



**Review of the wholesale broadband access markets
Consultation on market definition, market power determinations and
remedies**

TalkTalk response

Non-confidential version

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1 Introduction

- 1.1 This is TalkTalk Group's (TTG) response to Ofcom's consultation on the Wholesale Broadband Access Market Review.¹
- 1.2 TalkTalk Group provides broadband to over 4 million residential and business customers principally under the TalkTalk and TalkTalk Business brands. We are the UK's biggest local loop unbundler, operate the UK's largest next generation network (NGN) and are BT Openreach's largest external wholesale customer.
- 1.3 Our main points are as follows:
 - Ofcom has reached broadly appropriate conclusions on the relevant product market definition, although the method by which Ofcom has reached those conclusions is not best practice;
 - We consider that a 'three market' approach to geographic market definition remains somewhat preferable to Ofcom's 'two market' approach, but that Ofcom has allocated geographic areas in the correct way, given that a two market approach is preferred;
 - We agree both that BT has market power in Market A, but not in Market B, and that it is appropriate to impose a charge control on BT in Market A.

2 Market definition

- 2.1 Overall, TalkTalk believes that Ofcom's conclusions on market definition in the WBA market (and its related conclusions on market definition in retail broadband markets) are appropriate and well argued. We believe that the conclusions reached by Ofcom are broadly accurate and in line with the current available information.
- 2.2 This section provides TalkTalk's more detailed thoughts on the different areas of market definition set out by Ofcom in the WBA consultation.

2.1 Product market definition: retail market

2.1.0 Methodology of product market definition

- 2.3 Ofcom correctly starts its analysis of product market definition by considering the retail level. A sufficiently high level of substitution at the retail level can lead to products imposing competitive constraints on one another at the wholesale level, as wholesale price increases are passed on to the retail level, and the changes in relative retail prices lead to consumer substitution. This substitution by retail

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consumers in turn changes demand at the wholesale level, disciplining wholesale providers from increasing their prices.

- 2.4 However, throughout its WBA consultation, Ofcom fails to address the issue of the degree of substitution required at the retail level to lead to competitive constraints at the wholesale level. In formal terms, the degree of consumer substitution required will depend upon:
- the degree of pass-through of wholesale price changes into retail prices, which will itself depend upon the form of competition between different retail providers of consumer broadband; and,
 - the profit margins which are made by suppliers of wholesale broadband products.
- 2.5 Nowhere in its consultation does Ofcom address either of these issues. Rather, it consistently (and usually accurately) cites evidence that there is consumer substitutability between different retail products, and/ or evidence of similar product characteristics, and then takes this as sufficient evidence that indirect constraints will exist at the wholesale level.
- 2.6 As such, Ofcom has only pulled together part of the evidential base which is required to conclude that various products impose competitive constraints on one another at the wholesale level. Essentially, there is an implicit assumption that where Ofcom has identified consumer substitution at the retail level, this is sufficient to lead to a single product market at the wholesale level, without further answering the question of *how much* substitution is required, much less attempting to quantify whether the actual level of substitution observed is greater than this level.
- 2.7 We therefore do not believe that Ofcom has informed its market definition exercise using the hypothetical monopolist test, as set out in §3.13 of the WBA Consultation. Ofcom should have undertaken this test in a more systematic manner, using data specifically gathered to enable results to be derived from the test.²
- 2.8 Effectively, we believe that Ofcom has reached the correct outcome, but the process by which it has reached this outcome is deeply flawed. Although this is of limited importance in the current consultation, we believe that this makes it difficult to rely on the conclusions of this WBA market definition exercise in future Ofcom reviews, as there is no way of ascertaining how likely conclusions are to change. It also potentially makes it more likely that Ofcom's market definitions will be appealed, as they lack robustness and an appropriate evidential base.
- 2.9 TalkTalk agrees that the modified greenfield approach, as set out at §3.15, is the appropriate approach for undertaking market definition. We also agree that if WBA remedies were not imposed, there would continue to be supply from LLU operators,

² For example, Ofcom could have conducted consumer research into substitutability in order to calibrate the test, particularly using conjoint analysis. Alternatively or in addition, econometric analysis could have been undertaken using data sourced from various ISPs in order to determine consumers' reactions to changes in relative prices.

BT and Virgin Media in areas where these firms are active, which might impose a competitive constraint on a provider of WBA.

2.1.1 Copper, cable and fibre supply

2.10 TalkTalk agrees that it is appropriate to examine whether all of copper, cable and fibre are in the same market by considering different broadband speeds (§3.21).³ Moreover, we believe that in this case where the same broadband speed is available over copper and cable, or fibre and cable, then these products are likely to be in the same relevant economic market.

2.1.2 Broadband speeds

2.11 TalkTalk believes that the evidence presented by Ofcom on substitution between differing broadband speeds, at §§3.22 to 3.52 of the WBA Consultation, is unclear as to whether SFBB and SBB products impose competitive constraints on one another, and in particular whether SBB products impose a competitive constraint on SFBB products when both are priced at a competitive level.

2.12 We disagree with the statement at §3.36 of the Consultation that *'the gradual increase in price with speeds for both residential and business packages suggests that if the price of one speed increased by a small but significant amount, a significant number of customers would switch to an alternative service with a different headline speed'*. TalkTalk considers that the primary focus of Ofcom's analysis should be on the prices of speeds at 14-20, 38-40 and 76. These are the services available over copper and fibre, and leave aside Virgin Media's cable network.⁴ There are two major reasons for us disagreeing with Ofcom's statement at §3.36:

- We do not consider that a price uplift of around 24%, for moving from a headline speed of 14-20 Mb/s to 38-40 Mb/s, represents a gradual shift. This is a significant proportionate price difference which may indicate a discontinuity in the market.
- We in any case believe that the retail prices presented in Ofcom's work are distorted by BT's ongoing margin squeeze on SFBB products. If this margin squeeze were alleviated, there would be a larger difference between the price

³ This is only the case because the form of competition being examined in WBA is at a local level. If national competition were being examined (for example, in the context of WLA), there would also be a need to consider relevant product markets based on the asymmetry of overlap between cable and loop-based internet access.

⁴ There are several reasons underlying this. Firstly, Virgin Media's coverage is considerably less than national, at around 45% of premises. As such, under a modified greenfield approach Virgin Media should be included in less than half the country. When considering WBA, there is a clear ability to engage in geographic price discrimination; indeed, this is inherent in the form of regulation which has historically been adopted in WBA. This is itself reflected in the pricing behaviour of various market participants, such as BT Plusnet which sets a different retail price depending upon the degree of competition in the local area. Moreover, Virgin Media's pricing reflects that it faces no meaningful cost differences in supplying broadband at 30 Mb/s or 60 Mb/s, which is very different from copper/fibre based providers, who face GEA charges payable to BT Openreach.

for 14-20 Mb/s and 38-40 Mb/s, and there would be a greater probability of finding that SBB packages do not impose a constraint on SFBB packages.

- 2.13 TalkTalk notes Ofcom's comment at §3.38 that '*charging a premium for SFBB is consistent with a chain of substitution*', but it is also clear that charging a premium for SFBB is not inconsistent with a chain of substitution. Rather, the existence of a price premium is not determinative evidence in either direction.
- 2.14 Similarly, the evidence of customer usage presented at §§3.39 to 3.44 is of limited assistance in determining the boundaries of the relevant market between different speeds of broadband internet connection.
- 2.15 Although TalkTalk agrees with the views expressed at §§3.45 to 3.47 – that SFBB was not a mass market phenomenon during 2012 – it is important to recognise that the market definition exercise which Ofcom is undertaking is relevant to the period between April 2014 and April 2017. Backwards looking statements regarding the market in mid-2012 offer little insight for market definition, and in any case will generally reflect average, rather than marginal, consumers.⁵
- 2.16 Overall, none of the evidence on the relationship between SFBB and SBB presented by Ofcom is determinative. As such, we reiterate our view that it is at present unclear whether SFBB is competitively constrained by SBB, and continue to believe that there will be a separate SFBB market before the end of the next regulatory control period. However, we do not have any specific evidence on the matter which would enable us to contradict Ofcom's conclusion at §3.52 that there is insufficient evidence to conclude that SFBB and SBB will be separate markets before the end of the next review period.

2.1.3 Bundling

- 2.17 TalkTalk agrees with Ofcom's view, expressed at §3.70, that in the issue of bundling, and whether customers would be willing to purchase voice and broadband services separately, is not determinative in the context of the current regulatory review.
- 2.18 However, we believe that the market is shifting at present, such that the great majority of customers will purchase both voice calls and broadband within a single bundle, and voice calls and broadband as individual products will not impose a competitive constraint on bundled services. Most large providers have now ceased selling broadband without voice (i.e. line rental and calls) – TalkTalk no longer markets such products, and we understand that Sky and EE have also ceased doing so. As such, even if there is a legacy base of customers taking broadband independently of voice, this should not be placed in the relevant market, as there is little ability for customers to switch away from a bundle to a disaggregated service.

⁵ As with most economic analysis, market definition should be undertaken at the margin. If there have been a low number of customers who have switched from SBB to SFBB, but less than 10% of the SFBB customers at a given point in time would switch back to SBB following a 10% price increase to SFBB, then this may be sufficient for SFBB to represent a separate economic market from SBB.

2.1.4 Residential and business

2.19 TalkTalk has no comments on Ofcom's analysis of substitution between residential and business broadband products.

2.1.5 Mobile

2.20 We agree with Ofcom's analysis that mobile broadband, whether received via featurephone or smartphone, does not act as a competitive constraint on fixed line broadband.⁶ Rather, as set out at §3.98 of the Consultation, we see it as broadly complementary. The roll-out of 4G will not change this market definition, as we do not believe that 4G internet access will be able to provide the increasingly high speeds, and increasingly large bandwidth at a competitive price as demanded by fixed-line broadband customers. As set out at §3.95, 4G internet access would not be able to sustain a reasonable speed while providing sufficient bandwidth to substitute for a meaningful proportion of fixed-line internet usage.

2.1.6 Other means of internet access

2.21 We agree with Ofcom that none of symmetric broadband services, fixed wireless internet access, satellite broadband, and narrowband internet access impose a sufficient competitive constraint on fixed broadband access to fall within the relevant economic market.

2.2 Wholesale market definition

2.22 Ofcom appropriately defines the relevant wholesale market based on the outcome of its retail market definition exercise.

2.23 In line with our retail market definition exercise set out above:

- We agree with Ofcom's view (§3.137) that LLU and VULA operators impose a (direct and indirect) competitive constraint on WBA provision.
- We agree with Ofcom's view (§3.139) that cable internet access imposes a (indirect) competitive constraint on WBA provision.
- We believe that it is unclear based on the information presented by Ofcom whether copper-based access products impose a competitive constraint on fibre-based access products, as we do not believe that Ofcom has presented a sufficiently strong evidential base to demonstrate that a chain of substitution exists between different speeds of product. This differs from Ofcom's conclusions at paragraph 3.142, which we consider to be overly strong. We also disagree that direct substitution is of any meaningful relevance in this

⁶ A featurephone is a phone which has internet access, but does not have all of the features of a smartphone.

market, as the demand for fibre based wholesale access products is a derived demand. We consider Ofcom's conclusion in this area (§3.143) to be wrong.

- We agree that it is not determinative whether bundles compete with stand-alone broadband, and therefore Ofcom should not reach a conclusion on this topic (§§3.148, 3.149).
- We agree that mobile internet access does not impose a competitive constraint on fixed line internet access (§3.153).

2.24 Overall, therefore, we believe that Ofcom has reached broadly appropriate conclusions on wholesale market definition, which will not lead to material inaccuracies in market power determination.

2.3 Geographic market definition

2.25 Ofcom has made a significant change in the way it defines the geographic market by adopting a two market rather than three market structure⁷.

2.26 It seems that in practice Ofcom's methodological approach has been predicated on a starting point of there being two markets (one which will have SMP and a charge control and one which will have no SMP) and then assigning exchanges to each bucket depending on whether that exchange has SMP, rather than examining the characteristics of each market and deciding how many different markets are required to capture the differences. It is not that we disagree with this approach but rather suggest it would be useful for Ofcom to outline that this was the methodology it uses since it will tend to provide greater certainty and future regulatory predictability.

2.27 We broadly agree both with the two market structure (not least on proportionality grounds given that these markets are now quite small) and with the criteria for assignment of exchanges between the two markets:

- Market A (SMP, charge control): BT only and BT+1 other Principal Operator (PO)
- Market B (no SMP): BT+2 or more POs

2.28 We agree with Ofcom's definition of POs.

2.29 We consider that the only issue of regulatory judgement for Ofcom is whether BT+1 operator fits in market A or market B. Ideally we think markets with BT+1 would be better found to have SMP and no charge control (which would require a third bucket), but absent a third bucket it is appropriate to include them in market A. Ofcom should recognise that its approach will tend to deter further LLU roll-out since WBA prices will be regulated in areas where LLU roll-out is possible.

⁷ We ignore Hull since it is of no relevance to TalkTalk's business.

- 2.30 An important question for operationalising Ofcom’s approach is the assessment of whether a PO is present in an exchange. Both TalkTalk and Sky are continuing to unbundle exchanges and so Ofcom needs to decide what constitutes presence – an exchange having been unbundled already, or (say) plans to unbundle in next 12 months. In the last Market Review and WBA Charge Control Ofcom did not take a robust approach to this analysis (since they did not effectively update the roll-out plans when they set the charge control). We are pleased that Ofcom is taking a more robust approach this time, not only by having a more principled and transparent approach but also indicating that they will update the analysis prior to the regime coming into effect.
- 2.31 Ofcom has proposed to assume an operator will be present if a firm order is received (see Fig 4.1), since only then is it close to certain that unbundling will occur (and therefore meets Ofcom’s self-chosen criteria that the exchange is ‘committed’). However, by doing this Ofcom will miss some exchanges that should properly be in market B but are assigned to market A, meaning that Market A is too large.
- 2.32 Therefore, we think that Ofcom should consider using APO⁸ placed as the basis for deciding (which might if the APO does not turn into a firm order/build result in exchanges being assigned to market B when they should properly be in market A). Ofcom seems to want to be sure that it does not incorrectly place exchanges in market B that should properly be in market A but is happy to have errors the other way round, resulting in a bias towards the scope of regulation being overly wide.
- 2.33 Ofcom seems to suggest that TalkTalk had proposed in its response to the Call for Inputs that the geographic market definition should change during the market review period (§§2.49, 4.108). This is not correct – TalkTalk was arguing that the geographic market definition should be set as late as possible (and that Ofcom should have a process of doing this update quickly) so that it was as accurate as possible. This is what Ofcom seems to plan to do (§4.52). We were not suggesting (as BT and EE seem to) that the definition should change once the review period had started.
- 2.34 Regarding the analysis from §4.70 onwards there are many redactions. We do not understand why these are necessary – it is hardly very sensitive data. If the precise figures cannot be provided then narrower ranges can and should be used. Such excessive redactions reduce regulatory certainty and undermine confidence in Ofcom as a regulator.
- 2.35 [REDACTED]
- 2.36 [REDACTED]

⁸ APO – advanced POP order. See Fig 4.1

3 Market Power Assessment and Remedies

3.1 We agree with Ofcom's finding that BT has SMP in Market A and that no operator has SMP in Market B. We also agree with imposing a charge control on BT in Market A (as described above). We comment on some of the remedies below.

3.2 We note (at §6.55) that Ofcom considers that BT can demonstrate that it is not engaging in undue discrimination by publishing internal transfer prices:

It is essential, if the obligation to not unduly discriminate is to be meaningful, that BT is required to make transparent its wholesale prices and internal transfer prices, i.e. to demonstrate that it is not unduly discriminating against CPs. We therefore consider it necessary to retain an accounting separation requirement on BT in order to allow Ofcom, and third parties, to monitor its activities to ensure that it does not discriminate in favour of its own downstream business.

3.3 This is simply not correct. That the internal transfer price is the same or similar to the external wholesale price and there is EOI says absolutely nothing about whether BT is discriminating. BT's retail pricing behaviour does not reflect internal transfer prices but rather the cost that BT incurs – this is wholly different to external customers for whom the wholesale price equals the cost. The only way that Ofcom can be sure that BT is not discriminating would be by ensuring that the wholesale charge reflected the cost that BT faced and/or if it were shown that BT were not margin squeezing.

3.4 [X]

3.5 We note that costs and prices as between (the current) market 1 and market 2 look strange – see Fig 5.8 and also BT RFS 2013. For example:

- The unit costs in market 2 seem marginally higher than in market 1 whereas one would expect unit costs in market 2 to be lower since the exchange size is larger and so there are more scale economies⁹
- The prices in market 2 are higher than in market 1 suggesting that the constraint on prices from one additional operator is weak
- These factors are reflected in a very high return in market 2 – 32.4% in 2012/13

3.6 Regarding Hull we consider that it is disproportionate for Ofcom to spend any material regulatory efforts on regulation of WBA.

3.1 Charge control

3.7 Generally, the approach and assumptions used by Ofcom should be aligned with those used in the LLU/WLR charge control

⁹ Although BT has a larger market share in Market 1 (99% versus 80%) the exchanges in market 1 are very much smaller than market 2 and so the number of BT customers per exchange is much lower in Market 1 exchanges

- Migrations and connection should be priced at their LRIC cost and cease costs at zero
- The assumptions used for (e.g.) volumes, efficiency improvement, and cost allocations should be consistent between the two charge controls, unless there is some good reason for differences to exist – for instance, it appears that BT itself considers that there is more potential efficiency improvement in Openreach (i.e. LLU/WLR) than the rest of BT (which includes WBA)

3.8 We have a number of other comments

- At §6.80 Ofcom seems to suggest that BT only has cost minimisation incentives once it reaches the efficiency target. This is not correct – BT’s cost minimisation incentives are not dependent on where the efficiency target is set. For instance, from the LLU/WLR Charge Control

Once the charge control is set, BT will have an incentive to try to maximise profits and reduce costs regardless of whether the efficiency target has been set too high or too low. Setting the efficiency rate is therefore not about giving BT incentives but about ensuring that future prices are set at an efficient forecast cost level. (§A7.18)
- BT suggests (at §6.60) that a charge control is disproportionate since it is difficult to forecast costs. We do not consider this a sound reason since the WACC reflects the risk facing BT, providing funding to cover the expected cost of such return volatility.
- We agree that the rest of BT WACC should be used for WBA products.
- At §6.83 Ofcom says that a cost orientation only obligation at DSAC would give BT too much price flexibility. We agree. It would be useful if Ofcom could articulate the reasons why DSAC is too great in this context.
- Ofcom proposes a single basket for WBA services (§7.80). They rightly consider that homogeneity in terms of competitive conditions is necessary if the basket is to be wide (and, if the basket was heterogeneous, a narrower basket would be needed to prevent pricing abuse). However, Ofcom also needs to consider the risk of pricing abuse if the rate of internal and external use of different products differs materially.
- Ofcom argues (§7.88) that one of the reasons to use sub-caps instead of cost orientation obligations is that they can be adapted / targeted at particular products. This is not a valid reason since cost orientation could similarly be adapted / targeted.
- Ofcom has not explained how it chose the specific level of the sub-caps apart from to say it was ‘regulatory judgement’ (§7.149). Even if regulatory judgement is used there must be some underlying analysis that has provided direction to Ofcom – this should be made transparent.