would be unable adequately to address excessive pricing issues. It is also correct

that the impact of Openreach reform is sufficiently limited that it will not impact the manner in which BT provides services to Market A (§§6.13-6.19).

4.1 Excessive pricing and price caps

4.4 However, Ofcom's analysis of the risk of excessive pricing, at §§6.30-6.35, is wrong and fails to reflect BT's incentives and ability to set excessive prices if Ofcom does not apply charge controls in the WBA market.

4.5 Ofcom states that BT has maintained its price for its main brand for the past few years, even when Market A was considerably larger. However, this fails to reflect several changes in circumstances:

- it is only fairly recently that TalkTalk and Sky have stopped offering broadband in off-net areas. BT was therefore subject to a pricing constraint in previous years that no longer exists. The change in competitive constraints in Market A areas makes it more likely that BT would choose to regionally disaggregate pricing for BT Retail in the next market review period.
- BT has acquired EE in the past three years. Prior to that, EE was offering broadband on a national basis, including in market A areas, and would have imposed a competitive constraint on BT. That competitive constraint has been eliminated via the BT/ EE merger.
- BT has historically been regulated in Market A at the WBA level, making it easier for other providers to enter at a competitive price. In the absence of WBA regulation, BT could set its WBA pricing at a supranormal level, and then increase its retail price. BT would be protected from a loss of retail market share by the higher cost base of entrants, which would have to pay BT's excessive WBA charges. It could therefore take profits upstream while setting competitive retail margins, making retail entry unprofitable at the same time as setting an excessive end-to-end price to consumers.

4.6 Ofcom also states that there would be additional marketing and sales costs for BT in offering different tariffs in Market A. However, this has not provided sufficient incentive to push its Plusnet and EE brands to offer a single national tariff; both these brands have preserved geographically disaggregated pricing. As such, it seems likely that these extra costs are low relative to the additional profits which can be earned by geographic price discrimination.

4.7 Finally, Ofcom states that there would be a risk to BT's brand reputation in the event that it chose to move to geographically disaggregated prices, particularly in light of the political concern around rural broadband pricing. However, this risk is overstated. BT already has geographically disaggregated prices via its sub-brands Plusnet and EE, which are generally more aggressively priced than its BT Retail brand; it therefore already has higher prices in rural areas. Furthermore, BT can engage in geographic price disaggregation via below the line discounting as well as above the line discounting. For example, [§<]. Such programmes of meeting

competition— which may become more prevalent in future—would further open the price gap between competitive Market B and uncompetitive Market A areas.

4.8 The degree of competition in Market A might also influence the extent to which BT Retail customers are able to obtain discounts through retention activity. Knowing that there is no competition in Market A areas, BT could construct its CRM system to decline to offer any discounts to customers threatening to leave in these areas. This would enable the average price in Market A areas to be increased above that in Market B areas, without any change in headline pricing.

4.9 The Competition Commission, in its *Groceries* market investigation, considered similar issues in the context of a market where the main participants had national pricing policies, and where the argument about brand damage made by Ofcom was put to the CC in near identical terms by Tesco.¹² The CC rejected the retailers' contentions that national pricing structures were a necessary feature of the market, despite these submissions. This led to the CC's view that:

a store facing little local competition will not need to engage in 'extra' activities to attract customers. Fewer voucher campaigns, less attention to stock and a reduced range of products are, for example, the result of a less competitive environment. The more particular the activity is to the local market, the less easy it will be to identify systematic variation in individual aspects of the retail offer. However, if such variation does have an effect, it will show up in the store profit margin.¹³

4.10 A similar set of factors is likely to occur in an unregulated Market A, with fewer retention discounts, no locally specific offers, and higher prices from BT's fighting brands. The exact manner in which BT will exploit its SMP in Market A areas depends upon the specificities of BT Retail's customer management processes, [§<].

4.11 We note that Ofcom does not appear to have undertaken any analysis of BT Retail's margins from serving customers in Market A areas, compared to Market B areas. The profitability analysis which it has undertaken in Market A areas (which is at the upstream WBA level) found very high levels of profitability, which would be consistent with BT being able to flex its offer locally to exploit customers even in the presence of the current charge controls.¹⁴

4.12 Higher wholesale broadband prices in Market A areas are likely to lead to the reduction in scale or exit of the few existing competitors such as the Post Office. Ofcom's proposals at §§6.27-6.29 of its consultation paper are weak, and amount to little more than a statement that Ofcom will apply the provisions of the Competition Act (as it is in any case legally obliged to) in the event that BT is alleged to apply a margin squeeze on retailers active in Market A. There appears to be no proactive monitoring of margins, and Ofcom has proposed an Equally Efficient Operator (EEO)

¹² See Competition Commission (2008), *The Supply of Groceries in the UK market investigation*, at footnote 4 to §6.31.

¹³ Competition Commission, *op. cit.*, at §4.109

¹⁴ §5.15 of Ofcom's consultation document.

standard for apply margin squeeze protection, which may not provide enough room for smaller retailers to continue to exist in the market; there are no scale operators serving Market A areas other than BT.

- 4.13 Ofcom simply puts forward no regulatory proposals to protect these small operators. It effectively relies on general competition law, which is slow-moving, complex, and is unlikely to come into effect before smaller, weaker operators have been crushed.
- 4.14 Ofcom's contentions at §6.34 that '*we do not expect that even if we put a wholesale charge control in place, this would result in significantly greater retail competition in Market A going forward*' is misplaced. The aim of regulation in this case is not to enhance competition, but merely to protect what little competition remains in Market A, and prevent the market being completely monopolised by BT. Ofcom is failing to do this, and its inaction will lead to an increasingly dismal competitive environment for consumers in Market A areas.
- 4.15 Finally, some of Ofcom's reasons for failing to price regulate in Market A areas appear to be entirely speculative. For example:

with a reduced size of Market A it is possible that the unit costs of serving customers may be higher for the remaining premises served in Market A. There is therefore a risk that if we were to put a charge control in place that it might compromise incentives to invest.

It is inappropriate for Ofcom to speculate in this way; it should rather have ascertained the unit costs of serving Market A customers using data requests and modelling. In any case, as explained in section 2.2 of this paper, Ofcom has incorrectly defined the geographic scope of Market A, and Market A is therefore unlikely to have changed significantly in scope, which means that this argument is perforce wrong.

- 4.16 Ofcom's proposals to impose a condition that WBA in Market A is supplied on fair and reasonable terms is irrelevant; it makes no practical difference whether or not it is imposed. As Ofcom makes clear at §6.36 of its consultation, 'fair and reasonable' is, in this context, synonymous with not engaging in a margin squeeze which would in any case contravene the Competition Act.
- 4.17 Overall, therefore, Ofcom's proposal to deregulate the pricing of WBA products in Market A is fundamentally flawed. It has presented no meaningful evidence in support of its proposals, which are likely to have harmful consequences for consumers and competition. Ofcom should reconsult on the basis of a charge control being imposed in Market A.

4.2 Other remedies

- 4.18 TalkTalk agrees that the requirement not to discriminate and provide services on an EoI basis is necessary and proportionate in this case. BT holds SMP, and without these remedies in place it would have another mechanism (in addition to setting excessive wholesale broadband prices) for eliminating downstream competition.

- 4.19 Similarly, we agree that it is necessary for BT to be obliged to give at least 28 days' notice of changes to pricing, terms, and conditions of wholesale broadband products offered in Market A (§§6.86-6.92); to notify changes to technical information (§§6.99-6.102); and to publish quality of service information (§§6.109-6.115). All of these are required to help create a level playing field for retailers in Market A; however, in the absence of price regulation they will be of little benefit.
- 4.20 Accounting separation and a cost accounting obligation are also required, not only to support EoI obligations, but also to help Ofcom regulate other markets more effectively. In the absence of a cost-oriented charge control on WBA products in Market A, BT will have strong incentives to transfer costs from Market A into other regulated products, to increase their allowed price caps. Continued accounting separation will make this form of regulatory gaming more difficult for BT to undertake. In this regard, TalkTalk agrees with Ofcom's arguments at §6.144.