

Fixed Narrowband Retail Services Market Review

Response by KCOM

4 June 2009

Introduction

KCOM welcomes the opportunity to comment on Ofcom's proposals in respect of the fixed narrowband retail services market. Given the changes which have occurred in this market since the last review was undertaken we believe that Ofcom's review is timely and highlights some important developments which necessarily have an impact on the level of regulation which might now be considered appropriate in respect of retail narrowband services.

While our response is largely limited to Ofcom's analysis of the market in the Hull area and the conclusions which have been drawn, we are broadly in agreement with the proposals to deregulate BT's provision of fixed retail narrowband services. This is with the caveat that Ofcom's proposals in respect of the continued regulation of BT's wholesale narrowband services are confirmed.

Having reviewed Ofcom's conclusions we believe that they understate the extent of the competitive constraints faced by KCOM in the markets being considered, specifically:

- The extent of mobile substitution in the Hull area is likely to be more pronounced than in the rest of the UK due to the absence of the wider choice of fixed line providers available outside of the Hull area.
- The impact of leased lines substitution in the business analogue exchange lines and calls markets has been substantially underestimated. In particular if traffic using leased lines to bypass the PSTN is taken into account in the business calls market, KCOM's market share is substantially lower than estimated by Ofcom and no longer justifies a finding of SMP and the imposition of regulatory remedies.

We also believe that there is the potential for a more light touch regulatory regime to be applied in those markets where KCOM does retain market power and have proposed voluntary undertakings which we believe represent a more proportionate approach to regulation in the Hull area.

Finally, we welcome Ofcom's recognition of the need to ensure that Hull residents are not unduly disadvantaged compared to residents in the rest of the UK, particularly in respect of service bundles. This is already a very real issue for our customers and one that will be exacerbated as bundling of services in the rest of the UK becomes the norm. We believe that KCOM should be allowed to bundle services and are willing to provide comfort in the form of voluntary undertakings applicable to the SMP elements of any bundle together with a voluntary commitment to a price floor to apply to any broadband element of any bundle.



Question 4.1 Do you agree with our proposed market determinations for the UK excluding Hull and for Hull? If not, please provide reasons and your alternative proposals for the market structures?

We agree with Ofcom's proposed market determinations for the UK excluding Hull and for Hull.

We recognise the issues that Ofcom has identified in terms of substitutability including variations in customer attitudes, actual evidence of substitution and the pricing strategies of fixed call operators which has led Ofcom to conclude that it is unclear as to that substitution is sufficiently strong for fixed and mobile calls to be considered in the same market. However we do have concerns about Ofcom's conclusions regarding the substitutability of mobile calls for fixed calls in the Hull area.

The geographic spread of the customers questioned on the issue of fixed-mobile substitutability is unclear from the evidence presented and this raises a particular concern for us. We believe that customers in the Hull area may well demonstrate a greater inclination to substitute fixed calls with mobile calls in the absence of the more extensive choice of fixed line providers available to customers outside of the Hull area. For example, during the period 2005 - 2007, KCOM experienced a 14.5% decrease in volumes of residential geographic, IDD and calls to mobile. By comparison annual volumes of the same residential calls for all operators reported in Ofcom's Telecoms Market Data Tables published in Q4 2006, 2007 and 2008 decreased by only 10%. We believe this is illustrative of an increased tendency by customers in the Hull area to substitute fixed line calls with mobile calls.

Even if Ofcom continues to conclude that fixed and mobile calls are not in the same market, we note Ofcom's comment at paragraph 4.4 that "...what matters for an assessment of SMP is not so much whether mobile lies just "inside" or just "outside" the market but rather the constraint it imposes on the price of fixed access and calls." We believe that the constraint which mobile places on fixed line calls in the Hull area may be greater than that in the rest of the UK.

We are also concerned about the extent of the analysis which Ofcom has undertaken in respect of the substitution of fixed calls with mobile by business customers. At paragraph 4.95 Ofcom makes the comment that it does not have data of sufficient quality to determine the extent to which business have substituted to mobile while the customer research carried out by Ofcom is largely focused on very small business customers (84% of the SMEs questioned had 1-9 employees).¹ We question how representative Ofcom's survey sample is in terms of mobile usage by businesses – as Ofcom notes mobile penetration was found to be much higher in the larger companies surveyed with large companies more likely to use a mix of landline and mobile services. As a result we believe that Ofcom's research may well understate the propensity of business customers to substitute mobile calls for fixed line calls.

Finally we note that Ofcom has not addressed the issue of voice calls which bypass the PSTN such as VoIP calls or calls which are conveyed over alternative access

¹ SME Preferences in Narrowband Communications Research Report 19 March 2009

mechanisms such as leased lines. We address this point further below in response to Ofcom's analysis of the business calls market in the Hull area.

Question 5.2 Do you agree with the analysis set out above for the residential analogue access markets in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

KCOM accepts that there is no evidence of significant market entry in the Hull area by alternative providers offering residential analogue access lines.

However, we do not accept Ofcom's conclusion that there remain significant barriers to entry in the Hull area. Rather than acting as a disincentive to invest, the relatively small size of the Hull market offers competing providers access for a comparably small investment either in their own infrastructure or through the use of wholesale products offered by KCOM. This is particularly the case for the larger competitive CPs who have entered the UK market and grown their customer base significantly since Ofcom undertook the last narrowband market review and now benefit from much larger economies of scale and scope than KCOM. We believe that this threat of entry has only intensified given the propensity for competitive CPs to offer bundled packages which enable even greater advantage to be taken of their extensive economies of scale and scope.

The fact that we believe competitive entry remains a very real threat is evidenced by our pricing of retail services which Ofcom has noted is broadly comparable with that offered by BT. Furthermore, we are very aware that our customers have a very clear view of offers available to consumers in the rest of the UK market and as such will not hesitate to tell us if our pricing, products or customer service compares negatively with that available through other providers. As such our own customer base acts an effective constraint. Despite the lack of significant market entry by competing providers, KCOM is not in a position to act independently of the wider market.

We also believe that the introduction of NGA has the potential to prove an even greater constraint than those we currently face. Ofcom has not analysed the impact of the roll-out of NGA on the retail narrowband markets, but given the plans which have been announced we see it as being a key issue over the timeframes for this market review. In planning investment in new infrastructure, investment in a new geographic area such as Hull would represent a very small increment for an alternative provider and offer the opportunity of access to a new market. We would therefore expect Ofcom to carry out further analysis of the likely impact of NGA developments over the coming 4-5 years.

Finally we note Ofcom's comment at paragraph 5.100 that "there appears to be limited appetite to enter the Hull area". Quite apart from any finding of SMP this in itself raises issues regarding the potential negative customer impact of the application of regulatory remedies if there is little hope for efficient market competition. Competition in the rest of the UK is now based on an extensive range of bundled offerings, particularly those combining an access line, calls and broadband. If it proves to be the case that there is no little prospect for competitive entry in the Hull area then we believe that customers will effectively be denied access to services available in the rest of the UK due to the constraints of the regulatory regime. We provide our specific comments on the issue of bundling below.



Question 5.4 Do you agree with the analysis set out above for the business analogue access markets in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

We note that although Ofcom recognises that some CPs offer fixed exchange line services by other means in the Hull area (e.g. leased lines or fixed radio access) no estimate is given of the market share this represents. Rather the only figures given are the number of business exchange lines provided by KCOM during 2006/07 and 2007/08 which Ofcom concludes is a high market share creating a presumption of market power.

In its statement on the Business Connectivity Market Review published in December 2008 Ofcom concluded that KCOM no longer had SMP in the retail market for low bandwidth TI leased lines based largely on KCOM's low market share of 25%. This would suggest rather more extensive use of alternative access methods than suggested by Ofcom and must be taken into account by Ofcom in assessing the constraints which apply to KCOM's provision of business analogue exchange lines.

We also reiterate the concerns expressed in relation to residential analogue exchange lines. We believe that there is an even more significant threat of entry by competitors in the market for business access services which acts as an effective constraint. In particular the increased use of data services by businesses and lower cost leased line solutions mean that alternative access mechanisms which can also be used for voice traffic are becoming increasingly attractive for ever smaller customers creating a real risk of further attrition of KCOM's analogue exchange lines business.

Question 5.6 Do you agree with the analysis set out above for the ISDN2 market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Ofcom has concluded that the prospect of significant entry in the ISDN market appears muted, particularly as this is a product nearing the end of its lifecycle with customers opting for alternative technologies to provide the functionality they require. For these reasons we believe that the continued application of regulatory remedies is no longer justified.

Question 5.8 Do you agree with the analysis set out above for the ISDN30 market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Similarly to ISDN2, Ofcom recognises that growth of ISDN30 is likely to slow as customers migrate to IP based solutions which in turn impacts on the likelihood of further competitive entry. Again, in these circumstances we believe that the continued application of regulatory remedies is unjustified.



Question 6.2 Do you agree with the analysis set out above for the residential calls market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

We refer Ofcom to the points made earlier in relation to fixed to mobile substitution, particularly the constraint which mobile is likely to place on KCOM's behaviour in relation to the pricing of call services for residential customers.

Clearly there has been a degree of substitution from fixed to mobile call services particularly with the advent of inclusive minutes packages. Ofcom's analysis shows that as at Q3 2008 there has been an almost 60% decrease in residential call volumes relative to Q2 2004, while data from Ofcom's Communications Market Reports shows that over the same period mobile call volumes have risen by approximately 40% for UK calls only. We do not feel that the real extent of this substitution has been explored fully by Ofcom, particularly in light of the limited range of fixed alternatives actively marketed to Hull customers. As a result we believe that the degree of fixed to mobile substitution in the Hull market may well be higher than is the case in the rest of the UK and the constraint which mobile places on fixed line calls in the Hull area is likely to be greater. We note that at paragraph 6.29 Ofcom states that "most consumers want the same provider for both lines and calls" however, there appears to have been no specific research carried out on consumer preferences in the Hull market and what Hull customers would do in the event of an increase in call prices. We would suggest that there is a real likelihood that an increase in call prices would result in further mobile substitution. This requires further specific analysis by Ofcom.

As Ofcom has noted wholesale remedies are in place in Hull should other CPs wish to offer services to customers. KCOM has on a number of occasions held discussions with other providers interested in the provision of call services to customers in the Hull area and we do not agree with any suggestion that there remain significant barriers to entry. As we noted earlier, the relatively small size of the Hull market offers competing providers access to the market for a comparably small investment, particularly where they can utilise wholesale products to provide call services. This threat of competitive entry is a very real constraint on KCOM's behaviour in the pricing of its retail call services and as Ofcom's analysis has shown there is no evidence that KCOM has exploited its retail customers.

As a result we do not believe that the current regulatory remedies are justified or proportionate and, as we have already mentioned, may act to place Hull customers at a disadvantage in terms of the choice of service packages which can be offered. We suggest some alternative approaches which might be taken to remedies in response to question 7.3 below.



Question 6.4 Do you agree with the analysis set out above for the business calls market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

KCOM does not agree with the analysis which Ofcom has undertaken in relation to the market for business calls in the Hull area and suggests that it no longer holds a position of SMP in this market.

In Figure 6.9 Ofcom provides data which shows KCOM business call volumes over time. The first point we would make is that as at Q3 2008 there has been a decrease of approximately 40% in the volume of geographic, international and calls to mobile relative to Q2 2004. This represents a significant decrease and clearly points to a degree of substitution by business call users. Secondly, during 2008 KCOM's business call volumes have shown a marked decrease compared to the rest of the UK with a differential of close to 10%. This differential requires further investigation.

We believe that Ofcom has substantially underestimated the overall size of the business calls market in Hull. Ofcom's analysis concludes that fixed calls to business customers via indirect access and alternative means such as leased lines account for a very small proportion of the market on the basis that information provided by KCOM on average monthly minutes from February 2008 to January 2009 shows that indirect access minutes (both residential and business) are 10% of total outbound revenue. In fact for the same period business indirect access minutes accounted for 26% of total outbound business minutes (excluding local).

Furthermore, this does not take account of business calls which are carried over leased lines supplied to customers by either KCOM or an alternative provider. As discussed earlier, in its statement on the Business Connectivity Market Review published in December 2008 Ofcom concluded that KCOM no longer had SMP in the retail market for low bandwidth TI leased lines based largely on KCOM's low market share of 25%. We believe that this finding also has a knock-on effect in the context of the market for narrowband business calls.

Most larger or corporate entities operate private networks over a wide area, which are used for internal voice and data traffic. They are also used to transport services, including "PSTN" voice intended for destinations external to the private network to designated "breakouts", which are generally chosen because of favourable costs, for underlying economic reasons ("far end termination" for example) or because of better commercial deals being available. In the rest of the UK market where this breakout occurs is immaterial – the traffic of whatever nature can be identified wherever it appears. For Hull, however, this is not the case and undoubtedly leads to significant underestimation of the size of the overall business calls market and overstatement of the KCOM share.

We have undertaken some modelling looking at leased lines provided by KCOM to other CPs and business customers where only one end of the leased line is within the Hull area. We firstly calculated the number of 64Kbit/s channels provided over the leased lines in question and then assumed an overall average utilisation of 50% for each of these channels. We then applied further assumptions concerning the level of voice traffic utilising these channels depending on bandwidth to provide us with a view of the level of voice utilisation of each circuit. Finally we calculated average minutes carried over



KCOM business exchange lines. This was done by dividing average KCOM's average business minutes for 2007 (national, IDD and calls to mobile with local minutes excluded) by 2007 total business exchange lines. We then applied the voice utilisation percentage per 64Kbit/s channel to the average minutes. This provided us with a view of voice traffic being carried over these leased lines with only one end in Hull which is effectively bypassing the PSTN.

From a base of some 96,000 64Kbit/s channels our calculations estimated that approximately  million minutes p.a. are being carried by leased lines terminating outside of the Hull area. Combining this figure with 2007 average business call minutes (national, IDD and calls to mobile with local minutes excluded) with estimated bypass traffic provides a view of the overall market size of which bypass traffic accounts for 25%. This is in addition to indirect access calls which accounted for 26% of total outbound business minutes based on average monthly minutes from February 2008 to January 2009. It should also be noted that this does not include minutes for which substitutes are being used – mobile, VoIP, email.

We therefore estimate that KCOM's share of total business call minutes originating in the Hull area is below 50%. This is significantly below Ofcom's estimate and insufficient to support a finding of SMP.

We cannot accept Ofcom's view that the prospect of entry in the business calls market in Hull appears muted. There has already been significant entry and as more customers switch to leased line solutions to meet increasing data needs we foresee further loss of voice call minutes and revenues. We also note that Ofcom's comparison of KCOM and BT's nominal revenue per minute for geographic, international and calls to mobiles shows that KCOM's revenues per minute are lower, a further factor which supports our view that very real competitive constraints exist in the Hull market and that KCOM no longer holds a position of SMP.

We would urge Ofcom to reconsider its conclusions in respect of the business calls market in Hull in light of this analysis. We are happy to discuss this issue further and share our analysis with Ofcom.

Question 7.3 Do you agree with our continued imposition of retail price publication and no undue discrimination remedies on KCOM in Hull? If not, please state your reasons and your suggestion of the appropriate response to the SMP findings?

We agree with Ofcom's conclusion that increased intervention in the form of price controls is not justified in the Hull market. As Ofcom notes there is no evidence that KCOM charges are noticeably out of alignment with national charges. However we are disappointed that Ofcom continues to believe that it is appropriate to impose price publication and undue discrimination remedies.

In paragraph 7.8 Ofcom refers to the need to ensure that Hull residents are not unduly disadvantaged compared to the rest of the UK. We fully agree that this is vitally important and are only too aware of our customer concerns and their perception that services or packages available in other areas of the UK are simply not being made available to them. The ability to provide a bundle of services which includes broadband is a particular issue which we address further below in response to question 7.4.



More generally, the current regulatory remedies also prevent us from taking a more innovative approach to the pricing and packaging of access lines and calls. For example, some providers are now offering the ability for customers to build their own packages which ensure that customers are able to select the range of services they want at the best price possible. The current regulatory remedies make it impossible for KCOM to do this and consequently result in customers in the Hull area effectively being discriminated against as a result of regulatory constraints.

As we have previously indicated to Ofcom, we believe that there is the potential for a lighter touch regime to be imposed in the residential calls and access markets, particularly in the light of the effects noted above. Certainly, there has been no evidence of issues arising in terms of compliance with the current obligations or of any consumer harm.

As an alternative approach to formal remedies in the retail access and call markets we would like to explore the possibility of voluntary undertakings primarily designed to provide both consumers and other CPs with an appropriate level of visibility and certainty regarding Kingston's retail offerings:

- An undertaking to publish prices as currently required by the SMP conditions.
- An undertaking to benchmark prices against an identified BT entry level package and not to increase prices above those benchmarks.
- An undertaking that taken together the elements of any package will not fall below cost.

With regard to the markets for business calls and access, on the basis of the analysis we have carried out we do not believe there is evidence to support a finding of SMP in the business calls market. Furthermore, we believe that there are very real constraints on KCOM's provision of analogue exchange lines to businesses which arise from the competitive nature of the market for low bandwidth TI leased lines used to provide alternative access options for customers. For these reasons we do not believe that the continued application of regulatory remedies to KCOM's provision of analogue exchange lines and calls to businesses in the Hull area is appropriate.

Question 7.4 How would you view a proposal for a new bundled service in Hull mixing narrowband and other services at reduced total cost? What is your view of the options presented for considering such a proposal? If we were to consider allowing such a proposal what criteria would you consider necessary for the service to adhere to?

KCOM welcomes the fact that Ofcom recognises that with the deregulation of BT the likely move towards packages which bundle narrowband services with other services such as broadband has undesirable impacts for Hull customers. We would argue that this is already an issue given the prevalence of bundled offers available now in the UK of which Hull customers are only too aware due to national advertising campaigns. The inability to bundle services also creates problems of perception – often customers believe that there has been an active choice on the part of KCOM not to offer bundled services



and do not appreciate the regulatory constraints which stop us from packaging services in this way.

We fully agree with Ofcom's view that there is a need to ensure that Hull residents are not unduly disadvantaged compared to residents in the rest of the UK. However, we believe that they are being unduly disadvantaged as a result of Ofcom's current interpretation of the undue discrimination obligation which assumes that bundles of SMP and non-SMP products would be likely to be unduly discriminatory. As Ofcom notes this is particularly in relation to broadband where customers increasingly view it as a core service, with bundles incorporating low cost broadband offering the possibility of access to a wider range of customers.

We believe that the potential for disadvantage will also be exacerbated should the Government confirm a Universal Service Commitment for the provision of broadband services of a minimum specified speed. We do not think it is likely that any provider identified as the provider of a broadband USC in a particular geographic area will be forced to adopt a different approach to bundles in that area than it does in other geographic areas, particularly if they are already offering services in the USC area. In these circumstances KCOM is of the view that a continuation of the current policy with regard to bundling and undue discrimination is unsustainable.

We have already suggested a number of voluntary undertakings as an alternative approach to formal remedies in the retail calls and access markets. We believe that similar undertakings applied in respect of the SMP aspects of any bundle could equally provide the comfort required in respect of any bundled offerings. In addition we would be willing to agree to a voluntary commitment for a price floor to apply to any broadband element of a bundle based on wholesale broadband prices. We are happy to discuss further with Ofcom, in particular the approach we might take to the bundling of services.

