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Dear Markham,

Bundling of services

Further to our previous discussions, I am writing to set out a formal proposal for the basis on which KCOM might be given the freedom to bundle SMP and non-SMP services such that Ofcom would no longer assume that those bundles are unduly discriminatory.

In the Retail Narrowband Market Review undertaken in 2009, Ofcom set out its historic position regarding the bundling of services. In particular Ofcom confirmed that its current stated interpretation of the no undue discrimination SMP services condition is that bundles of SMP and non-SMP products are assumed likely to be unduly discriminatory. This interpretation has effectively prohibited KCOM from offering bundles of services to customers in the Hull area where it is subject to a requirement not to unduly discriminate due to a finding of SMP in the provision of narrowband calls and access services.

In its consultation and statement Ofcom recognised that bundles of services could be welfare enhancing, offering customers lower prices, better value and providing some customers with access to services they might not otherwise be able to afford. Ofcom also indicated that it was open to discussions with KCOM about the manner in which KCOM might be able to offer bundled services to its customers in the future.

Bundles of services have been offered to both residential and business customers for some time now by non-SMP players. In the Retail Narrowband Market Review Ofcom identified a potential hypothetical situation where residents of Hull might be the only UK customers unable to take advantage of bundled offers should BT be deregulated. Since publication of the final statement and deregulation of BT this is no longer a hypothetical situation. BT has indeed begun to offer bundled services to its customers, increasing their prevalence in the residential market. As a result Hull residents are now the only UK customers unable to benefit from bundled offers as KCOM is prevented by regulation from offering bundled services and no alternative providers have yet chosen to enter the Hull market providing service bundles.



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We are seeing increasing demand from our customers for bundled services, reflecting the availability of such offers throughout the rest of the UK of which they are only too aware due to national advertising campaigns. We are concerned that current regulatory constraints are effectively stopping us from offering our retail customers the services which they not only want but which would benefit them in terms of lower prices and better value. Consequently we welcome Ofcom's recognition that the current stated interpretation of undue discrimination obligations may be having negative impacts for our customers in Hull and East Yorkshire.

KCOM appreciates that if Ofcom were to allow bundles of services to be offered in the Hull area appropriate safeguards should be in place in order to ensure that bundled offers which include SMP products do not create competition or margin squeeze issues. We have carefully considered what the appropriate safeguards might be and can confirm that we are willing to provide the following undertakings:

- Bundles will be available to the widest range of customers possible and pricing for standard service bundles will be published.
- Bundles will be subject to a price floor below which they cannot be offered. The floor will be comprised of a "wholesale" charge for SMP products together with the cost of any non-SMP services offered as part of any bundle plus relevant retail costs.
- In calculating the "wholesale" charge, we will use pricing for BT's WLR product, our IPLine product and our call origination and termination interconnection services. IPLine is our wholesale broadband service available to other CPs wishing to offer retail broadband services in the Hull area. We do not currently provide WLR services in the Hull area and therefore believe that BT's WLR pricing, with an appropriate uplift to reflect differences in our cost base, provides an appropriate proxy. Where a product for which we do not have SMP at either the retail or wholesale level is offered as part of a bundle, the cost of that product will be included in the cost stack when calculating retail pricing.
- The appropriate retail costs of sale will be extracted from the model used to create the Regulatory Statements, broken down into the categories used in the DoCAS. For each relevant department, the relevant retail costs applying to analogue and DSL will be separated from those applying to other products – ISDN, TISBO and AISBO. They will then be reviewed and adjustments made to the allocation based on current knowledge about cost bias. These costs will be allocated over the relevant volumes to determine a retail cost per unit. This cost per unit is then subtracted from the product margin (retail price less wholesale costs) to establish the true margin for any margin squeeze test.
- These costs will form the basis against which all bundles that KCOM offers to customers will be tested. Measures will be put in place to ensure that the test is an integral part of the process for developing pricing propositions. Documentation detailing the costing and pricing assumptions will be retained for the period during which the bundle to which they relate is offered. This will contain sufficient detail



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to enable an assessment to be made of compliance with the price floor obligations.

- All products for which we have SMP at either a wholesale or retail level (or both) which form part of any bundle will continue to be offered as stand-alone products should a customer wish to purchase them separately.
- KCOM will notify Ofcom of new bundles when they are launched, however, they will not require approval before launch.

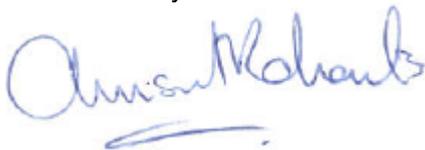
We would stress that what we are proposing in respect of WLR input costs are not true wholesale product prices. However if there was reasonable demand for wholesale products we would of course work with other CP's to provide products and pricing which meet our regulatory obligations and use those prices to ensure that our retail bundle offerings did not create margin squeeze issues.

We note that we have undertaken and shared with you some analysis on some proposed bundles pricing on the basis suggested above and believe the pricing levels we are considering present no problems.

Given the accepted 'Hull problem' we believe our proposals provide a reasonable and competitively neutral way of bringing the benefits of bundled retail offers to the customers as soon as possible. We believe that this approach provides a relatively straightforward way of addressing competition concerns and demonstrating that any bundle pricing adopted by KCOM presents no margin squeeze issues.

We look forward to confirmation that our proposals provide an acceptable way forward.

Yours sincerely



Christine Roberts
Regulatory and Interconnect Policy Manager



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